THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

June 2023

MODULE 2.10 – UNITED STATES OPTION

SUGGESTED SOLUTIONS

PART A

Question 1

Part 1

Robert is tax resident in the US by virtue of being a US citizen.

Rina is not a US citizen or green card holder. She will only be tax resident in the US if she meets the substantial presence test. This test is met if the individual is physically present in the US on at least: (1) 31 days in the year being tested; and (2) 183 days during the 3 year period ending with the year being tested (Y), taking all of the days in year Y, one-third of the days in year Y-1, and one-sixth of the days in year Y-2.

2020

Rina is present for 30 + 31 + 30 + 17 days = 108 days. She meets the 31-day test, but not the 183-day test as she had no days of presence in the previous years.

Rina is not US tax resident for 2020.

2021

Rina is present for 28 + 31 + 30 + 15 + 30 + 31 days = 165 days. She meets the 31-day test. To assess the 183-day test we take all of year 2021 days (165 days) plus one-third of 2020 (36 days) giving a total of 201 days.

Rina meets the substantial presence test for 2021 and is US tax resident for 2021.

2022

Rina is present for 31 + 28 + 30 + 31 + 30 = 150 days. She meets the 31-day test. To assess the 183-day test we take all of year 2022 (150 days) plus one-third of 2021 (55 days) plus one-sixth of 2020 (18 days) giving a total of 223 days.

Rina meets the substantial presence test for 2022 and so will be treated as US resident.

Notwithstanding that she meets the substantial presence test for 2021 and 2022, Rina can claim to be non-US tax resident if she can meet the “Closer Connection” Exemption. To meet this Rina would need to have spent less than 183 days in the US, maintained a tax home outside the US in Country X throughout the year, and demonstrate a closer connection with Country X than the US.

She meets the <183-day test. She will have a tax home where her main place of business or employment is, which (based on the information given) seems to be met in Country X. As her main home, family and friends are in Country X she is likely to be able to demonstrate a closer connection with Country X than the US. More information could help make the determination (e.g. where Rina owns a car and holds a drivers licence, where she is registered to vote, etc.).

Therefore, assuming she makes a claim, Rina is not US resident for 2021 or 2022.

Note – points will be awarded based on knowing and applying the rules, regardless of whether the candidate concludes the closer connection exemption is met or not.

Part 2

Robert is US resident and taxable on his worldwide income. He will therefore be liable for US tax on the entirety of his $80k salary each year. He may be entitled to a credit for the 15% tax paid in Country X. He may be able to claim the Foreign Earned Income Exclusion on his salary

Rina is not a resident of the US for 2020. However, work carried out in the US is treated as a US trade or business and liable to US taxes, taxable at graduated rates. Therefore, the portion of Rina's salary attributed to her days in the US will be taxable in the US.

[If the candidate concluded Rina was non-resident in 2021 or 2022:] In 2021/2022 the same principles apply and she is taxable on a proportion of her salary.

[If the candidate concluded Rina was US resident in 2021 or 2022:] In 2021/2022 Rina is US resident and taxed on the entirety of her $80k salary in the US.

There is an exemption from US income tax on income from personal services performed in the US if three conditions are met: (1) the taxpayer is in the US for less than 90 days in the year; the income is paid by a non-US payer; and (3) the pay for the services is not more than $3,000.

Rina fails both (1) and (3) and therefore this exemption will not be available to her in any of the years 2020 to 2022.

Part 3

If there is a treaty between Country X and the US Rina may be able to claim benefits under Article 14 "Income from Employment". She will be able to claim benefits if she meets the limitation on benefits test in Article 22. She will qualify for the limitation on benefits by virtue of being an individual (Art 22, para 2(a).

The treaty states that the income is taxable only in Country X provided: (a) Rina is in the US for a period or periods not exceeding 183 days in any twelve-month period; (b) the remuneration is paid by an employer who is not a resident of the US; and (c) the remuneration is not borne by a permanent establishment the employer has in the US.

Based on the information provided, Rina meets these conditions and therefore the income for the years in which she is non-US resident will be exempt from US taxation.

[If the candidate concluded Rina was US resident for 2021 and/or 2022:] In 2021/2022, while she is treated as resident in the US under the substantial presence test, the treaty will treat her as resident in Country X under Article 4 because her permanent home and center of vital interests is in Country X. She will therefore remain a resident of Country X for treaty purposes and her salary will be exempt from US taxation for 2022.

The treaty will not affect Robert's tax and he will remain taxable in the US on the entirety of his US income. As a US citizen he is tax resident in the US and Article 1, para 4 of the treaty (the 'Savings Clause') preserves the rights for the US to tax him as a citizen.

Extending the stay in the US will not affect Robert's tax as he is fully taxable in the US.

For Rina, as she already meets the substantial presence test for 2022, adding a further 15 days will not change the analysis.

For Rina, as the employment income article of the treaty refers to 183 days in "all twelve-month periods commencing or ending in the taxable year", this should be checked. During the period 1 December 2021 to 30 September 2022 she will spend 31 + 31 + 28 + 30 + 31 + 30 = 181 days.

Therefore extending the trip by 15 days would breach the 183-day test, meaning treaty benefits are no longer available. She would become liable to tax in the US on her employment income, at rates in excess of the 15% charged in Country X. Therefore, I would not recommend that Rina extends her stay in the US.

Question 2

US Sales

As a result of changes in United States taxation of corporations due to Tax Cuts and Jobs Act, 2017, USCo will pay a flat 21% tax on its US source sales income. $50 million is taxable at 21%. Total Tax liability=$10.5 million.

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.

The formula for computing FDII is as follows:

$$\text{Deduction eligible deduction less 10\% of Tangible Assets} \times \frac{\text{Foreign Derived Deduction Eligible Income}}{\text{Deduction Eligible Income}}$$

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 (QBAI).

The QBAI 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.

The average of USCo's QBAI is $60 million of which 30% i.e. $18,000,000 relates to its direct foreign sales. 10% of QBAI = $1,800,000.

As a result, $1,800,000 of its direct sales income will be taxed at the full 21%.

FDII deduction= 37.50% [$30 million less 10% QBAI i.e. $1.80 million] = $10.575 million

Tax liability on foreign Direct sales = 21% of ($30 million less $10.575 million) = $4.0795 million for a blended tax rate of 13.5%. No credit is available as no taxes are paid abroad in this regard.

Taxable Income: $19.425 million; Tax liability= $4.0795 million

Branch Income

A branch is ignored for US tax purposes and USCo's branch income will be reported along with its 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 $20 million will be taxed at the full 21% rate. Tax liability would be $4.2 million and foreign tax credit of $4.2 million will be available and balance $0.80 million foreign tax credit ($5 million less $4.2 million) will be available to carry backward for 1 year and carry forward for 10 years.

X Co

X Co is a CFC. X Co performs certain mechanical and assembly operations. The IRS regulations provided for 4 alternative tests to determine whether the CFC has indulged in manufacturing or not. Out of 4 methods, under the safe harbour test, the code deems manufacturing to occur if the conversion costs account for 20% or more of the total cost of goods sold. Here, total cost of goods sold is $2,500 per product and conversion cost is $500 per product. Hence, as a result, the conversion cost is 20% of COGS. Accordingly, the income earned by X Co is not a foreign base company sales income.

The above Income will now fall under GILTI as the same is not a subpart F 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 xCo's income is eligible for the participation exemption (since it has no basis in its assets) but all of xCo's income is GILTI, eligible for the 50% deduction. Thus, USCo will report the $10,000,000 of xCo, income, claim a deduction of $5,000,000 and pay tax at 21% on the remaining $5,000,000 for an effective tax rate of $10.5% i.e. GILTI Tax liability would be $1.05 million. The foreign taxes paid of $1.5 million will be eligible as credit to the extent of 80% i.e. $1.20 million. The ultimate tax liability would be $0 ($1.05 million less $1.20 million but restricted to $1.05 million) and excess credit of $0.15 million lapses forever.

Y Co

The CFC has manufactured the product in country Y and also sold in country Y so there cannot be any foreign base company sale income and hence, the same goes out of subpart F income.

Under the code, foreign tax of a CFC that exceeds 18.9% (being 90% of 21%) would be exempt from GILTI. Hence, GILTI offers exclusion from tested income that would be excluded as high tax income under subpart F.

Hence, the income of $2 million will neither be covered as subpart F income nor be covered as GILTI inclusion due to Effective tax rate being more than 18.9%.

The said income will be subject to dividend received deduction under code section 245A and will not be taxed in USA due to participation exemption. No foreign tax credit will be available as the income is exempt from taxation in US.

Z Co

The income earned by Z Co, a CFC from sale of goods is not considered as foreign base company sales income as the same is manufactured by Z co within country Z.

The interest income of $16 million earned by Z co is a passive income (foreign personal holding income-FPHI) and accordingly, foreign base company income. As per code section 954(b)(3)(B), as per de maximis rule for full inclusion, all of a CFC's gross income is treated as subpart F income if the sum of the CFC's gross foreign base company income for the year exceeds 70% of the CFC's total gross income for the year.

Ordinarily only $16 million of interest income should be considered as subpart F income. But, entire $20 million is subpart F income due to full inclusion rule.

Tax liability

Interest income (FPHI) = $16 million x 21%	= $3.36 million
Less: foreign tax credit (passive income limitation) Taxes paid $1.6 million will be available as tax rate is 10%	 =($1.6 million)

Sales income = $4 million x 21%	= $0.84 million
Less: FTC (General Income Limitation)	
Taxes paid $0.4 million will be available as tax rate is 10%	= ($0.40 million)

Note: It is pertinent to note that a GILTI inclusion is an inclusion from the CFC at the US Shareholder level and that the US Shareholder does an analysis for each CFC in which it has an ownership stake and then aggregates its (that is the US SH's) pro rate share of the tested income and loss from its CFCs. Here, US Co has three CFCs which it owns 100%, so, in case, the income earned by all 3 CFCs fall within GILTI inclusion, any tested income or loss from each of the three would then be combined at US CO's shareholder level to arrive at its "net CFC tested income." The tax implications may change/arise accordingly.

PART B

Question 3

Part 1

Giulia is not a US citizen or Green Card Holder. She will therefore only be US tax resident if she meets the substantial presence test. Visiting the US for less than 3 months of the year will not be sufficient for her to breach the 183-day test. She is therefore not US tax resident for any of the years 2020 to 2023.

As a non-US tax resident she is only liable to US tax on her activities if they amount to a 'trade or business' in the US. There is no clear definition of 'trade or business' but case law indicates that for an activity to be a trade or business it must be considerable, continuous and regular.

2020

Visiting the US in 2020 and meeting with various people is not likely to be sufficient to create a trade or business.

2021

Similarly in 2021, appointing FAB to distribute her clothing in the US is also unlikely to constitute a trade or business, as the activities of an independent agent are not attributed to the principal.

2022

In 2022, her activities have become more substantial and she now has premises and staff in the US. It is likely that she has now crossed over into having a US trade or business which will give rise to US taxation.

The profits generated from her business in the US will be considered income effectively connected with a trade or business in the US ('effectively connected income' or 'ECI'). Giulia will be taxable on the ECI generated at graduated rates of US income tax.

2023

The same will apply in 2023, with Giulia being taxed on the ECI generated.

Note: there is no right or wrong answer to when her activities become a trade or business in the US. Points are allocated based on describing what constitutes a trade or business and how it is taxed, and giving a view on when the test is met. Points are not lost if the candidate thinks the test is met in a different year to that stated above.

Part 2

If Country X had a double tax treaty with the US, Article 7 may provide Giulia with some relief from US tax. Giulia will need to meet the limitation on benefits conditions in Article 22 of the Treaty. She will qualify for benefits because she is an individual (Art 22, para 2(a)).

Under Article 7 of the Treaty, business profits are taxable in the US only if they are conducted through a permanent establishment ('PE') in the US.

Article 5 defines a PE as "a fixed place of business through which the business of an enterprise is wholly or partly carried on". The question is therefore whether Giulia's activities constitute a PE in the US.

2020 and 2021

In 2020 and 2021 Giulia did not have any fixed place of business in the US, and therefore she will not be liable to US tax on her activities in the US.

Article 5 also defines a PE as including a person acting on behalf of the enterprise (a 'dependent agent PE' or 'DAPE'). Guilia must consider whether the relationship with FAB could constitute a DAPE. Art 5 para 6 excludes an enterprise from creating a DAPE where it operates through a broker or agent of an independent status acting in the ordinary course of its business.

As FAB Clothing Inc are independent of Guilia's business, and are acting in the normal course of their business as clothing distributors, they should not create a DAPE for Giulia in the US.

2022

In 2022 she signed a lease on a warehouse. Article 5 para 2 includes offices, factories and workshops etc, as specifically constituting a PE. Guilia's warehouse would therefore likely be treated as a fixed place of business PE.

However, Art 5 para 4 excludes from the definition of PE certain facilities used solely for storage, display, or delivery of goods or merchandise belonging to the enterprise. As Giulia's warehouse is used for storage and display of her merchandise, this should provide an exemption from the warehouse creating a taxable PE.

Therefore, in 2022 she should not be taxable in the US because no PE exists during that year. The treaty will therefore exempt Guilia's profits in 2022 from US tax, which would otherwise have been taxable.

2023

In 2023 Guilia now has more premises in the US through which she is making sales. The shops will constitute a fixed place of business PE and as sales are being made she will not be able to rely on the exemptions in Art 5 para 4. Therefore, she will be taxable in the US on the profits attributable to the PE.

Art 7 para 2 of the treaty explains that the profits attributable to the PE must be calculated based on the profits it might be expected to make assuming the PE is a separate and independent enterprise, particularly its dealings with other parts of the enterprise. Therefore, Guilia will need to attribute profits to the PE, which will be taxable in the US, based on transfer pricing principles.

Question 4

Part 1

Branch Profit Tax

Internal Revenue Code Section 884(a) now imposes a 30 percent branch profits tax on the post-income tax earnings of a foreign corporation's U.S. trade or business, to the extent not reinvested in a U.S. trade or business by the close of the tax year. Reinvestment and withdrawal are measured by annual changes in the value of the equity of the foreign corporation's U.S. trade or business. The tax is imposed on the "dividend equivalent amount" ("DEA") of the corporation's "effectively connected earnings and profits" for the taxable year as computed under Internal Revenue Code and as modified and adjusted by the branch profits tax regulations. The branch profits tax is payable in the same manner as a foreign corporation's regular tax, except that no estimated tax payments are required with respect to the branch profits tax.

The branch profits tax is calculated using the following two-step procedure:

Step 1 – Compute the foreign corporation's ECEP for the taxable year. ECEP equals the earnings and profits attributable to income effectively connected with the foreign corporation's U.S. trade or business, before the reduction for dividend distribution, the branch profits tax, or the tax on excess interest.

Step 2 – Adjust the effectively connected earnings and profits amount for any changes in the foreign corporation's U.S. net equity during the year. The ECEP amount from Step 1 is reduced by the amount of any increase in U.S. net equity for the year (but not below zero), and is increased by the amount of any reduction in U.S. net equity for the year. In other words, an increase in U.S. net equity during the year is treated as a reinvestment of earnings and profits in the U.S. branch operation, whereas a reduction in U.S. net equity during the year is treated as a repatriation of earnings and profits.

2020

The ECEP for current year is $250,000. There is increase in US net equity during the year amounting to $250,000 ($950,000 less $700,000). If increase in equity is reduced from ECEP, the result is $0 and as entire amount is reinvested in US trade or business, there is no liability for Branch Profit Tax in 2020.

2021

ECEP = $0
Computation of DEA is as follows:

1) ECEP = $0
2) Increase in US net equity= Opening US net equity $950,000 less Closing US net equity $900,000. There is decrease in US net equity = $50,000
3) DEA= (1)+(2) = $50,000

BPT = $50,000 x 30% = $15,000.

Assuming that For Co qualifies for treaty benefits under a treaty similar to the US Model, the treaty will provide a significant benefit. Under Article 10 Paragraph 10, the US may impose the branch profits tax. However, the branch profits tax cannot be imposed at a rate exceeding the direct investment dividend withholding rate in Article 10 Paragraph 2(a), or 5%.

The above position is required to be disclosed in Form No. 8833 along with Return in Form No. 1120F.

2022

ECEP = $50,000
Computation of DEA is as follows:

1) ECEP = $50,000
2) Increase in US net equity = Opening US net equity $900,000 less Closing US net equity $600,000. There is decrease in US net equity = $300,000
3) DEA= (1)+(2) = $350,000

As per Reg 1.884-1 of IRC, the DEA cannot be more than current year ECEP $50,000 and previously untaxed ECEP $200,000 ($250,000 of 2020 less DEA taxed in year 2021 of $50,000).

Hence, the DEA will be restricted to $250,000.

BPT = $250,000 x 30% = $75,000.

Treaty Rate

Assuming that For Co qualifies for treaty benefits under a treaty similar to the US Model, the treaty will provide a significant benefit. Under Article 10 Paragraph 10, the US may impose the branch profits tax. However, the branch profits tax cannot be imposed at a rate exceeding the direct investment dividend withholding rate in Article 10 Paragraph 2(a), or 5%.

The above position is required to be disclosed in Form No. 8833 along with Return in Form No. 1120F.

Estimated Tax Payments

The branch profits tax is payable in the same manner as a foreign corporation's regular tax, except that no estimated tax payments are required with respect to the branch profits tax.

Part 2

Interest expense allocation under regulations section 1.882-5

Under Section 1.882-5 of the Treasury Regulations, the deductible interest expense of a foreign corporation that has a branch in the U.S. is determined under a three-step process:

Step One: Determine value of foreign corporation's U.S. assets.

Step Two: Compute the total amount of the foreign corporation's connected liabilities. [The value of the foreign corporation's assets multiplied by the world-wide debt to asset ratio = the foreign corporation's US connected liabilities] (normally a foreign corporation may elect to use fixed ratio of 50% and branch of a bank uses 95%); and,

Step Three: Compare the amount of the foreign corporation's US connected liabilities (determined in step II above) to its US booked liabilities (those liabilities that are booked to the foreign corporation's US trade or business).

In brief, If FC's booked liabilities> US connected liabilities = the FC's interest expense will be equal to interest on US books reduced by ratio of US connected liabilities to US booked liabilities

If FC's booked liabilities < US connected liabilities = then the FC can increase its interest expense deduction for interest on the excess amount of connected liabilities.

The calculation of interest allocation is as under:

Step 1) US assets $200,000

Step 2) US connected liabilities = US Assets $200,000 x worldwide debt to asset ratio (30%) = $60,000

[Global liability $40,000 + $80,000 = $120,000; Global Assets = $200,000 + $200,000 = $400,000; Worldwide debt to asset ratio = $120,000 / $400,000 = 30%] ratio = $200,000 x 30% = $60,000

Step 3) US connected liabilities =$60,000 US booked liabilities $80,000.

As US connected liabilities are lower than booked liabilities. The interest expenses deduction will reduce as below = $8,000 x $60,000 / $80,000 = $6,000.

The interest deduction available is $6,000 as per $1.882-5 and a separate schedule I needs to be attached to Form No. 1120-F in this regard.

However, the entire amount of interest expense of $8,000 is subject to the interest withholding tax.

<u>Part 3</u>

<u>Tax on Excess Interest</u>

Meaning: A foreign corporation's excess interest, if it exists, equals the excess of interest expense on US connected liabilities over interest expense on US booked liabilities.

Interest allocation as per reg 1.882-5 is $250,000. The taxpayer has paid and booked interest of $150,000, all of which is subject to the branch interest withholding tax. Therefore, For co has excess interest of $100,000 ($250,000 less $150,000). On $100,000 x 30% = $30,000 withholding tax is required to be deducted.

As per Article 11 of US MTC 2016, the excess interest of $100,000 will be subject to 0% of reduced rate. In all cases, the US branch must report the tax due on excess interest on income tax returns.

The tax on excess interest is borne by the foreign corporation's US Branch as per Reg. § 1.884-4(a)(2)(ii).

PART C

Question 5

As a US corporation, BigCorp is required to withhold US tax on any payments of Fixed Determinable Annual or Periodic income (FDAP). Both dividends and interest constitute FDAP. The domestic rate of withholding on FDAP is 30% unless an exemption or reduction applies either under domestic law or under a double tax treaty.

Part 1

The dividend is FDAP so withholding tax at 30% could apply. However the treaty with Country A could reduce the withholding tax. As Albert is an individual he will qualify for the 15% rate in Article 10 paragraph 1(b). As an individual, Albert will be considered a “qualified person” under Article 22 para 2(a) and will therefore satisfy the limitation on benefits clause of the treaty.

Withholding tax of $15,000 will be payable by BigCorp Inc (i.e. $100,000 x 15%).

Part 2

The dividend is FDAP so withholding tax at 30% could apply. There is no treaty with Country B so the domestic rate applies.

Withholding tax of $24,000 is due on the dividend (i.e. $80,000 x 30%).

The interest payment is also FDAP and so liable to 30% withholding tax. No reduction is possible under a treaty as there is not one in place. However US domestic law grants an exemption for “Portfolio Interest”. Becky will qualify for this exemption as she owns less than 10% of BigCorp Inc, and satisfies the other requirements for the exemption (registered form, foreign lender, not contingent, lender is not a bank).

No withholding tax is due on the interest.

Part 3

The dividend is FDAP and withholding tax at 30% could apply. However the treat with Country C could reduce the withholding tax. As Capital Investments limited is a company owning over 10% of BigCorp Inc it will qualify for the 5% rate of withholding tax (assuming it has held the shares for over 12 months at the time of payment).

Capital Investments Limited will be treated as a “qualified person” under paragraph 2(f) of Article 22, as it is owned at least 50% by Claire who would herself qualify for benefits under the treat. It also meets the base erosion test as it has negligible expenses. Capital Investments will therefore satisfy the limitation on benefits clause of the treaty. The reduced rate of withholding applies on the full dividend notwithstanding that 20% of Capital Investments Ltd is owned by individuals in non-treaty jurisdictions.

Withholding tax of $12,500 is due on the dividend ($250,000 x 5%).

Question 6

2020

Johan is US person who owns 25% making him a US Shareholder as he holder 10% of more of the company; Beth is not a US person so she is not a US Shareholder, nor is her 5% share constructively owned by Johan.

Bill is a US person who owns 25% making him also a US Shareholder.

Chris is a US person who owns 5% directly. As Chris owns 10% of Stingray, the shares owned by Stingray are apportioned to Chris (10% of Stingray's 40% holding = 4%). Chris therefore owns 5% direct and 4% indirect = 9% ownership. However, as this is less than 10% of the company Chris is not a US Shareholder.

Conclusion: for 2020 US Shareholders are Johan (25%) and Bill (25%) making 50%. Greenbay is therefore not a CFC (which requires greater than 50% to be held by US Shareholders). No one includes any of Greenfield's income in their tax return.

2021

As above, Johan is a US person who owns 25% making him a US Shareholder. Beth's 5% holding is not included as she is not a US person.

Bill is a US person who owns 25% direct and (as they are now married) he is attributed Chris' 5%. He therefore is treated as constructively owning 30% and a US Shareholder.

Chris is also now attributed Bill's shares giving a total of 30% constructive ownership, thus making Chris a US Shareholder.

Conclusion: For 2021 US Shareholders are Johan (25%), Bill (30%) and Chris (30%). It is not possible to double count the shares (see § 1.958-2(b) for family and (f)(2) for removal of double counting), so US Shareholders collectively hold: Johan 25%; Bill 25%, Chris 9% = total 59%. Greenbay is therefore a CFC for 2021 as US Shareholders own more than 50% of the stock of the company..

The individuals must include their pro-rata share of the sub-part F income of Greenbay – which is the $1m of dividend income.

Johan must include 25% of the company's dividend income ($250,000) in his US taxable income.
Bill must include 25% of dividend income ($250,000).
Chris owns 9% (5% direct and 4% indirect) and would not normally include any sub-part F income. But due to the constructive ownership of Bill's shares, Chris is a US Shareholder and must include 9% of the dividend income ($90,000).

2022

Johan now holds 12% and is therefore a US Shareholder. Beth's 5% holding is not included as she is not a US person.

Chris is a US person and now owns 5% directly and owns 5.3% (i.e. 10% of 53%) indirectly via Stingray. However, as Stingray now owns greater that 50% of Greenbay, it is deemed to own 100% of Greenbay, so Chris is treated as constructively owning 10% of 100% = 10%. Chris is also treated as constructively owning the 25% owned by Bill, giving Chris a total ownership of 5% + 10% + 25% = 40%. Chris is a US Shareholder.

Bill is a US person and owns 25% direct. Bill also constructively owns the shares held directly and constructively by Chris (5% + 10% = 15%) meaning he is treated as owning 40% and is a US Shareholder.

Conclusion

For 2022 US Shareholders are Johan (12%), Chris (40%) and Bill (40%). It is not possible to double count the shares, so US Shareholders collectively hold: Johan 12%; Bill 25%, Chris 15% = total 52%. Greenbay is therefore a CFC for 2022.

Johan must include 12% ($120k) of the company's dividend income in his US taxable income under Sub part F.

Bill must include $250k of dividend income in US Income under Sub part F.

Chris must include 5% direct and 5.3% indirect (total 10.3%) of Greenbay's sub part F income – i.e. an inclusion of $103k of dividend income.

Question 7

Part 1

The worldwide taxable income of MNC Co. for year 2021 is $0 which includes overall domestic loss of $200,000 and foreign source income of $200,000. The set-off of both the source turns out to be $0 taxable income.

MNC Co. has paid foreign taxes of $50,000 on foreign source income of $200,000 i.e. tax rate of 25%. Normally, the taxpayers compute their foreign tax credit limitation using the below mentioned formula:

= pre-credit US tax on worldwide income x foreign source income/worldwide income. The same is in line with provisions contained in code section 904(a) of IRC.

In view of the above, the said amount will not be available as foreign tax credit as there is no pre-credit US tax on worldwide income during the year 2021. The said excess credit of $50,000 will be allowed to be carried backward for one year / carried forward for ten years.

Part 2

In 2021, the taxpayer was in overall domestic loss situation. This situation arises when domestic deductions/allocated expenses exceed domestic income. In such situation, US Source loss offsets foreign source income which reduces the ability of taxpayer to claim foreign tax credit. Therefore, as per code section 904(g)(1), in subsequent year, i.e. year 2022, the taxpayer may recapture and treat as foreign source income the lower of:

1) 50% of taxpayer's US source income in the next year or
2) overall domestic loss (ODL) of earlier year which has not yet been captured.

Accordingly, the portion as mentioned above would be recharacterised as foreign source income for the purpose of computation of foreign tax credit.

In view of the above, the Global income for year 2022 would be $420,000 and pre-credit US tax liability of $88,200 @ tax rate of 21%. Foreign source income will be recaptured to the extent of $100,000 (i.e. 50% of $200,000 (US Source income in 2022) or $200,000 (unrecaptured ODL). Accordingly, the foreign source income will stand revised to $320,000 [$220,000 plus $100,000 (recaptured portion)] from $220,000.

FTC Limitation of MNC Co = $88,200 x $320,000 (foreign source income) / $420,000 (Global Income) = $67,200.

Accordingly, the net US tax liability will be $21,000 [$88,200 less tax credit of $67,200].

However, the tax consequence as mentioned above may change if MNC Co opts to claim taxes paid in 2021 as allowable deduction from taxable income because the choice between a deduction and a credit applies to all creditable foreign taxes paid or accrued during the year [Reg. § 1.901-1(c)].

Question 8

Part 1

Reg 1.6038A-4(a) – Any reporting corporation that fails to either file Form 5472 or maintain requisite records may be subject to penalty of $25,000 for each year that the failure occurs for each foreign party.

If any failure continues for more than 90 days after the IRS provides notice of the failure, the IRS can assess an additional penalty of $25,000 for each additional 30-day period.

Part 2

As IRS does not have authority to send their staff into another country to serve a summon on a foreign parent. However, if a US subsidiary does not obtain its foreign parent's permission to be an agent for receipt of service of a summons, code section 6038A(e) allows the IRS to reduce cost of goods sold deduction of the US subsidiary.

Within 30 days after an IRS request, a foreign parent must appoint its US subsidiary as its limited agent for service of a summons. Failure to appoint such an agent can result in the LB&I using its sole discretion to determine the amount of the relevant deduction to the US subsidiary (Id. Reg code section 1.6038A-5)

Part 3

The reporting in Form 926 applies to outbound transfers of both tangible and intangible property. The penalty for failure of a US person to report a transfer to a foreign corporation equals 10% of the fair value of the property transferred.

However, the penalty does not apply if the US person can show that the failure to comply was due to reasonable cause and not due to wilful neglect. Moreover, the penalty cannot exceed $100,000 unless the failure is due to an intentional disregard of the reporting requirements.

Part 4

There are two potential penalties to promote more voluntary compliance with the arm's length standard via the transactional penalty and the net adjustment. Either penalty equals 20% of the tax underpayment-related to a transfer pricing adjustment made by the IRS.

The transactional penalty applies if the transfer price used by the taxpayer is 200% or more (or 50% or less) of the ALP

Net adjustment penalty applies if the net increase to taxable income exceeds either $5 million or 10% of the taxpayer's gross receipts.

Higher Penalty

Both penalties increase to 40% of the related tax underpayment if the transfer price used by the taxpayer is 400% or more (or 25% or less) of the arm's length amount or if the net increase to taxable income exceeds either $20 million or 20% of the taxpayer's gross receipts. The transactional and net adjustment penalties apply automatically whenever an IRS adjustment exceeds the numerical thresholds.

Working of addition (TP adjustment) to taxable income

$100 million x $2.00 per battery = $200 million purchase
$100 million x $1.80 per battery = $180 million purchase

IRS will make a total adjustment of $20 million.

Tax rate of 21% on $20 million = $4.2 million

This is not a case of transactional penalty i.e. Transfer price (of $2 per mobile battery) used is not 200% or more of ALP of $1.80 per mobile battery.

This is a case of net adjustment penalty as the net adjustment to taxable income of $20 million exceeds $ 5million, US sub is subject to § 6662(e) penalty of $840,000 (20% of the $4.2 million of the tax understatement). Here, the higher penalty of 40% of tax underpayment cannot be levied as the net increase to taxable income is not more than $20 million but exactly equal to $20 million.

<u>Steps to reduce penalty</u>

The only way to avoid the penalty in these cases is to satisfy certain safe-harbor requirements. In the case of the transactional penalty, the IRS waives the penalty if the taxpayer can demonstrate that it had reasonable cause and acted in good faith.

In the case of the net adjustment penalty, the taxpayer can satisfy the reasonable cause and good faith requirements only if the taxpayer can demonstrate, through contemporaneous documentation provided to the IRS within 30 days of a request that the taxpayer acted reasonably in selecting and applying a transfer pricing method. These added requirements for avoiding the net adjustment penalty force taxpayers to develop and have waiting for the IRS all of the documentation that the IRS ordinarily would need to review in a transfer pricing examination. In addition to providing protection against the transfer pricing penalty, the documentation may also persuade the IRS that a transfer pricing adjustment is not necessary.