THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

June 2022

MODULE 2.10 – UNITED STATES OPTION

SUGGESTED SOLUTIONS

PART A

Question 1

Part 1

The $10 million of net income from the manufacture of Product A and its resale within the United States is US source income and includable of Acme's tax return.

The $3 million of net income from the manufacture of Product A and its sale to customers in Asia is US source income based on the place of manufacture. It is includable on Acme's tax return but eligible for the 37.5% FDII deduction which is based on place of final use rather than source of income. Acme will report $1,875,000 US source income from these sales. However, since the income is US source income, the 15% foreign income tax paid will not be creditable.

The $2 million of net income from the purchase of Product B and the export sale of Product B for ultimate use by customers in Asia is foreign source income since title passes in Asia. It is also eligible for a deduction of 35.7% as foreign-derived intangible income. Since we are told its basis in assets is zero, there is no reduction in the income for qualified business assets, Acme will report $1,875,000 of income. The income and the $600,000 foreign taxes paid will be in the general basket for foreign tax credit limitation calculations.

The $1 million of net income from the sale of Product B by its branch in France, all to customers for ultimate use in France. The title to Product B transferred to the purchasers in France. This is foreign source branch income. The income, and the $150,000 foreign taxes paid by the branch will go into the branch basket.

The $2 million of income earned by Acme from its purchase of Product B and its resale to Acme Italia is foreign source income since title passes in Italy. It is also eligible for a deduction of 37.5% as foreign-derived intangible income. Since we are told its basis in assets is zero, there is no reduction in the income for qualified business assets, Acme will report $1,250,000 of income. The income will be in the general basket for foreign tax credit limitation calculations. There were no foreign taxes paid in this income.

The $1 million of income earned by Acme Italia is made up of $400,000 Subpart F income and $600,000 of Global Intangible Low Taxed Income. None of the income qualifies for the participation exemption since Acme Italia has no QBAI. The Subpart F income is not eligible for the de minimis exception – it is less than $1 million but more than 5% of Acme's Italia's income. There is $300,000 of Subpart F earning and profits (the $400,000 less the 25% taxes). Acme will report $400,000 of Subpart F income after the § 78 gross up. The income and $100,000 of related taxes will go into the active basket. There is $450,000 of GILTI earning and profits (the $600,000 less the 25% taxes). Acme will report $600,000 of GILTI after the § 78 gross up. The income is eligible for a 50% deduction to $300,000 and $120,000 (80% of $150,000) of the taxes paid will go into the GILTI basket.

US source income:

- $10 million from the manufacture of sale of Product A in the US
- $1,875,000 from the manufacture of Product A and its export sale to Asia

Foreign Source Income – General Basket $2,900,000:

- $1,250,000 of FDII from the purchase of Product B and its export sale to Asia.
- $1,250,000 of FDII from the purchase of Product B and its sale to Acme Italia.
- $400,000 Subpart F income from Acme Italy's resale of Product B purchased from Acme

Foreign Source Income – GILTI Basket:

- $300,000 of GILTI from Acme Italy

Foreign Source Income – Branch Basket:

- $1 million from the sale of Product B by its branch in France

Total Income reported:

- $11,875,000 US source
- $4,200 Foreign source

Part 2

US Source

There is no foreign tax credit allowable on US source income. Therefore, the foreign taxes paid on Acme's $1,875,000 of net income from the manufacture of Product A and the export sale of Product A for ultimate use by customers in Asia is not creditable.

Foreign Source General Basket

Even though the foreign source FDII earned by Acme is eligible for the FDII deduction, the foreign taxes paid are creditable in full. There is $2,900,000 of foreign source general basket income. The US tax on that income at 21% is $609,000. Under the foreign tax credit limitation, this is the maximum amount of foreign taxes which can be credit in the general basket.

Acme incurred $600,000 of foreign income tax on its purchase of Product B and the export sale of Product B for ultimate use by customers in Asia. It incurred no foreign income tax in its sale of product B to Acme Italia but is deemed to have paid $100,000 of foreign income tax paid by Acme Italia on its Subpart F income. The total taxes paid in the general basket is $700,000. Only $609,000 will be creditable. The remaining $81,000 is eligible for a 1 year carryback, 10 year carryforward in the general basket.

Foreign Source GILTI basket

There is $300,000 of taxable income in the GILTI basket. Only a maximum $120,000 (80% of $150,000) foreign income taxes paid are eligible to be credited. The US tax on the GILTI income is $63,000. Therefore only $63,000 of the $120,000 of foreign income taxes paid on the GILTI income are creditable. The excess expires worthless.

Foreign Source Branch basket

The $1,000,000 of branch income is subject to a US tax of $210,000. The $150,000 of French taxes paid on this income is fully creditable. The excess credits in the general and GILTI baskets cannot be used to offset the US tax on the branch basket income.

Question 2

Part 1

The interest paid by the branch would be foreign source income under the general rules since it is legally being paid by Beta. However, if a foreign corporation is engaged in a US trade or business, or has gross income treated as effectively connected with a US trade or business, then interest paid by a US branch of the foreign corporation is treated as if it were paid by a domestic corporation. § 884(f)(1)(A). The $40,000 of interest paid to the unrelated foreign corporation is exempt from tax as portfolio interest. § 881(c). Thus, it is not subject to withholding. § 1442(a). However, the $20,000 of interest paid to the 15% owner of Beta does not qualify as portfolio interest and thus is subject to the interest withholding rules. § 881(c)(3).

Part 2

A foreign corporation doing business in the US as a branch is subject to the branch profits tax in addition to the regular income tax. A 30% branch profits tax is imposed Beta's $3,160,000 of effectively connected earnings and profits reduced to the extent the profits are reinvested in the branch operations. An asset is treated as needed in a trade or business only if the asset is held to meet the present needs of the trade or business and not its anticipated future needs. The $1,000,000 needed for day to day operation is treated as a reinvestment in branch operation. Beta would pay the 30% branch profits tax on the remaining $2,160,000 dividend equivalent amount.

Part 3

Beta would now have an investment in the business of $3,000,000 and only the remaining $1,160,000 would be subject to the 30% branch tax. The actual repatriation of the cash to the home office does not necessarily change the analysis. It does raise a question of whether the $1,000,000 is really needed for day to day operations but it is not unusual for a corporation to consolidate cash.

Part 4

If Beta 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 dividend withholding rate in Article 10 Paragraph 2(a) which is 5%.

PART B

Question 3

Part 1

FCo is a CFC if its “United States shareholders” own (or are treated as owning) more than 50% of the corporation’s stock, by voting power or value. A “United States Shareholder is any US person who owns (or is treated as owning) 10% or more of a foreign corporation’s stock by voting power or value. Stock owned by a foreign entity is considered as owned proportionately by the entity’s owners.

Under the general rule, Martina would be considered as owning 36% of FCo’s outstanding stock (60% x the 60% owned by HoldCo), enough to make her a US shareholder but not enough to cause FCo to be a CFC. However, since HoldCo owns more than 50% of a corporation’s stock by voting power, it is treated as owning all of the FCo’s stock. Martina is therefore treated as owning her 60% share of HoldCo’s deemed 100% ownership of FCo’s stock, or 60% of FCo’s stock. As a result, FCo is a CFC.

Part 2

Looking only at the direct ownership by United States Shareholders we count only the stock owned by USLP and USCo. X and T would not be US shareholders based solely on direct ownership because they do not own 10% of FCo’s stock by either voting power or value. The total direct ownership by US shareholders is only 46%. However, applying the constructive ownership rules, X is treated as owning her proportionate share of the FCo stock owned by USLP. Thus, X owns 5% directly and 9% by attribution, making her a US Shareholder. When we include X’s 5% direct ownership to the ownership by USLP and USCo, US shareholders own 51% of FCo, making it a CFC.

PART C

Question 4

Part 1

In order to qualify for the exclusion, Mary must have 1) a tax home in Nigeria and 2) meet either the bona fide residence test or the physical present test. A tax home is a person's principal place of business. It is a facts and circumstances determination, including whether the assignment is temporary or indefinite. Since Mary expected her employment in Nigeria to continue, her principal place of business is Nigeria.

Part 2

Under the Bona Fide residence test, Mary must reside in Nigeria for an uninterrupted period that includes an entire tax year and establish an intent to permanently reside in Nigeria. She was not there for the full calendar year and thus does not meet the bona fide residence test regardless of her intent to permanently reside in Nigeria.

Part 3

The physical presence test requires that Mary be present in a foreign country for at least 330 full days within any consecutive 12-month period. The 330 days do not need to be consecutive so long as they are within the 12-month period. December 31 will not count since she left Nigeria on that day. However, January 3, 20X1 will be treated as a full day even though she arrived in Abuja at 1AM. That is because her presence is treated as beginning once her plane was over the air space of a foreign country, which occurred at 11PM on January 2 when her plane passed over southern Africa.

Even though she was not physically present in Nigeria for the entire your, her starting date will be January 1 and her ending date will be December 31. There can be multiple 12 month testing periods. She has 330 days of presence for the 12 month testing period starting January 3 which takes her through the end of the year. But she also has 330 days of presence for the 12 month testing period ending December 28, 20X1 which takes her back to December of the prior year, thus covering the entire year.

Question 5

Part 1

Contributions to an 80% or more owned corporation are typically tax free under § 351. However, § 367(a)(1) provides that FCo is not treated as a foreign corporation, with the result that § 351 would not apply. Under pre-TCJA rules, there was an exception to § 367(a)(1) and allowed nonrecognition treatment where the foreign corporation will use the transferred assets in the "active conduct of a trade or business outside of the United States." However, TCJA repealed the active trade or business exception. Thus, no gain would be recognized pre-TCJA but this is a fully taxable transaction post-TCJA.

Part 2

The contribution of inventory required the recognition of gain under prior law and after the TCJA changes.

Part 3

Under § 367(d) if a US person transfers intangible property to a foreign corporation in a § 351 exchange, the US person is treated as having sold the intellectual property in exchange for deemed annual payments that are contingent on the productivity, use or disposition of the IP over the useful life of the IP. If, in future years, the patent becomes more valuable, the imputed payments to USCo will be correspondingly higher under a commensurate with income approach. The imputed payments continue through the useful life of the intangible asset. Prior to TCJA the royalty continued for the entire period during which the asset has value, but not in excess of 20 years.

Question 6

Part 1

A limited liability company formed in the United States is eligible to choose its tax status. It will default to a partnership if owned by two or more members, or a disregarded entity if owned by one member. A check the box election will change its tax status to a corporation.

Part 2

With foreign entities we must first determine if it is on the "per se" list. A foreign entity on the per se list will be treated as a corporation for US purposes and cannot make a check the box election. If it is not a per se entity, then it will default of a corporation if none of the owners have unlimited liability. If it has more than owner, and any of them have unlimited liability, it will default to a partnership. Here it has two owners neither of whom have unlimited liability. It will therefore default to a corporation and a check the box election will change its US tax status to a partnership.

Question 7

Part 1

Under § 861(a)(1), interest is sourced based on the residence of the debtor at the time of payment. Where the loan was entered into, what the money was used for, and where resides is irrelevant. Able, was an Albanian resident when he borrowed the money but was a US resident when he paid the interest income. Therefore, Baker's income is US source income.

Part 2

Since FCo is a corporation, FCo is a resident of France when paying the interest. The interest payment is taxed based on the residence of FCo. It is foreign source.

Part 3

Because FCo has elected to be a disregarded entity, its activities are treated in the same manner as a branch of USCo. Thus, the debt that FCo owes to the French bank is considered to be owed by USCo and the interest on the debt is paid by USCo and therefore US source. That is true even if all the borrowed money was used to purchase branch assets or pay branch expenses and the branch itself makes the interest payments from a French bank account.