THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

June 2021

MODULE 2.10 – UNITED STATES OPTION

SUGGESTED SOLUTIONS

PART A

Question 1

Part 1

Since USCo is formed in the United States, it is a domestic corporation for US federal income tax purposes and will be taxed on its worldwide income.

These export sales will trigger the application of the Foreign Derived Intangible Income ("FDII") regime since they are sales by USCo to unrelated foreign persons for the customer's foreign use.

In order to understand how FDII would apply to USCo's business we must know the tax basis of the depreciable tangible property used by USCo in its trade or business. To the extent that the income earned from the export sales is equal to or less than a 10% return on USCo's depreciable tangible property used in USCo's trade or business generating the FDII income, the income will be taxed at the full 21% corporate tax rate. Income in excess of this fixed rate of return will be eligible for a 37.5% deduction resulting in an effective tax rate of 13.125%.

Whether USCo will be eligible for a foreign tax credit for the foreign taxes paid on the export income depends on the application of the source rule. The income must be foreign source to entitle USCo to a foreign tax credit. Since this is purchased inventory, the title passage rule applies. If title passes within the US, then all the FDII income would be US source income and no foreign tax credit would be allowed. If title passes outside the US it will give rise to foreign source income and the potential for a foreign tax credit offsetting the US tax on the export sale income.

Part 2

Since USCo is formed in the United States, it is a domestic corporation for US federal income tax purposes and will be taxed on its worldwide income.

Transfer pricing rules must be applied so that the sale price from USCo to FCo meets the arm's length standard.

The income earned by USCo on its sales to FCo will qualify for FDII treatment, even though sold to a related party.

Under the manufactured inventory place of manufacture sourcing rules, all of USCo's income will be US source. Thus, it will not be eligible for any foreign tax credit on the foreign taxes paid on this income (unless it has other foreign source income in the same basket). Any unused foreign tax credits can be carried forward one year and carried back 10 years.

The income earned by FCo from its sales into Country Y will be Subpart F income because it is purchasing from a related party and reselling outside its country of formation. All of FCo's income from these sales will be immediately taxable to USCo at full corporate rates. USCo will be entitled to a foreign tax credit for the allocable taxes, subject to the application of the foreign tax credit limitation. Any unused foreign tax credits can be carried forward one year and carried back 10 years.

The income earned by FCo from its sales for ultimate use in Country X will be subject to the GILTI rules. A portion of the income may qualify for the participation exemption in an amount equal to 10% of the average adjusted basis of depreciable assets allocable to this income. The participation exemption income will not be taxed to USCo when earned by FCo, nor when distributed by FCo in an actual or deemed dividend. The foreign taxes paid on participation income will never be creditable in the US since the income will never be taxed in the US.

The income earned by FCo from its sales for ultimate use in Country X in excess of the amount treated as participation exemption income will be immediately taxable to USCo as GILTI but subject to a 50% deduction, for an effective tax rate of 10.5%. Only 80% of the foreign taxes paid on participation income will be creditable in the US, subject to the foreign tax credit limitation. Any unused foreign tax credits immediately expire.

Question 2

Part 1

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

Since Mary was present in the United States for a total of 189 days during 20X1, she is a US tax resident.

There is no applicable exception.

Her residency starting date is the first day of 20X1 on which she is present in the US. This ordinarily would be January 2. However, § 7701(b)(2)(C) states that Mary is allowed to disregard 10 days of presence in the US if she can establish a closer connection to Country X during those days. Assuming that she can do so (it seems likely that she can, since she was only visiting the US for a short time on family vacation), for this limited purpose, Mary is allowed to disregard all 9 days from her January trip, Her residency starting date is July 1, 20X1.

If she were subject to the 2016 US Model Convention, since she would be a resident of both countries, we would have to apply the tiebreaker rules of Article IV, Paragraph 3. Under the first tie breaker rule, she will be treated as a resident of the country in which she has a permanent home available. Since she has a home in Country X and did not have a permanent home in the United States, she will be a resident of Country X and not the United States.

Part 2

Mary is not a United States resident in 20X1 because she was here for only 180 days during the year, and was not present in any prior year.

Mary was not present in the United States for a sufficient number of days in 20X2, just looking at her 20X2 presence. Mary however is a United States resident in 20X2 under the lookback rule. She was present in the United States at least 31 days in 20X2 and counting her days in 20X2 (140) plus 1/3rd of her days in 20X1 (1/3rd of 180 = 60) total 200 days of presence.

Since Mary is a resident solely as the result of the lookback rule, she can attempt to avoid United States residency for the "closer connection" exception of § 7701(b)(3)(B). To meet the closer connection exception, Mary 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. This is a facts and circumstances test, and we are not provided the necessary facts to analyze whether this exception will apply.

If the closer connection test does not apply, but she were subject to the United States Model Income Tax Convention of 2016, she would be a Country X resident, and not a United States resident under the tiebreaker rules of Article IV, Paragraph 3 as discussed above.

PART B

Question 3

Part 1

Whether FCo is engaged in a trade or business in the US is uncertain. The issue is whether by leasing a warehouse in the US and fulfilling sales orders from that warehouse, FCo is engaging in a level of business activity sufficiently "regular, continuous, and extensive" to constitute a US trade or business. FCo engages in no other sales activities within the United States. Whether FCo is engaged in a US trade or business is a facts and circumstances determination which, under these facts could be resolved either way.

On the other hand, if FCo were eligible to claim the benefits of a Tax Convention identical in terms to the 2016 US Model Convention, FCo would not be subject to taxation in the United States.
Article 7, Paragraph 1 of the US Model Treaty states that the profits of a foreign enterprise will be taxable only in in its country of residence unless the enterprise carries on business in the US through a "permanent establishment" ("PE").

Having a fixed place of business in the US such as a warehouse would normally give rise to a permanent establishment. However, Article 5, Paragraph 4 of the US Model provides that, notwithstanding the general rule of Paragraphs (1) and (2), a fixed place of business will not be treated as a permanent establishment if it is only used for the activity or activities described in Paragraph 4. Under Paragraph 4(b), the maintenance of a stock of goods solely for the purpose of storage, display, or delivery also does not by itself constitute a PE.

FCo activity in the US of maintaining a warehouse, while likely sufficient a fixed place of business to constitute a US trade or business, will not give rise to a permanent establishment. If there is no PE, Article 7 Paragraph 1 exempts any US source income from US taxation.

Part 2

In determining whether FCo is engaged in a US trade or business, the issue is whether the activities of USCo will be attributed to FCo. It must be determined if USCo is a dependent or independent agent.

A dependent agent is one that is under the legal or financial control of the principal. Since FCo is the only client of USCo it would be possible to conclude that USCo is a dependent agent. If so, the activities of USCo would be attributed to FCo and FCo would clearly be engaged in a US trade or business. Note that there is authority which would support attributing the activities of USCo to FCo even if USCo were found to be an independent agent.

On the other hand, if FCo were eligible to claim the benefits of a Tax Convention identical in terms to the 2016 US Model Convention, FCo would not be subject to taxation in the United States regardless of whether USCo were found to be a dependent or independent agent.

Under Article 5 Paragraph 6, the activities of an agent of an independent status will not be attributed to the principal and will not give rise to a PE for the principal, provided that such persons are acting in the ordinary course of their business as independent agents. Even if USCo were determined to be a dependent agent, under Article 5 Paragraph 5, the activities of a dependent agent are attributed only where the dependent agent is acting on behalf of an enterprise and has and habitually exercises in a Contracting State an authority to conclude contracts that are binding on the enterprise. Even if USCo is a dependent agent, its activities are not attributed to FCo for purposes of determining whether FCo has a PE since USCO does not have the power to bind FCo.

PART C

Question 4

Part 1

Rent constitutes FDAP income subject to 30% tax on the gross amount.

His income from the rental equals $750,000 – the rent plus the expenses paid on his behalf by the tenant. His tax liability will be $225,000 which the tenant must withhold from the rent and pay over to the US Treasury.

Since a single property rented on a triple net lease basis is not a trade or business, Johan would not be taxed under the effectively connect income regime.

Part 2

Johan could elect under § 871(d) to have his income from his real estate ownership treated as effectively connected income.

He would still have $750,000 of income but would now be entitled to deductions for the insurance, property taxes and maintenance along with his depreciation deductions.

His taxable income would be reduced to $100,000 by these deductions and he would be taxed at progressive rates on his taxable income.

Question 5

Part 1

Since FCo had no Subpart F income and no QBAI (and thus was not eligible for the participation exemption) all of its income is Global Intangible Low Taxed Income ("GILTI").

The GITLI earnings and profits of $390,000 (the $500,000 earnings less the $110,000 foreign taxes paid) are deemed to be distributed as a dividend to its US shareholders regardless of whether an actual dividend is paid. § 951A

USCo is entitled to claim a foreign tax credit of 80% of the foreign taxes paid, subject to the foreign tax credit limitation.

USCo's income is grossed up for the entire amount of foreign taxes paid. It will report $500,00 of income, reduced by the 50% deduction to $250,000

USCo's US tax at 21% equals $52,500. USCo will be treated as having paid $80,000 in foreign taxes.

The foreign tax credit will wipe out USCo's US tax liability on FCo's income. The excess foreign tax credits expire worthless.

Part 2

As a branch, USCo will report $500,000 of income and a direct foreign tax paid of $100,000.

USCo will owe $105,000 in US tax. It is not eligible for the 50% deduction but is entitled to claim 100% of the foreign taxes for the credit.

The $110,000 in foreign taxes paid will eliminate USCo's US tax on the branch income.

Question 6

Part 1

FCo1 is a controlled foreign corporation since USCo is a US shareholder and owns more than 50% of the vote or value of FCo1.

Its purchase from a related party for resale gives rise to foreign base company sales income under Subpart F, except to the extent that FCo1 resells in its country of formation.

Under this general rule only 80% of FCo1's income is Subpart F income. However, under the full inclusion rule, all of FCo1's income will be treated as Subpart F income.

FCo2 has no Subpart F income because it is not a controlled foreign corporation since US shareholders own exactly 50% of the company.

Part 2

FCo2 would now be a CFC.

The test for CFC is ownership by US shareholder of more than 50% of the vote or value of a foreign corporation. Since USCo owns more than 50% of the value of FCo2, FCo2 is a CFC even though USCo continues to own only 50% of the vote.

Since all of FCo2's sales are for use outside its country of formation, all of its income is Subpart F income.

Question 7

Part 1

Under § 864(b) the term "trade or business within the United States" includes "the performance of personal services within the United States at any time during the taxable year."

A single day of presence is sufficient for a nonresident to be engaged in a US trade or business based on personal services.

Under § 864(b)(1) certain services performed in the US do not constitute a US trade or business where: (i) the services are performed for a foreign person not engaged in a US trade or business or a US person's foreign office, and (ii) the nonresident is present in the US for not more than 90 days during the taxable year and earns not more than $3,000 for his services performed in the US.

Christine will meet the not more than 90 day test. However, she will fail the not more than $3,000 test since her daily prorated salary exceed $3,000.

Christine will be taxable in the United States on her one day of prorated salary.

Part 2

The US Model treaty provides for a much broader exemption than the Internal Revenue Code.

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

Christine meets all these requirements. She was in the United States for only one day and her compensation is paid by FCo, a foreign corporation with no United States presence. There is no maximum salary requirement.

Under the treaty, Christine would not be subject to US income tax on her one day of salary.