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**International Tax I & II**

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***Problems & Answers***

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# Chapter 1: Residency Classification Rules

## Readings

* Course Book: Entire Chapter
* Cook v. Tait
* Rev. Rel. 2004-77

## Problems

1-1. Determine the entity classification for U.S. tax purposes of the following entities:

(a) A Delaware corporation owned entirely by citizens and residents of the United States.

*Answer:*

* The entity is per se a corporation. § 301.7701-2(b)(1).
* Because the entity is incorporated in the U.S. it is a U.S. person. §7704(a)(4).

(b) A Delaware LLC owned entirely by citizens and residents of Chile.

*Answer:*

* The entity is an eligible entity. §301.7701-3(a).
* The entity will default to a partnership, unless an entity classification election is made to treat it as a corporation. §301.7701-2(c)(1).
* Because the partnership is created in the United States it is a domestic partnership. §7704(a)(4).
* The partnership is not a U.S. person because it is a pass-through entity. tax is imposed on each partner of a partnership in accordance with each partner’s distributive share of partnership income, and each partner’s status as a nonresident or resident of the U.S. (e.g., as nonresident alien or U.S. citizen, as a foreign corporation or domestic corporation).

(c) A Delaware corporation owned entirely by a Canadian citizen and resident.

*Answer:*

* The entity is per se a corporation. § 301.7701-2(b)(1).
* Because the entity is incorporated in the U.S. it is a U.S. person. §7704(a)(4).

(d) A Public Limited Company formed in Singapore.

*Answer:*

* The entity is a per se corporation. Reg. 301.7701-2(b)(8)(i).
* Because the entity is formed in Singapore it is a foreign person. §7704(a)(5).

(e) A GmbH formed in Germany and owned by two United States persons, with respect to which neither has any personal liability under German law.

*Answer:*

* The entity is an eligible entity. §301.7701-3(a).
* Because it is foreign eligible entity and all members have limited liability, the entity will default to association taxable as a corporation, unless an entity classification election is made. §301.7701-3(b)(2).
* Because the entity is formed in Germany it is a foreign person. §7704(a)(5).

(f) A German Kommanditgesellschaft (“KG”) owned half by a Delaware corporation and half by a Delaware LLC, with the Delaware LLC owned entirely by the Delaware corporation. The Delaware corporation (but not the Delaware LLC) has personal liability for the debts of the KG.

*Answer:*

* The entity is an eligible entity. §301.7701-3(a).
* Rev. Proc. 2004-77 provides that to figure out the entity classification, we first need to figure out classification of the entities up the chain.
* Therefore, we need more information on the Delaware LLC.

(g) A Private Limited Company formed in Ghana and owned entirely by two United States persons, one of whom is personally liable for the debts and obligations of the entity under Ghanaian law.

*Answer:*

* The entity is an eligible entity. §301.7701-3(a).
* Because one member has personal liability for the debts of the entity, that member does not have limited liability.
* Because the entity has two members, and one member does not have limited liability, the entity will default to a partnership, unless an entity classification election is made. §301.7701-3(b)(2).
* Because the entity is formed in Ghana it is a foreign partnership. §7704(a)(5).

(h) How would your answer to (g) change if the Ghanaian company was owned by a single United States person who was personally liable for the company's debts?

*Answer:*

* The entity is a disregarded entity. §301.7701-3(b)(2).

1-3. Eduardo, a citizen of Peru,was present in the United States for 90 days during Year 1, 120 days during Year 2, and 125 days during Year 3, with Year 3 being the most recent year. Eduardo was not a lawful permanent resident of the United States during any of those years and was not pre-sent in the United States at any time before Year 1.

(a) What is Eduardo's residency status in the United States for each of the three years?

*Answer:*

* Under application of the substantial presence test, he was non-resident in:
  + Year 1 (90+0+0) 90 < 183
  + Year 2 (120+(90/3)) 150 < 183
  + Year 3 (125+(120/3)+(90/6)) 180 < 183.

(b) How would your answer to (a) change if Eduardo was present in the United States for 190 days during Year 3?

*Answer:*

* Under application of the substantial presence test, he was a resident in year 3, because (190+(120/3)+(90/6)) 245 > 183.

(c) How would your answer to (a) change if Eduardo was present in the United States for 360 days during Year 1, 300 days during Year 2, and 30 days during Year 3?

*Answer:*

* Under application of the substantial presence test, he was resident in Year 1 and Year 2:
  + Year 1 360 > 183
  + Year 2 (300+(360/3)) 420 > 183
* Under application of the substantial presence test, he was in the U.S. for the following number of days in Year 3: (30+(300/3)+(360/6)) 190 >183.
* He was non-resident in Year 3 because he was present for ≤ 30 days in Year 3, meeting the de minimis exception under §7701(b)(3)(A)(i).

(d) How would your answer to (a) change if Eduardo was present in the United States for 90 days during Year 1, 180 days during Year 2, and 150 days during Year 3? Assume Eduardo spent the remainder of each year in Peru where his wife and children live, where he operates a thriving business, and where he is registered to vote and licensed to drive. Eduardo travels to the United States in order to sell the widgets produced by his Peruvian business.

* Under application of the substantial presence test, he was in the U.S. for the following number of days:
  + Year 1: 90 < 183.
  + Year 2: (180)+(90/3)) 210 > 183.
  + Year 3: (150+(180/3)+(90/6)) 240 > 183.
* He was not a U.S. resident in Year 2 or 3 because he meets the requirements of the tax home exception under §7701(b)(3)(B).

1-4. Geir, a citizen of Ghana, is a student at the University of Arizona and is in the United States on a student visa. He plans to be present in the United States for four years of college, returning home for summers. If he is offered a good job, Geir may stay in Arizona after he graduates.

(a) What is Geir's residency status?

* Geir is not a resident because his is an exempt individual under §301.7701(b)(3)(b)(1)(iii).

(b) After four years in the United States, Geir's student visa was set to expire upon his graduation on May 1. He did not find a job, so he planned to skip commencement ceremonies and return to Ghana. As Geir was driving to the Tucson airport on April 28 to catch his flight home, he was distracted by the beauty of the Tucson countryside and drove into an embankment. Geir recovered from the accident but only after being immobilized in a body cast until December 28 of the year of his graduation. He flew home on December 31 of that year. What was his residency status for that year?

*Answer:*

* Following the end of his status as a student, Geir was in the country from May 1st to December 31st (i.e., 245 days).
* He will be eligible for the medical condition exception from April 28th to December 28th (i.e., 242). §301.7701(c)(1).
* The three days of travel will also likely qualify for the medical condition exception, because it accounts for arrangements to leave. §301.7701(c)(2).

# Chapter 2: Source Rules

## Readings

* Course Book: 2.01-2.04; 2.07-2.16
* Stemkowski v. Commissioner, 690 F.2d 40 (1982) (NYU Classes) [Just read Facts and Section 1 of the Discussion]
* Rev. Rul. 68-443 (NYU Classes)
* SDI Netherlands v. Commissioner, 107 T.C. 161 (1996) (NYU Classes) [Skip discussion of burden of proof and increased deficiencies in the Discussion]
* Boulez v. Commissioner, 83 T.C. 584 (Full Case on NYU Classes, not CB excerpt)
* "A&A of Expenses" (NYU Classes)

## Problems

2-1. Determine the source of each of the following items:

(a) An interest payment of $1,000 made by Ramli, a Malaysian citizen who is present in the United States for the whole year during which the payment' was made, and whose only gross income for all years consists of interest and dividend income from investments in Malaysia.'

*Answer:*

* Ramli is a U.S. person under the substantial presence test.
* Interest income is sourced by the residence of the payor. §§861(a)(1); 862(a)(2).
* Because Ramli is a U.S. person, the interest income is U.S. source.

(b) An interest payment of $1,000 made by Texas Co., a corporation organized in Texas, on a general obligation bond.

*Answer:*

* Texas Co. is a U.S. person.
* Interest income is sourced by the residence of the payor. §§861(a)(1); 862(a)(2).
* Because Texas Co. is a U.S. person, the interest income is U.S. source.

(c) How would your answer to (b) change if the interest is paid not by Texas Co. but by its Singapore branch on a deposit at that branch? Like Texas Co., the branch is engaged in a commercial banking business.

*Answer:*

* Texas Co. is a U.S. person.
* Interest paid on deposits by a foreign branch of a U.S. bank are foreign source. §861(a)(1)(A)(i).
* The interest paid on deposits by the foreign branch of Texas Co. are foreign source.

(d) How would your answer to (b) change if Texas Co. derives 15 percent of its income from United States sources attributable to the active conduct of its business in the United States, and 85 percent of its income from foreign sources attributable to the active conduct of its business outside the United States?

*Answer:*

* Texas Co. is a U.S. person.
* Interest income is sourced by the residence of the payor. §§861(a)(1); 862(a)(2).
* Because Texas Co. is a U.S. person, the interest income is U.S. source.
* However, if Texas Co. qualifies as an “existing 80/20 company” then a portion of the interest paid may be treated as foreign source.

2-2. Determine the source of each of the following items:

(a) A cash dividend (out of earnings and profits) paid to shareholders by Wash Co., a corporation organized in Washington.

*Answer:*

* Wash Co. is a U.S person.
* Dividend income is sourced by the residence of the payor. §§861(a)(1); 862(a)(2).
* Because Wash Co. is a U.S. person, the interest income is U.S. source.

(b) A cash dividend (out of earnings and profits) of $1,000 paid to shareholders in Year 4 by Foreign Co., a foreign corporation that conducts business in the United States and has the following items of gross income for Years 1 through 4 (amounts in $000):

|  |  |  |  |
| --- | --- | --- | --- |
| **Year** | **Gross income effectively connected with United States business** | **Other gross income** | **Total gross income** |
| 1 | $2,000 | $10,000 | $12,000 |
| 2 | $3,000 | $10,000 | $13,000 |
| 3 | $5,000 | $10,000 | $15,000 |
| 4 | $10,000 | $10,000 | $20,000 |
| **Total** | **$20,000** | **$40,000** | **$60,000** |

*Answer:*

* The general rule is that a dividend paid by a foreign corporation is foreign source. §862(a)(2).
* However, there is an exception for a foreign corporation with a substantial U.S. trade or business. §861(a)(2)(B).
  + The portion of the dividends paid by a foreign corporation are U.S. source income if, during the preceding three taxable years, 25% of more of the foreign corporation’s gross income was effectively connected with the conduct of a U.S. trade or business.
  + If a foreign corporation meets the 25% test, the U.S. source portion equals the amount of the dividend times the ratio of the foreign corporation’s gross income that was effectively connected with a U.S. trade or business during the three year testing period to the foreign corporation’s total gross income during the testing period. The U.S. portion of the dividend is not subject to U.S. withholding tax.
* Here, the total ECI was $10,000 and total gross income was $40,000. Therefore the exception applies. $250 will be U.S. source income and $750 will be foreign source.

(c) How would your answer to (b) change if the dividend was declared in Year 3 but not paid until Year 4?

*Answer:*

* Look at dividend declaration date.
* Look at 2 years before that: $5,000 / $25,000 = 20%.
* Therefore, none of the dividends paid will be U.S. sourced.

2-3. Evita is a citizen and resident of Argentina. Evita came to the United States in Year 1 to sell clothing on behalf of Patagonia, an Argentine corporation. Evita is one of many agents that Patagonia sent to the United States in Year 1. Evita makes $3,000 in commissions on sales to domestic customers during her five-month stay in the United States.

(a) What is the source of Evita's commissions?

*Answer:*

* Generally, compensation for personal services performed in the United States is U.S. source income. §861(a)(3).
* Because Evita earned the commission for services performed in the United States, and no other exception applies, the commission for services is U.S. source.

(b) How would your answer to (a) change if Evita was in the United States for only 60 days?

*Answer:*

* Under §861(a)(3) compensation for services performed by a nonresident alien individual temporarily present in United States is foreign source income if:
  + The individual is not present in the U.S. for more than 90 days during taxable year;
  + The compensation does not exceed $3,000; and
  + The payments are from a foreign employer not engaged in a trade/business in the United States (or foreign office of U.S. employer/individual).
* Because Evita qualifies for the de minimis exception, the commissions are foreign source.

2-5. Straw Co. is a domestic corporation that sells drinking straws. Determine the source and amount of Straw Co.'s income from the sale of its inventory in each of the following alternative situations:

(a) Straw Co. purchases its inventory from an unaffiliated Ohio manufacturer for $30,000 and sells it to an unaffiliated distributor in Nigeria for $70,000, with title passing in Nigeria. The distributor sells the straws to Nigerians for $100,000.

*Answer:*

* Income derived from the purchase of inventory inside the United States, but sold outside the United States is sourced where where title passes. § 1.861-7(a).
* Because title passes in Nigeria, the $40,000 of income ($70,000 less $30,000) is foreign source.

(b) Straw Co. manufactures its own inventory for $20,000 at a factory plant in Ohio and sells it to an unaffiliated distributor in Nigeria for $70,000, with title passing in Nigeria. The distributor sells the straws to Nigerians for $100,000.

*Answer:*

* Income derived from the sale of produced inventory is sourced by the location of the production assets. §863(b)(2).
* Because the productions assets are located in the United States, the $50,000 of income is U.S. source.

(c) Same facts as (b), except the distributor is a wholly-owned Nigerian subsidiary corporation of Straw Co.

*Answer:*

* The fact that the Nigerian company is a subsidiary of Straw Co. should not affect the determination of the source of the income of Straw Co.
* There is an anti-abuse provision in §1.863-3(c)(1)(iii), if the taxpayer has entered into or structured one or more transactions with a principal purpose of reducing its U.S. tax liability.
* Because the intercompany price is arm’s length, the anti-abuse rule should not apply.

(d) Same facts as (c), except Straw Co. sells the straws to its Nigerian distributor for $30,000 (instead of $70,000).

*Answer:*

* Because the intercompany price is not arm’s length, IRS will adjust the price under §482 and adjust the sourcing under §1.863-3(c)(1)(iii).

2-6. Determine the source of a $60,000 gain from the sale of an antique auto-mobile located in the United States, with title passing therein, owned by Soledad, a Chilean citizen and resident.

*Answer:*

* Income from the sale of non-inventory personal property is sourced to the residency of the seller. §865(a).
* For purposes of §865(a), you look to the taxpayer’s home under §865(g).
* Because the Soledad’s tax home is in Chile, the $60,000 of gain on the sale of the auto-mobile is foreign source.

2-8. Tarek, a citizen and resident of Lebanon, composed a symphony while in Turkey for two months. He is now considering various offers from music publishers throughout the world. For each offer described below, determine whether the proposed transaction will produce United States or foreign source income.

(a) A United States publisher offers to pay for the exclusive right to publish and sell the work in the United States. Under the proposed contract, Tarek would "receive five percent of the publisher's gross revenues from each sale of Tarek's work.

*Answer:*

* Sales of intangible assets for contingent consideration are sourced under the royalty source rules of §861(a)(4). §865(d)(1)(b).
* Royalties from the license of intangible property are sourced according to where the intangibles are used/exploited. §§ 861(a)(4), 862(a)(4).
* Because the transaction is for the right to publish and sell the work in the United States, income from the transaction is U.S. source.

(b) A Kenyan publisher makes the same offer described in (a).

*Answer:*

* Because the transaction is for the right to publish and sell the work in United States, income from the transaction is still U.S. source.

(c) A United States publisher offers to pay Tarek a fixed sum in exchange for all rights to the composition.

*Answer:*

* Income from the sale of personal property is sourced to the residency of the seller. §865(a).
* For purposes of §865(a), you look to the taxpayer’s home under §865(g).
* Because Tarek’s tax home is in Lebanon, the gain on the sale of the intangible property is foreign source.

(d) The offers in (a) and (b) were made and accepted before Tarek started composing the symphony.

*Answer:*

* The issue is the character of the income. Is this compensation for personal services or the sale of property.
* The determination will depend on a number of factors as illustrated in Boulez.
* If this were personal services, then the income is foreign source.
* Income derived from services performed abroad are foreign source. §862(a)(3).

2-A. A US company is engaged in the manufacture, sale, and lease of computers. The company has a French branch which leases a computer to the French branch of a German company. What is the source of income from the lease?

*Answer:*

* Rental income is sourced where the property giving rise to income is located or used. §§ 861(a)(4), 862(a)(4).
* Because the computers are located or used in France, the rental income of the U.S. company (flowing through from the branch) is foreign source.

2-B. Same as problem 2-A but with the following additional information. The US company offers the computer for sale (new) for $2K. Alternatively, the US company will lease the computer (new) for a term of $800/year for 3 years, with an option to purchase at end of lease term for $100. What is the source of the income from the lease?

*Answer:*

* Sale: The US company offers the computer for sale (new) for $2K
  + The source of production and sale income is the situs of “production activities”.
  + Because the computer is produced in the United States, the source of the income is 100% U.S. source.
* Option Contract: The US company will lease the computer (new) for a term of $800/year for 3 years, with an option to purchase at end of lease term for $100.
  + The issue is what is the character of the income—rental of personal property or sale of personal property.
  + Because the option is so low, this looks like a sale. In substance, this might be financing.
  + Analyse both as a sale and as a lease.

2-C. Roger Federer enters into a contract with Nike. He is paid $5M for one year. The contract specifies that Nike will have the exclusive right during the period of the contract to design and sell tennis apparel branded as the “Roger Federer” line throughout the world. All clothing will be emblazoned with a stylized “RF” logo. Federer agrees that he will wear clothing from the line during all professional tennis matches in which he participates. What is the source of the $5M?

*Answer:*

* The issue is what is the character and source of the $5M payment made by Nike to Roger Federer.
* First, a portion of the $5M is either a license of the right to use the trademark, or a purchase of the trademark.
  + Because the contract is limited in duration, this is likely a royalty.
  + The source of royalty will be apportioned between U.S. and foreign based on some determination of how much the trademark will be used in each jurisdiction (e.g., expected revenue in U.S. versus rest of world).
* Second, a portion of the $5M is compensation for personal services.
  + The source of the personal services income will need to be allocated between the U.S. and rest of world in accordance with §863(b).
  + The regulations provide a number of allocation methods. §1.861-4(b).

# Chapter 8: Treatment of Foreign-Owned United States Business Income

## Readings

* Course Book: 8.01-8.12
* Rev. Rul. 70-424 (NYU Classes)
* Rev. Rul. 86-154 (NYU Classes)
* United States v. Balanovski at CB 158
* Scottish American Investment Co. at CB 162

## Problems

8-1. To what extent is each taxpayer described below engaged in a trade or business within the United States?

(a) X Corp is organized in Ecuador. X Corp enters into a contract with Anne, a United States citizen, under which Anne serves as X Corp's exclusive agent in selling its products in the United States. Anne receives a commission for each sale to a United States customer. The contract prohibits Anne from selling any competing products in the United States and from acting as the agent for another in selling any competing products in the United States.

*Answer:*

* The issue is whether X Corp is engaged in a U.S. trade or business.
* If X Corp activities in the United States are regular, continuous, and significant, the X Corp will be engaged in a U.S. trade or business.
* X Corp is not directly engaged in a U.S. trade or business but may be indirectly engaged in a U.S. trade or business through Anne, its agent.
* Under Rev. Rule 74-244, the factors to consider are risk and control.
* Because Anne is receiving a commission and not bearing any risk of loss, her activities are likely attributable to X Corp.
* X Corp will have a U.S. trade or business because the facts and circumstances indicate that Anne’s activities in the United States are regular, continuous, and significant.

(b) Y Corp is organized in Panama, but has a branch office in the United States. Y Carp's products are sold in the United States by domestic employees working out of a rented office building in Tulsa, Oklahoma. All orders from United States customers must be approved by Y Carp's home office in Panama, and no domestic employee has the power to bind Y Corp in any way.

*Answer:*

* The issue is whether Y Corp is engaged in a U.S. trade or business.
* If Y Corp’s activities in the United States are regular, continuous, and significant, the Y Corp will be engaged in a U.S. trade or business.
* Y Corp is directly engaged in the United States through U.S. employees, a rented office, and sales to U.S. customers.
* The fact that sales must be approved through the home office is a red-herring. The U.S. employees are dependent agents, and approval from the home office will not make them independent agents.
* Y Corp will have a U.S. trade or business because the facts and circumstances indicate that its activities in the United States are regular, continuous, and significant.

(c) Z Corp is organized in Belize. Z Corp purchases goods in the United States for sale to customers in foreign countries. Z Corp maintains an office in San Diego, California, that is staffed by domestic employees who facilitate purchases and arrange for shipping.

*Answer:*

* The issue is whether Z Corp is engaged in a U.S. trade or business.
* If Z Corp’s activities in the United States are regular, continuous, and significant, the Z Corp will be engaged in a U.S. trade or business.
* Z Corp is directly engaged in the United States through U.S. employees, an office in San Diego.
* The purchase of U.S. goods, for resale to foreign customers, combined with the other factors indicate that Z Corp’s activities in the United States that are regular, continuous, and significant.
* The case is analogous to Balanovski.

8-5. ForCo is a Bolivian corporation that purchases zippers for sale. It has facilities in the United States, Argentina, and Bolivia. The zippers bought in the United States are sold exclusively in the United States. Likewise, the zippers from Argentina are sold exclusively there, and the zippers from Bolivia are sold exclusively within Bolivian borders. ForCo generates all of its income from sales in these three countries. ForCo does not have a separate division that oversees operations in the United States. In addition, ForCo purchases wine from a distributor in Argentina and sells it exclusively therein. For Year 1, ForCo incurs $50,000 in general administrative expenses related to both United States and non-United States operations. ForCo borrows from an unrelated bank $80,000 at a ten percent rate and incurs $18,000 in deductible interest expense in Year 1 from its borrowings used to improve the Bolivian facility. This loan is not reported on ForcCo's United States books and records. It has $150,000 expense for labor/wages regarding the zippers: $90,000 in the United States, $40,000 in Argentina, and $20,000 in Bolivia, and $70,000 expense for labor/wages regarding the wine. ForCo's asset bases and gross income from each country in Year 1 are as follows:

|  |  |  |  |
| --- | --- | --- | --- |
|  |  | **Zippers** | **Wine** |
| **Country** | **Asset Bases\*** | **Gross Income** | **Gross Income** |
| United States | $50,000 | $100,000 | $0 |
| Argentina | $100,000 | $200,000 | $600,000 |
| Bolivia | $200,000 | $300,000 | $0 |
| \* Assume no adjustment necessary to asset bases for purposes of determining asset value under Treas. Reg 1.882-5(b). | | | |

Assuming the income from the sale of zippers in Bolivia and the sale of the zippers and wine in Argentina is not effectively connected with ForCo's United States operations, what is ForCo's taxable income in Year 1 for United States income tax purposes?

*Answer:*

* **FACTS:**
  + Gross Income
    - $100K Gross Income From Zippers (ECI)
    - $500K Gross Income From Zippers (non-ECI)
    - $600K Gross Income From Wine (non-ECI)
  + Expenses
    - $18K of Interest
    - $50K of SG&A
    - $90K of U.S. zipper salary
    - $60K of foreign zipper salary
    - $90K of foreign wine salary
* **FIRST:** determine the classes of the taxpayer’s gross income:
  + Gross income from zippers
  + Gross income from wine
* **SECOND:** Categorize each expense as one subject to special allocation and apportionment rules (i.e., interest expense) or as subject to generally applicable rules:
  + Generally applicable rules:
    - $50K of SG&A
    - $90K of U.S. zipper salary
    - $60K of foreign zipper salary
    - $90K of foreign wine salary
  + Special Allocation Rules
    - $18K of Interest
* **THIRD:** In the case of expenses subject to special rules, apply those rules.
  + U.S. assets = $50K
  + WW liabilities = $80K
  + WW assets = $350K
  + U.S. connected liabilities = $50K \* [$80K/$350K] = $11.4K
  + U.S. apportioned interest expense = $11.4K \* 10% = $1.4K
* **FOURTH:** For all other expenses, characterize as:
  + An expense definitely related to a class of gross income
    - $90K of U.S. zipper salary
    - $60K of foreign zipper salary
    - $90K of foreign wine salary
  + An expense treated as definitely related to all gross income
    - $50K of SG&A
  + An expense not definitely related to any gross income.
    - N/A
* **FIFTH:** For expenses definitely related to a class of gross income:
  + Allocate: Allocate expenses to a class of gross income.
    - Gross income from zippers
      * $90K of U.S. zipper salary
      * $60K of foreign zipper salary
    - Gross income from wine
      * $90K of foreign wine salary
  + Apportion: Apportion expense within each class between U.S. and foreign sources.
    - Gross income from zippers
      * Apportionment Base = Gross income [Not Best Choice]
        + US Expense = $150K \* [$100K/$600K] = $25K
        + Foreign Expense = $125K [ $150K-$25K]
      * Apportionment Base = Salary expense
        + US Expense = $150 \* [$90K/$150K] = $90
        + Foreign Expense = $60 [ $150-$90]
    - Gross income from wine
      * Apportionment Base = Gross income
        + US Expense = $600K \* [$0K/$600K] = $0K
        + Foreign Expense = $600K [$600K-$0K]
* **SIXTH:** For an expense treated as definitely related to all gross income:
  + Apportion: Apportion expense between U.S. and foreign sources using a bases for all classes of income.
    - Apportionment Base = Gross income
    - US Expense = $50 \* [$100K/$1,200K] = $4.2K
    - Foreign Expense = $20.8K [ $25K-$4.2K]
* **SEVENTH:** For an expense not definitely related to any gross income:
  + N/A
* In sum, F Corp has $100K of U.S. gross income, $95.6K of U.S. expense, and $4.4K of U.S. taxable income.

# Chapter 9: Taxation of Branch Profits, Investments in United States Real Property, and the Base Erosion Anti-Abuse Tax

## Readings

* Prepare Problems at CB 9-1, 9-2 [but change question to “What is source of all interest payments?" and ignore question whether “branch interest tax applies”], 9-3, 9-4(a), (b), (d), (f), (g)
* Course Book: 9.01-9.03; 9.06-9.15; 9.17

## Problems

9-1. Vietindo Corporation is a privately-held corporation organized in Vietnam that sells luxury automobiles (manufactured by an affiliated corporation) in its showroom in New York City to United States customers. In all cases, title passes to the customers in the United States. Vietindo rented the showroom and funded its branch operation with a $200,000 contribution. For Year 1, it earned $100,000 of United States net income, paid tax of $21,000, and invested the rest of its earnings in its United States showroom. In Year 2, it earned $200,000 of such net income, paid tax of $42,000, placed the excess earnings in a United States bank account, and repatriated $50,000 to Vietnam. In Year 3, Vietindo earned $300,000 of net income, paid tax of $63,000, and repatriated $250,000.

(a) What is the amount of the branch profits tax, if any, for Years 1-3?

*Answer:*

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  | **Year End Net Equity** | **Change in Net Equity** | **ECEP** | **DEA** | **BPT** | **Untaxed ECEP**  **(The “Cap”)** |
| Year 1 | 279 | +279 | 79 | 79-279 = 0 | 0 \* 30% = 0 | 0 |
| Year 2 | 279 + 158 – 50 = 387 | +108 | 158 | 158-108 = 50 | 50 \* 30% = 15 | 79 + 158 – 50 = 187 |
| Year 3 | 387 + 237 – 250 = 374 | -13 | 237 | 237+13 = 250 | 250 \* 30% = 75 | 187 + 237 - 250 = 174 |

(b) How would your answer in (a) change for Year 3 if Vietindo earned $100,000 in that year, paid tax of $21,000, but still repatriated $250,000?

*Answer:*

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  | **Year End Net Equity** | **Change in Net Equity** | **ECEP** | **DEA** | **BPT** | **Untaxed ECEP**  **(The “Cap”)** |
| Year 3 (Revised) | 387 + 79 – 250 = 216 | -171 | 79 | 79+171 = 250  (Note: 171K increase almost implicates cap but not quite; that’s why answer comes out the same as in baseline Year 3). | 250 \*30% = 75 | 187 + 79 - 250 = 16 |

9-2. FC, a foreign corporation, has $100,000 of interest expense allocated to effectively connected income from a United States trade or business for Year 1. Its interest expense payments consist of $55,000 of interest to N, a non-resident individual not engaged in a United States trade or business; $25,000 interest to C Corporation, a foreign corporation owning 15 percent of FC's voting stock; and $20,000 to D Corporation, a Delaware corporation. What is source of all interest payments?

*Answer:*

* Under §884(f)(1)(A), interest paid by FC that is attributable to its US branch (i.e. all three interest payments) is treated as U.S. source income.

9-3. FC Corporation, a foreign corporation, has $120,000 of interest expense allocable to effectively connected income from a United States trade or business. It pays branch interest aggregating $100,000 in the same amounts as specified in 9-2 above. To what extent is the § 884(f)(l)(B) branch excess interest tax applicable?

*Answer:*

* Because FC's interest apportioned to ECI under §1.882-5 (i.e., $120) exceeds its branch interest (i.e., $100), under §884(f)(1)(B), FC has excess interest of $20, which is subject to a 30% tax of $6 under §881.
* The lviability will be on FC’s return and it cannot be collected thru w/h as there is no actual interest payment from which to w/h.

9-4. Teo, an individual, is a citizen and resident of Argentina who has never been present in the United States. Teo owns the following assets: (1) vacant land located in Oregon held as investment property; and (2) 100 percent of the common stock of Y Corporation, a foreign corporation.

(a) Assume that Teo realizes a $13,000 gain on the sale of the vacant land in Oregon. What are the United States income tax consequences, if any, to Teo?

*Answer:*

* This is USRPI under §897(c)(1)(A)(i).
* Absent FIRPTA the sale of personal property is foreign source.
* Under 897 this is treated as ECI.
* Can get deductions by return.
* Withhold on 15% of proceeds.

(b) Assume that Y Corporation, a foreign corporation, owns exclusively real property located in the United States. If Y Corporation sells a parcel of real property to an unrelated purchaser, what United States income tax consequences, if any> arise?

*Answer:*

* The sold property is USRPI under §897(c)(1)(A)(i).
* Under 897 this is treated as ECI to Y Corp.
* The purchaser of the property will need to withhold 15% of proceeds.

(d) How would your answer to (a) change if Teo exchanges the vacant land in Oregon for vacant land in Ireland?

*Answer:*

* §897(e) does not apply because Teo is exchanging USRPI (vacant land in Oregon) for non-USRPI (vacant land in Ireland).
* Under 897 this is treated as ECI.
* Can get deductions by return.
* Withhold on 15% of proceeds.

(f) How would your answer to (a) change if Teo contributes the vacant land in Oregon to Z Corporation, a domestic corporation, in return for all of its stock?

*Answer:*

* §897(e) applies because this is a transfer of USRPI (vacant land in Oregon) for USRPHCO (stock in Z Corporation) in a non-recognition transaction.

(g) Assume the facts in (f) occurred in Year I. In Year 2, Teo sells the Z stock for a gain of $20,000. What are the United States income tax consequences to Teo in Year 2?

*Answer:*

* Under 897 the gain is treated as ECI.
* Can get deductions by return.
* Withhold on 15% of proceeds.

# Chapter 7: Treatment of Foreign-Owned United States Investment Income

## Readings

* Read CB 7.01 - 7.07
* Prepare Problem at CB 7-1(a), 7-3(a), (b), (c), (d), (e)

## Problems

7-1 Surya, a citizen and bona fide resident of Nepal, has never been present in the United States. During Year 1, he had no United States trade or business, but he owns a number of assets that produced the following items of income:

* $20,000 dividend on the stock of DelCo, a corporation formed in Delaware;
* $5,000 gain on sale of 10 shares of stock in UruCo, a corporation formed in Uruguay;
* $13,000 dividend on the UruCo stock, of which $5,200 is United States source and $7,800 is foreign source;
* $10,000 in rents from rental property located in the United States;
* $1,000 of foreign-source interest on a loan made to Emily, a citizen and resident of Bolivia;
* $2,000 of interest on a deposit at a Chicago, Illinois bank; and
* $8,000 in cash from the sale of the United States rights to a patent Surya created for five percent of the net profits from products produced through its use.

Surya's potential deductions for the year consist of depreciation and expenses with respect to the rental property of $3,000, and a $1,000 loss on the sale of five shares of UruCo stock. Assume that Surya would be subject to a 20 percent effective tax rate on his taxable income if §§ 1 and 55 applied.

(a) What is Surya's United States taxable income and his tax liability for Year l?

*Answer:*

* $20,000 dividend on the stock of DelCo, a corporation formed in Delaware
  + The dividend is U.S. source
  + Dividend income is passive category income
  + The $20K is subject to 30% withholding tax, assuming no treaty
  + The income tax is therefore $6K
* $5,000 gain on sale of 10 shares of stock in UruCo, a corporation formed in Uruguay
  + The source of gain is determined based on the tax home of the seller.
  + Here, the gain is foreign source.
  + The gain is not passive category income because it is foreign source.
  + The gain is not active category income because there is no U.S. trade or business.
* $13,000 dividend on the UruCo stock, of which $5,200 is United States source and $7,800 is foreign source
  + Dividend income is passive category income.
  + The $5,200 of U.S. source dividends is subject to 30% withholding tax, assuming no treaty
  + However, the U.S will not try to collect it under §871(i)(2)(D).
* $10,000 in rents from rental property located in the United States
  + The rent income is U.S. source
  + Under the default rule, rental income is passive category income. The $10K would be subject to 30% withholding tax, assuming no treaty
  + However, Surya will likely elect to treat the rental income as U.S. trade or business. Factoring in the $3,000 of rental property deductions, Surya would have taxable income of $1.4K ($10K - $3K \* 20%).
* $1,000 of foreign-source interest on a loan made to Emily, a citizen and resident of Bolivia
  + Interest income is sourced to the residence of the payor.
  + The $1,000 of interest income is foreign source.
  + The gain is not passive category income because it is foreign source.
  + The gain is not active category income because there is no U.S. trade or business.
* $2,000 of interest on a deposit at a Chicago, Illinois bank
  + Interest income is sourced to the residence of the payor.
  + The $1,000 of interest income is foreign source.
  + This is passive category income, but is excepted from withholding tax as bank deposit interest under §871(i)(2)(A)
* $8,000 in cash from the sale of the United States rights to a patent Surya created for five percent of the net profits from products produced through its use
  + The sale of intangible property sold on contingency is sourced under the royalty rules. §865(d)(1)(B).
  + Royalties from the license of intangible property is sourced according to where the intangibles are used/exploited.
  + Here, the royalties are U.S. source.
  + Royalty income is passive category income.
  + The $8K is subject to 30% withholding tax, assuming no treaty

7-3. SaudiCo is a corporation organized in Saudi Arabia. Except as otherwise provided, all of SaudiCo's shares are owned by citizens and residents of Saudi Arabia who have no connection to the United States. Saudi Co has a number of investments in the United States, but it does not conduct a trade or business within the United States. For each situation described below, determine whether the interest received by SaudiCo is subject to United States taxation under §881(a).

(a) Interest from a certificate of deposit issued by a California bank.

*Answer:*

* Interest income is sourced to the residence of the payor.
* The interest income earned by SaudiCo is U.S. source.
* The interest income is not subject to U.S. tax because of the bank deposit interest exception under §881(d).

(b) Interest from a certificate of deposit issued by the Italian branch of a California bank.

*Answer:*

* Interest paid on deposits with foreign branch of U.S. bank are foreign source. §861(a)(1)(A)(i).
* The interest income is not subject to U.S. tax because it is foreign source income.

(c) Interest from a loan to an unrelated Delaware corporation.

*Answer:*

* Interest income is sourced to the residence of the payor.
* The interest income earned by SaudiCo is U.S. source.
* The interest income is not subject to U.S. tax because of the portfolio interest exception under §881(c).

(d) Sarne as (c), except that the amount of interest payable to Saudi Co is dependent upon the domestic corporation's net profits each year.

*Answer:*

* The portfolio interest exception does not apply because of the contingent interest exception. §881(c)(4).
* The interest income is subject to 30% withholding tax, assuming no treaty.

(e) Interest from a loan to its wholly-owned United States subsidiary corporation.

*Answer:*

* Because none of the exceptions under §881(c)(4) apply, the interest income qualifies for the portfolio interest exception under §881(c).
* The interest income is not subject to U.S. tax.

# Chapter 10: Tax Treaties – Overview

## Readings

* Prepare Problems at CB 10-1 and 10-4 (US-Canada Treaty in Appendix to CB)
* Read Aiken Indus. v. Commissioner, Aiken, 56 T.C. 925 (NYU Classes)
* Skim LOB US Model Treaty (2016) (NYU Classes) Art. 22
* Read Article 5 and Article 7 of US Model Treaty (2016) (NYU Classes)
* Read Article 5 and Article 7 of US-Canada Treaty (Appendix A in CB)

## Problems

10-1. Hans, a citizen and resident of Canada, works in the United States each year from January 1 to July 31. During his stay in the United States, Hans rents an apartment in New York City. He owns a home in Canada, where his spouse and children live year round. Hans is a registered voter in Canada, and Canada is the location of his bank accounts, stocks, and auto-mobiles. Is Hans subject to United States taxation on the dividends he receives from his Canadian stock?

*Answer:*

* Hans was present in the United States for 212 days in the current year. Therefore, under the substantial presence test he is a resident alien.
* Hans is a resident in both the United States and Canada, because he is taxable in both countries.
* Under the Article 4(2) tie-breaker rules, Hans is treated as a resident of the Canada, and is eligible for treaty benefits.
* Under Article 29(2), the savings will not apply because Hans is not a resident under Article 4(2) and is not a U.S. citizen.
* Hans is not subject to U.S. tax on the dividend under Article 10(1).

10-4. Eduardo, a citizen and resident of Argentina, forms Eduardo Inc., a wholly-owned Canadian corporation, for the sole purposes of investing in, and receiving annual dividends from, a United States corporation. Are benefits under the Canada Treaty available? Explain the policy implicated by this situation.

*Answer:*

* Under the Article 4(3)(a), Eduardo Inc. is a resident of Canada and eligible for treaty benefits.
* However, under Article 22A, Eduardo Inc. will not qualify for treaty benefits because of the limitations on benefits clause.
* The dividends from the U.S. corporation to Eduardo Inc. will be subject to 30% withholding tax.

# Chapter 12: Tax Treaties and Business Income

## Readings

* Prepare Problems at 12-1, 12-2, 12-5(a), (b)
* Read CB Unit 12.C
* Read Rev. Rul. 58-63, Rev. Rul. 72-418, Rev. Rul. 76-332 (all at CB 12.D)
* Read Unger v. Commissioner (CB 12.D)
* Read Articles 6, 10, 11, 12, 13, 22 in US-Canada Treaty (Appendix A in CB)
* Read Articles 6, 10, 11, 12, 13, 21 of US Model Treaty (2016) (NYU Classes)

## Problems

12-1. CanCo is organized under the laws of Canada and is owned entirely by Canadian citizens and residents. Its principal business activity consists of the worldwide sale of goods purchased in Canada. All of Can Co's office facilities are located in Canada.

(a) If CanCo receives unsolicited orders from United States residents, is its income subject to taxation in the United States?

*Answer:*

* There is no U.S. trade or business because there is not indication that it has either direct or indirect activities in the U.S. which are regular, continuous, and considerable.
* There is no PE because there is no fixed place or business, and there is not agency in the U.S.

(b) How would your answer to (a) change if CanCo sends catalogues to various individuals in the United States and advertises on United States television, all of which leads to the placement of orders by United States residents?

*Answer:*

* There is no U.S. trade or business because mailing in catalogues from outside the US and advertising in the US does not regular, continuous, and considerable activity.
* There is no PE because there is no fixed place or business, and there is not agency in the U.S.

(c) How would your answer to (a) change if, respecting its sales made in the United States, orders for CanCo's goods are solicited by its traveling salespersons operating out of the home office in Canada on a commission basis? Assume that purchase orders are sent to the Canadian office where they are accepted by CanCo and filled from inventory warehoused in Canada. Also assume that CanCo maintains no inventory, plant, office, or other facilities in the United States.

*Answer:*

* This is a U.S. trade or business because CanCo is indirectly engaged in regular, continuous, and considerable activity through its agent (employees are always agents). Whether the agent has the authority to bind the principal is irrelevant for these purposes.
* The treaty analysis is different.
* The treaty applies because residence and LOB seem to be satisfied.
* There is no fixed place or business because the dependent agents lack authority to bind the principal. See Article 5.
* Therefore, there is not PE.

(d) How would your answer to (c) change if Can Co maintains a branch office located in leased office space in Chicago, the branch maintains a leased warehouse for storage of purchased inventory, and United States sales staff employed by Can Co work out of Can Co's Chicago office, but all orders must be accepted in Canada?

*Answer:*

* This is a U.S. trade or business because CanCo is directly and indirectly engaged in regular, continuous, and considerable activity in the United States.
* This is also a PE.
* While Article 5(6) excludes certain items from reach of PE, such as mere storage, we have more than mere storage taking place (because employees are operating out of the facility).

12-2. Would CanCo in the preceding question have a permanent establishment in the United States if it were a shareholder in a corporation conducting a trade or business through a fixed place of business in the United States?

*Answer:*

* No trade or business because no attribution of activities. Note, there are some isolated circumstances in which corporation is treated as acting as agent but rather rare. Has to be case that there is no substance to the corporation. Not enough that corporation is furthering business interests of parent.
* No PE under Art. 5(8).

(a) How would your answer change if CanCo is a significant shareholder? A majority shareholder? The sole shareholder?

*Answer:*

* The answer is unchanged.

(b) How would your answer change if Can Co instead invests in a general partnership or limited liability company rather than a corporation?

*Answer:*

* CanCo has U.S. trade or business under domestic law (§875 attribution)
* CanCo has U.S. trade or business has a PE under reasoning of Unger case.
* Same for LLC assuming it is disregarded entity.

12-5. George is a self-employed Canadian architect representing a client that is constructing a building in San Francisco. As part of his services, George was on site on six different days during the year.

(a) Is George subject to taxation by the United States?

*Answer:*

* This could be U.S. trade or business under domestic law.
* The safe harbor would depend on the under $3K requirement under §864(b).
* If not under safe harbor then looking to common law.
* Under the treaty we would be examining this as independent services. This is now dealt with under the PE article. This is under the Protocol to US-Canada treaty and is standard in newer treaties. This would likely be too insubstantial.

(b) Would your answer to (a) change if George was on site for nine consecutive months during the year?

*Answer:*

* Same analysis under domestic law.
* The site would not by itself be attributed to George (i.e., not his buidling site; he just works on it). Also, his enterprise is not the construction site itself so cannot rely on the 1 year exception. Question here would be whether he has his own space that he leases, for example. Article 5.9 on services comes into play *only* if no PE under other parts of Article 5. Thus if he has no office or use of space, it would seem that he does have PE under 5.9(b) which deals with 183 days or more provided to a resident or PE in connection with same project (assuming the client is either resident or non-resident with a PE).

# Chapter 11: Tax Treaties and Investment Income

## Readings

* Prepare Problem 11-1, 11-2, 11-3 (c), (d), (e)
* Read CB Unit 11.C
* Read Rev. Rul. 84-17 (NYU Classes)

## Problems

11-1. Surya, the Nepalese resident in Problem 7-1, has become a citizen and bona fide resident of Canada, and has never been present in the United States. During Year 1, he had no United States trade or business, but owned a number of assets that produced the following items of income:

* $20,000 dividend on the stock of DelCo, a corporation formed in Delaware;
* $5,000 gain on sale of ten shares of stock in UruCo, a corporation formed in Uruguay;
* $13,000 dividend on the UruCo stock, of which $5,200 is United States source and $7,800 is foreign source;
* $10,000 in rents from rental property located in the United States;
* $1,000 of foreign-source interest on a loan made to Emily, a citizen and resident of Bolivia;
* $2,000 of interest on a deposit at a Chicago, Illinois bank; and
* $8,000 in cash from the sale of the United States rights to a patent Surya created for five percent of the net profits from products produced through its use.

Surya's potential deductions for the year consisted of depreciation and expenses with respect to the rental property of $3,000 and a $1,000 loss on the sale of five shares of UruCo stock. Assume that under §§ 1 and 55, Surya would be subject to a 20 percent effective rate on his taxable income.

(a) What is Surya's United States taxable income and his tax liability for Year 1, assuming none of his holdings constitutes a permanent establishment under the United States-Canada Tax Treaty (the "Canada Treaty")? How does this compare to Surya's United States taxable income and tax liability in Problem 7-l(a)?

*Answer:*

* Threshold questions:
  + Residency
  + LOB
  + USTOB
  + PE
* $20,000 dividend on the stock of DelCo, a corporation formed in Delaware
  + Under domestic law:
    - The dividend is U.S. source
    - Dividend income is passive category income
    - The $20K is subject to 30% withholding tax
  + Under Article 10, the withholding tax rate is reduced to 15%
  + The income tax is therefore $3K
* $5,000 gain on sale of 10 shares of stock in UruCo, a corporation formed in Uruguay
  + Under domestic law:
    - See §871(a)(2).
    - The source of gain is determined based on the tax home of the seller.
    - Here, the gain is foreign source.
    - The gain is not passive category income because it is foreign source.
    - The loss does not apply (no provision in the code for this).
  + Under Article 13(4), gain is taxable only in Canada because Surya is a resident of Canada.
  + Because Surya is not subject to tax under domestic law, she will not claim treaty benefits.
* $13,000 dividend on the UruCo stock, of which $5,200 is United States source and $7,800 is foreign source under §861(a)(2)(b).
  + Under domestic law:
    - Dividend income is passive category income.
    - The $5,200 of U.S. source dividends is subject to 30% withholding tax, assuming no treaty
    - However, the U.S will not try to collect it under §871(i)(2)(D).
    - Unclear whether there is BPT?
  + Under Article 10, the withholding tax rate is 15%. Because Surya is not subject to tax under domestic law, she will not claim treaty benefits
  + If there is BPT, is there also withholding tax on the BPT!!!
* $10,000 in rents from rental property located in the United States
  + Under domestic law:
    - The rent income is U.S. source
    - Under the default rule, rental income is passive category income. The $10K would be subject to 30% withholding tax, assuming no treaty
    - However, Surya will likely elect to treat the rental income as U.S. trade or business. Factoring in the $3,000 of rental property deductions, Surya would have taxable income of $1.4K ($10K - $3K \* 20%).
  + Under Article 6, the tax consequences are the same.
* $1,000 of foreign-source interest on a loan made to Emily, a citizen and resident of Bolivia
  + Under domestic law:
    - Interest income is sourced to the residence of the payor.
    - The $1,000 of interest income is foreign source.
    - The gain is not passive category income because it is foreign source.
  + Under Article 11, payment of this interest is not subject to tax under the treaty because this is a transaction not involving the Unites States.
  + Because Surya is not subject to tax under domestic law, she will not claim treaty benefits.
* $2,000 of interest on a deposit at a Chicago, Illinois bank
  + Under domestic law:
    - Interest income is sourced to the residence of the payor.
    - The $1,000 of interest income is foreign source.
    - This is passive category income, but is excepted from withholding tax as bank deposit interest under §871(i)(2)(A)
  + Under Article 11, the withholding tax rate is 30%.
  + Because Surya is not subject to tax under domestic law, she will not claim treaty benefits.
* $8,000 in cash from the sale of the United States rights to a patent Surya created for five percent of the net profits from products produced through its use
  + Under domestic law:
    - The sale of intangible property sold on contingency is sourced under the royalty rules. §865(d)(1)(B).
    - Royalties from the license of intangible property is sourced according to where the intangibles are used/exploited.
    - Here, the royalties are U.S. source.
    - Royalty income is passive category income.
    - The $8K is subject to 30% withholding tax, assuming no treaty
  + Under Article 12(4), the term royalties includes gains from the alienation of intangible property to the extent such gains are contingent on the productivity, use, or subsequent disposition of such property. Under Article 12(1), The $8K is subject to 10% withholding tax.

11-2. Shaida, the Guyanese resident in Problem 7-2, is now a citizen and resident of Canada. In Year 1, Shaida purchases ten shares of stock in DelCo, a Delaware Corporation, for $7,000. In Year 3, Shaida sells the shares for $10,000 cash to an unrelated individual residing in the United States. To what extent will the United States impose income tax with respect to Shaida's $3,000 gain in Year 3 under each of the following scenarios?

(a) Shaida was never physically present in the United States at any time in Year 1, Year 2, or Year 3.

*Answer:*

* Under domestic law:
  + The source of gain is determined based on the tax home of the seller.
  + Here, the gain is foreign source.
  + The gain is not passive category income because it is foreign source.
* Under Article 13(4), gain is taxable only in Canada because Surya is a resident of Canada.
* Because Surya is not subject to tax under domestic law, she will not claim treaty benefits.

(b) Shaida was not physically present in the United States at any time during Year 1 or Year 2, but she was physically present in the United States for 200 days during Year 3, and not physically present in the United States during Year 4 or thereafter.

*Answer:*

* Under domestic law:
  + Shaida is a U.S. person in year 3 under the substantial presence test.
  + Because Shaida is a U.S. person, she is taxable on her worldwide income.
  + The source of the gain will depend on the tax home of Shaida.
* Under treaty law
  + Shaida will most likely be a Canadian resident under the tie-breaker rules of Article 4(2)
  + Under Article 13(4), gain is taxable only in Canada because Surya is a resident of Canada.

(c) Same as (b), except that for 100 of the 200 days of presence in the United States during Year 3, Shaida was a student residing in the United States with a visa issued under the Immigration and Nationality Act.

*Answer:*

* Under domestic law:
  + Shaida is a non-resident alien because she does not meet the requirements of the substantial presence test.
  + Capital gains is potentially passive category income under §871(a)(2), but the the source of gain is determined based on the tax home of the seller.
  + Here, the Shaida’s tax home is most likely Canada.
  + The gain is not passive category income because it is foreign source.
* Under treaty law
  + Shaida will most likely be a Canadian resident under the tie-breaker rules of Article 4(2)
  + Under Article 13(4), gain is taxable only in Canada because Surya is a resident of Canada.

11-3. CanCo is a corporation organized in Canada. All of CanCo's shares are owned by citizens and residents of Canada who have no connections to the United States. CanCo has a number of investments in the United States, but it does not have a permanent establishment therein. For each situation described below, determine whether the interest income received by CanCo is subject to United States taxation. How does this compare to SaudiCo's treatment in Problem 7-3?

(c) Interest from a loan to an unrelated Delaware corporation.

*Answer:*

* Under domestic law:
  + Interest income is sourced to the residence of the payor.
  + The interest income earned by CanCo is U.S. source.
  + The interest income is not subject to U.S. tax because of the portfolio interest exception under §881(c).
* Under treaty law:
  + Under Article 11, the withholding tax rate is 30%.
* Because Surya is not subject to tax under domestic law, she will not claim treaty benefits.

(d) Same as (c), except that the amount of interest payable to CanCo is dependent upon the Delaware corporation's net profits each year.

*Answer:*

* Under domestic law:
  + The portfolio interest exception does not apply because of the contingent interest exception. §881(c)(4).
  + The interest income is subject to 30% withholding tax, assuming no treaty.
* Under treaty law:
  + Under Article 11(6)(a), the withholding tax rate is 15%.

(e) Interest from a loan to its wholly-owned United States subsidiary corporation.

*Answer:*

* Under domestic law:
  + Because none of the exceptions under §881(c)(4) apply, the interest income qualifies for the portfolio interest exception under §881(c).
  + The interest income is not subject to U.S. tax.
* Under treaty law:
  + Under Article 11, the withholding tax rate is 30%.

# Chapter 4: The § 245A Dividends-Received Deduction

## Readings

* Read CB Unit 4.C
* Skim Code 164(a)(3), (b)(3); 245A; 275(a)(4); 901(a), (b), 903
* Prepare Problem 4-1, 4-2, 4-4

## Problems

4-1. On December 30, 2017, Domco Inc., a Delaware corporation, forms Venco S.A. as a wholly-owned Venezuelan corporation. In 2018, Venco earns $100,000 selling handbags to customers in Caracas, and pays $34,000 in Venezuelan income taxes. On December 31, 2018, Venco pays a $50,000 dividend to Domco, which is subject to Venezuelan withholding tax of $7,500. Assume Domco is generally subject to the 21 percent corporate tax rate, and none of Venco's earnings is subject to subpart F of the Code.

(a) What is Domco's United States tax liability with respect to the dividend received from Venco?

*Answer:*

* Because Domco owns 10% or more of Venco and received a dividend distribution of $50K, Domco reports the $50K dividend in gross income, but simultaneously reduces its gross income by $50K as a DRD under §245A.
* One issue in these facts that may cause the DRD to be disallowed is the holding period. To qualify, Domco must have held the stock for 365 days before the dividend is paid.

(b) May Domco claim a foreign tax credit against its United States tax liability for the $34,000 Venezuelan tax payment? What about the $7,500 Venezuelan withholding tax?

*Answer:*

* Under §245A(d), no FTC is allowed for any taxes paid or accrued with respect to any dividend for which a DRD is allowed under §245A.
* Therefore, Domco cannot claim a FTC for either the $34,000 of Venezuelan tax paid or $7,500 of Venezuelan withholding tax paid.

4-2 Assume the same facts as in 4-1, except that the Venco stock is owned by Domco LLC, a Delaware limited liability company wholly owned by Domco.

(a) How would your answers to 4-1 change?

*Answer:*

* Domco LLC will be a “domestic eligible entity” under the entity classification rules. The default classification for a domestic eligible entity with a single owner is that of disregarded entity. This means the problem collapses into the identical analysis as in problem 4-1. That is, Domco has $50K of income but offsetting $50K of DRD under section 245A.

(b) Assume that Domco LLC was wholly owned not by Domco, but by Dominic Costas, a United States citizen. How would your answers to 4-1 change?

*Answer:*

* If VenCo is held by a U.S. individual citizen then the 245A DRD is no longer available. However, it will now be possible to claim a foreign tax credit under section 901 with respect to the $7500 w/holding tax.

4-4. EmpireCo Inc., a New York corporation, owns all the stock of IrishCo LTD, an Irish corporation. EmpireCo's basis in its IrishCo stock is $600,000. During 2018 and 2019, IrishCo earns a total of $800,000 providing financial services to companies with operations in Ireland, and pays $120,000 in Irish income taxes. On January I, 2020, EmpireCo sells the lrishCo stock to an unrelated company for $2,000,000. EmpireCo is generally subject to the 21 percent corporate tax rate. What is EmpireCo's United States tax liability with respect to its sale of the Irish Co stock? Assume none of IrishCo's earnings are subject to subpart F of the Code.

*Answer:*

* Because EmpireCo wholly owns IrishCo it is a CFC.
* Under §1248, EmpireCo must treat gain on the sale of IrishCo as a dividend to the extent of E&P that accumulated while EmpireCo owned the shares and IrishCo was as CFC.
* Any gain in excess of the deemed dividend will be accorded capital gain treatment.
* EmpireCo’s gain on the transaction is $1,400K ($2,000K - $600K).
* The E&P of IrishCo for purposes of §1248 is $680K ($800K - $120K).
* Because EmpireCo owns 10% or more of IrishCo and received a deemed dividend distribution of $680K, EmpireCo reports the $680K dividend in gross income, but simultaneously reduces its gross income by $680K as a DRD under §245A.
* The remaining gain of $720K ($1,400K - $680K) receives capital gain treatment.
* The tax is $151.2K ($720K \* 21%).

# Chapter 5: Foreign Tax Credit: Overview

## Readings

* Read CB Unit 5.C
* Skim Code 904(a), (c), (d)(1)-(2)
* Skim Code 904(b)(5)
* Prepare Problem 5-3

## Problems

5-3. DelCo is a domestic corporation. Its principal business activity consists of the manufacture and sale of industrial machinery, and its main plant and offices are located in Delaware. DelCo also has a branch plant located in France where DelCo manufactures and sells its products in Europe. During the year, Del Co realizes $100,000 of taxable income from its United States plant activities, and $75,000 of taxable income from its foreign branch activities. The foreign branch paid $40,000 in business income taxes to France. Assume that DelCo's United States tax liability (pre-credit, at a 21 percent tax rate) is $36,750.

(a) What is DelCo's final United States tax liability for the year?

*Answer:*

* Threshold questions why §245A does not apply.
* The U.S. tax on worldwide income = $36,750 ($175,000 \* 21%)
* The maximum foreign tax credit = $75,000/$175,000 \* $36,750 = $15,750
* Tax = $36,750 - $15,750 = $21,000
* Total taxes = $21,000 + $40,000 = $61,000

(b) What if the taxes paid to France are $10,000?

*Answer:*

* The U.S. tax on worldwide income = $36,750 ($175,000 \* 21%)
* The maximum foreign tax credit = $75,000/$175,000 \* $36,750 = $15,750
* Tax = $36,750 - $10,000 = $26,750
* Total taxes = $26,750 + $10,000 = $36,750

# Chapter 6: Foreign Tax Credit: The § 904 Limitations

## Readings

* Read CB Unit 6.C
* Skim Code 904(a),(c),(d)(1)-(2)
* Skim Code 904(b)(5)
* Skim Code 904(f)(1)-(2), (5)
* Prepare Problems 6-1(a), (b); 6-2(a); 6-3(a), (b); 6-5(a), (c)

## Problems

6-1. HealthWise Inc., a Delaware corporation, operates a pharmacology consulting business. In Year 1, HealthWise realizes $100,000 of taxable income from Colombia, on which it pays Colombian income taxes of $25,000. HealthWise also realizes $150,000 of domestic taxable income. Assuming the United States imposes a 21 percent tax rate, and assuming for 6-l(a) through (c) that§ 904(d) is not part of the Code:

(a) How much foreign tax credit, if any, can Health Wise claim for Year l?

*Answer:*

* Tentative U.S. tax on worldwide income = $52,500 ($250,000 \* 21%)
* The maximum foreign tax credit = $100,000/$250,000 \* $52,500 = $21,000
* The amount of creditable foreign taxes equals $25,000.
* Because the foreign credit tax limit is $21,000, HealthWise can claim only $21,000 of a credit.
* U.S. Tax = $52,500 - $21,000 = $31,500

(b) What result in (a) if, in addition to the above transaction, Health Wise derived $50,000 of United States source interest income?

*Answer:*

* Tentative U.S. tax on worldwide income = $63,000 ($300,000 \* 21%)
* The maximum foreign tax credit = $100,000/$300,000 \* $63,000 = $21,000
* The amount of creditable foreign taxes equals $25,000.
* Because the foreign credit tax limit is $21,000, HealthWise can claim only $21,000 of a credit.
* U.S. Tax = $63,000 - $21,000 = $42,000

6-2. Ewessco Corporation is a domestic corporation engaged in the worldwide manufacture and sale of paper products. In Year 1, Ewessco realizes taxable income from its United States plant of $50,000, taxable income from its Brazilian plant of $30,000 (paying $15,000 in Brazilian income taxes), and $40,000 in gain from the sale of passively-held rental real estate held as a capital asset for more than one year and sold in Chile (paying $8,000 in Chilean income taxes). Assuming the United States imposes a 21 percent tax rate:

(a) What is Ewessco's allowable foreign tax credit for Year l?

*Answer:*

* Tentative U.S. tax on worldwide income = $25,200 ($50,000 + $30,000 + $40,000 \* 21%)
* Foreign Branch Category Income
  + Foreign Source Income = $30,000
  + Creditable Foreign Taxes = $15,000
  + Limitation = $25,200 \* ($30,000 / $120,000) = $6,300
* Passive Category Income. §954(c)(1)(B)
  + Foreign Source Income = $40,000
    - §862(a)(5)
  + Creditable Foreign Taxes = $8,000
  + Limitation = $25,200 \* ($40,000 / $120,000) = $8,400
* The allowable foreign tax credit is $14,300 ($6,300 + $8,000)
* U.S. Tax = $25,200 - $14,300 = $10,900

6-3. Staplers Inc. is a Delaware corporation selling office supplies in the United States and abroad. It owns all the equity in (1) Staplers LLC, a Delaware LLC that operates in Great Britain and is classified as a disregarded entity for United States tax purposes; and (2) Staplers B.V., a Dutch company that elects to be classified as a corporation for United States tax purposes. During Year 1, Staplers Inc. earns $3,000,000 from domestic sales; Staplers LLC earns $1,000,000 from sales in Great Britain (paying $150,000 in British income tax); and Staplers B.V. earns $500,000 from sales in the Netherlands (paying $200,000 in Dutch income tax). At the end of Year 1, Staplers B.V. pays Staplers Inc. a $100,000 dividend, subject to Dutch withholding tax of $10,000. Assuming a United States tax rate of 21 percent on Staplers Inc.'s income and that none of Staplers B.V.'s earnings are subject to subpart F of the Code:

(a) What is Staplers Inc.'s United States tax liability for Year l?

*Answer:*

* The total U.S. taxable income is $4,000,000 [$3,000,000 + $1,000,000 + $100,000 (Div) - $100,000 (DRD)]
  + §904(b)(4)
* Tentative U.S. tax on worldwide income = $840,000 ($4,000,000 \* 21%)
* Foreign Branch Category Income
  + Foreign Source Income = $1,000,000
  + Creditable Foreign Taxes = $150,000
    - $10,000 disallowed because claimed DRD. §245A(d)
  + Limitation = $840,000 \* ($1,000,000 / $4,000,000) = $210,000
* U.S. Tax = $840,000 - $150,000 = $690,000

(b) How would your answer to (a) change if Staplers B.V. elects to be classified as a disregarded entity for United States tax purposes?

*Answer:*

* The total U.S. taxable income is $4,500,000 [$3,000,000 + $1,000,000 + $500,000]
* Tentative U.S. tax on worldwide income = $945,000 ($4,500,000 \* 21%)
* Foreign Branch Category Income
  + Foreign Source Income = $1,500,000
  + Creditable Foreign Taxes = $360,000 ($150,000 + $10,000 + $200,000)
  + Limitation = $945,000 \* ($1,500,000 / $4,500,000) = $315,000
* U.S. Tax = $945,000 - $315,000 = $630,000

6-5. Z Corporation, a domestic corporation, commences foreign operations in Year 1 by establishing a Brazilian branch which produces a loss of $40,000, while its domestic operations generate $40,000 of income.

(a) In Year 2, its Brazilian operations result in taxable income of$100,000 with an attendant tax payment of $45,000, while its domestic operations generate taxable income of $75,000. What is Z Corporation's tax liability for Year 2 if its pre-credit United States tax liability for that year (at 21 percent) is $36,750?

*Answer:*

* There is an overall foreign loss of $40K in Y1.
* This loss can offset the $40K of domestic income so there is no US tax liability in Y1.
* In Y2, we have recapture of the OFL because there is positive FSTI.
* Under 904(f)(1) the amount of recapture in Y2 is the lesser of: (i) unrecaptured OFL ($40K) or ½ of FSTI ($50K).
* Here that means we take $40K and recharacterize such amount as US source taxable income.
* The FSTI is thus $60K and the FTC limit is .21 \* $60K = $12,600.
* We have $45K of creditable tax but $12,600 of FTC limit, so we credit $12,600.
* This should all be in the foreign branch basket. The final U.S. liability in Y2 is $36,750 - $12,600 = **$24,150**.

(c) Same results as in Year 1, except that Z Corporation also realizes foreign source rental income of $50,000 from property it owns in Mexico. It does not actively manage the property; it holds the property strictly for the production of rental income with little or no effort. Z Corporation pays Mexican tax of $5,000 on the rental income. What is its tax liability for Year 1 if the pre-tax credit United States tax liability (at 21 percent) is $10,500?

*Answer:*

* The rental income should be in the passive basket.
* The $40K loss should be in the foreign branch basket, as above.
* Thus there is now both a separate limitation loss and separate limitation income in Y1.
* The rule of 904(f)(5) is implicated.
* Note that there is now no *overall* foreign loss in Y1.
* With a separate limitation loss we must take the $40K loss and allocate it proportionately to baskets that have separate limitation income.
* In this case the $40K loss is allocated to the $50K of income in passive basket.
* We end up with $10K FSTI in the passive basket, which produces $2100 of FTC limitation.
* There is $5K of creditable tax.
* Thus the taxpayer may take $2100 of FTC.
* Bottom line U.S. liability is $10,500 - $2100 = **$8,400**.
* If there is income in the foreign branch basket in future years, it will be allocated to the passive basket (up to $40K).

# Chapter 13: Introduction to Controlled Foreign Corporations

## Readings

* Read CB Unit 13.C
* Skim Code 951(a)(1), (b); 957(a), (c); 958(a), (b); 318
* Skim Reg. 1.957-1
* Read Summary of Section 958(b) Constructive Ownership (NYU Classes)
* Prepare Problems 13-1; 13-2; 13-A; 13-B; 13-C; 13-D

## Problems

13-1. X Corporation is a foreign corporation with three classes of capital stock outstanding, consisting of 60 shares of Class A stock, 40 shares of Class B stock, and 150 shares of Class C stock. The owners of a majority of the Class A stock are entitled to elect three of the five corporate directors, and the owners of a majority of the Class B stock are entitled to elect the other two directors. The Class C stock has no voting rights. Dividends are paid on a per share basis and there are no liquidation preferences.

Y Corporation is a foreign corporation with one class of stock outstanding, consisting of 90 shares.

Danielle, a United States citizen, owns 25 shares of X Corporation's Class A stock and 45 shares of Y Corporation's stock during the entire year. Y Corporation owns 15 shares of X Corporation's Class A stock during the entire year. The remaining shares of stock are owned by unrelated foreign persons.

Determine the status of Danielle, X Corporation, and Y Corporation in Year 1 for purposes of §§ 951 and 957.

*Answer:*

* Y Corp
  + Danielle is a U.S. shareholder of Y Corp under §951(b).
  + Danielle is the sole U.S. shareholder because all other shareholders are foreign persons.
  + This is not a CFC under §957(a) because U.S. shareholders do not own more than 50% of the combined voting power of all classes of shares or more than 50% of the total value of the foreign corporation.
* X Corp
  + Danielle is a U.S. shareholder of X Corp under §951(b)
    - She directly holds 25% [(25/60) \* (3/5)] of the voting power of X Corp. §958(a)(1)(A).
    - She indirectly holds 7.5% [(45/90) \* (15/60) \* (3/5)] of the voting power of X Corp. §958(a)(2).
    - She constructively holds 7.5% [(45/90) \* (15/60) \* (3/5)] of the voting power of X Corp. §958(b).
    - She owns 10% (25/250) of all classes of shares. This is probably 10% of the value, since dividend rights are the same across shares, plus her shares have voting rights.
  + Danielle holds indirectly ½ of Y Corp’s 15 shares, or 7.5 shares. (Note that this is indirect ownership, not constructive ownership.) Added to her direct shares she holds 32.5 shares. This is more than 50% of Class A, which has 3/5 of the vote. Under §1.957-1(b)(1)(i) if you have the power to elect a majority of directors, then this counts as control. So long as she has ability to direct votes of Y Corp’s shares in X Corp, then she should have control. Therefore X Corp is a CFC.

13-2. At all times during Year 1, three individuals owned the outstanding shares of FC Corporation, a French corporation. As of January 1, Year 1, Jacques, a citizen and resident of France, owned 50 shares of the stock, while Ken and Lisa, both United States citizens and residents, each owned 25 shares. On July 1, Year 1, FC Corporation redeemed ten shares held by Jacques. On July 2, Year 1, tax counsel warned of potential United States income tax problems associated with the redemption. Accordingly, on July 4, Year 1, FC Corporation redeemed five shares from each of Ken and Lisa. The holdings of the shareholders remained unchanged for the balance of Year 1. Were there tax problems and, if so, did the July 4, Year 1, redemption transactions avert the United States income tax problems?

*Answer:*

* Notice at outset we begin with exactly 50-50 foreign versus US ownership. The 50% US interest is clearly held by US shareholders. So, we are a whisker away from CFC status but not there yet. Effect of redemption? Now, the US shareholders own 50/90 and thus we have a CFC. Effect of further redemption? Now they hold 40/80 and we are exactly on the cusp again. Is the problem thus cured? Under pre-2018 rules, the problem would have been cured. The reason is that although we have a CFC for three days, there were no required inclusions under the regime unless you have CFC status for 30 consecutive days, which we would not have in this case. Under the 2017 Tax Act the rule is that one generates inclusions if there is a CFC at any time during the year, which would be the case here. How important is this? Although we are just looking at the threshold question at this point, note that the actual effect under subpart F is for US shareholders to include a “pro rata” share of subpart F income. One aspect of the “pro rata” limitation is to take account only of that amount of subpart F income proportionate to the number of days the F Corp is a CFC. In this case we limit number of CFC days to 3. So actual inclusions will be only 3/365 of the F Corp’s base that would count as subpart F income. Thus the second redemption does not exactly cure the problem caused by the first redemption, but it greatly limits the impact, as compared to case where the company remains a CFC for the entire rest of the year.

13-A. FCo, a foreign corporation is held by DomCo, a widely held domestic corporation, and 6 US citizen shareholders. DomCo has 460 shares and each US citizen has 90 shares each. Is FCo a CFC?

*Answer:*

* DomCo is a U.S. shareholder of FCo under §951(b), because it directly owns 46% of FCo.
* None of the U.S. citizens are U.S. shareholder of FCo §951(b), because they only own 9% of FCo.
* DomCo is not a CFC under §957(a) because U.S. shareholders do not own more than 50% of the combined voting power of all classes of shares or more than 50% of the total value of the foreign corporation.

13-B. Same as part A except the number of individual shareholders is reduced from 6 to 5 – still 1000 shares outstanding but 540 was held by individuals

*Answer:*

* DomCo is a U.S. shareholder of FCo under §951(b), because it directly owns 46% of FCo.
* Each of the U.S. citizens are U.S. shareholders of FCo §951(b), because they own 10.8% (540/5) of FCo.
* DomCo is a CFC under §957(a) because U.S. shareholders own more than 50% of the combined voting power of all classes of shares or more than 50% of the total value of the foreign corporation.

13-C. Same as part A except that one of the individual shareholders is replaced by a US investment partnership and one of the individual shareholders has a 5% interest in the investment partnership.

*Answer:*

* DomCo is a U.S. shareholder of FCo under §951(b), because it directly owns 46% of FCo.
* U.S. individual is not a U.S. shareholder under §951(b), because he only owns 9.45% of FCo
  + Owns 9% directly under §958(a)(1)
  + Owns 0.45% constructively under
* U.S. partnership is a U.S. shareholder under §951(b), because it only owns 18% of FCo
  + Owns 9% directly under §958(a)(1)
  + Owns 9% constructively under §318(a)(3)(A).
* DomCo is a CFC under §957(a) because U.S. shareholders own more than 50% of the combined voting power of all classes of shares or more than 50% of the total value of the foreign corporation.

13-D. Same as part A except that two of the individuals are husband and wife.

*Answer:*

* DomCo is a U.S. shareholder of FCo under §951(b), because it directly owns 46% of FCo.
* The spouses are U.S. shareholders of FCo under §951(b), because they own 18% of FCo under §318(a)(1)(A).
* DomCo is a CFC under §957(a) because U.S. shareholders own more than 50% of the combined voting power of all classes of shares or more than 50% of the total value of the foreign corporation.

# Chapter 14: Controlled Foreign Corporations – Subpart F Inclusion

## Readings

* Read CB Unit 14
* Skim Code 78; 250; 951A; 904(c), (d).
* Skim Code 952(a); 954(a), (b)(3)-(5), (c)(1)-(2), (d)(1)-(3), (e); 959(a); 960(a); 961; 1248(a)
* Skim Code 952(a); 954(a), (b)(3)-(5), (c)(1)-(2), (d)(1)-(3), (e); 959(a); 960(a); 961; 1248(a)
* Prepare Problems 14-1(a)-(b); 14-2(a)-(f); 14-3(a), (b), (d)

## Problems

14-1. A, B, and C, each United States citizens and residents, own one-third of the stock of Z Corporation, a Bolivian corporation formed as a Sociedad Anonima.

(a) In Year 1, Z Corporation earns $100,000 of interest income and $200,000 of dividend income from unrelated persons. What are the United States income tax consequences under subpart F, assuming no income inclusion under§ 951A?

*Answer:*

* CFC. We have a corporation (per se under 301.7701-2(b)(8)). We have 3 US shareholders because they each own 10%. We have control because they own over 50% in total.
* Each of dividend and interest is FPHCI under 954(c).
* Thus $300K of subpart F income. Each of A, B, and C must include $100K, that is the pro rata share.
* Basis in Z Corp stock will increase by $100K for each under section 961.

(b) In Year 2, Z Corporation again earns $100,000 of interest and $200,000 of dividend income. It also opens a travel business in Bolivia, which generates $7,000,000 in gross income. How much of Z Corporation's income is currently subject to United States income tax under subpart F other than § 951A? How would your answer change if Z Corporation generates $90,000 of gross income from its travel business?

*Answer:*

* The $7M is not subpart F income because it does not fit into any of the categories. Thus we have 300K/$7.3M in total. This comes to 4.1% and thus we are in the de minimis case. §954(b)(3)(A). There are no constructive dividends under subpart F.
* Now the $90K is still not subpart F income but the relevant fraction is $300K/$390K, or 77%. This implicates the full inclusion result. §954(b)(3)(B). Each shareholder will have $130K of constructive dividend.

14-2. Abe, a United States citizen, and Dom Co, a domestic corporation wholly-owned by Abe, form Chala Co., a corporation under Peruvian law, on January 1, Year 1, each contributing $5,000 in return for 50 shares of common stock. Chala Co. purchases equipment in the United States from DomCo and sells the equipment to unrelated parties in Peru and other South American countries. In Year 1, Chala Co. earns $50,000 of net income from sales in other South American countries and $100,000 of net income from sales in Peru. Chala Co. is classified as a corporation for United States tax purposes. No foreign income taxes are paid by Chala Co. on its income.

(a) What are the United States income tax consequences for Abe, Dom Co, and Chala Co. in Year 1 under subpart F, assuming no income inclusion under§ 951A?

*Answer:*

* Chala is a CFC and Abe and DomCo are US shareholders.
* Analyze the income as FBCSI. For the $100K it comes outside the provision because not for use outside jurisdiction of incorporation. The $50K seems to meet all requirements. Need purchase from related, personal property, not manufactured, and for sale/use outside the jurisdiction. (Note there is a technical question regarding relatedness here -- that is, whether Chala and DomCo are related for these purposes. We did not discuss this issue in class. Obviously in the wholly-owned CFC case, which we dealt with in class, you will have relatedness. Technically, under the statute a related person is one who controls a CFC (954(d)(3)(A)). DomCo owns exactly 50% of Chala so does not quite have control just through direct ownership. But under section 958 DomCo is treated as owning Abe’s shares in Chala (this is because Abe owns all of DomCo and cutoff for attribution down is just 50%). Thus Chala and DomCo are related.)
* We have $50K of subpart F income and each of Abe and DomCo must include $25K. Note that imputation of income arises only with respect to actual and indirect ownership, not constructive ownership. (Section 951(a) says include with respect to stock you own under 958(a) but not 958(b).) Remember indirect is only through foreign corps. So Abe owns shares through DomCo constructively but not indirectly. Thus he does not have additional inclusions by reason of interest in DomCo. That makes sense as any other result would be double counting.
* Note that de minimis rule does not apply.
* The high taxed exception of 954(b)(4) does not apply.
* Each has a basis upward adjustment, so $5K + $25K = $30K.

(b) What result in (a) if Chala Co. pays income tax to the other South American countries of $7,500 on its income from sales in those countries? How would your answer change if Chala Co. pays $10,000 in taxes on the sales?

*Answer:*

* In the first instance, the high tax exception is not implicated because $7,500/$50,000 = 15%. Since the tax rate is only 71% (15%/21%) of the U.S. tax rate the high tax exception does not apply.
  + With taxes we need to take account of effect on subpart F income and the effect on potential FTC under section 960.
  + Allocable taxes. Under 954(b)(5) we reduce foreign base company income for allocable taxes. So here the $50K gets reduced to $42,500K. Pro rata share is $21,250 each. Thus each of Abe and DomCo has $21,250 of subpart F income.
  + FTC. DomCo (but not Abe) can claim a section 960 credit. Half of the foreign tax, or $3750, will be attributed to DomCo. Note that 960 speaks in terms of attributable taxes. It doesn’t tell you how to do the attribution but the only sensible approach here would be to follow the way one deducted taxes in calculating subpart F income. DomCo will have a section 78 gross-up in the same amount as the taxed deemed paid.
  + Thus DomCo’s total inclusion will be $21,250 + $3750 = $25,000. Problem doesn’t stipulate a US rate but assume the current US 21% rate. This would create tentative tax of $5250.
  + Need to apply separate basket limitations. FBCSI is in the general basket. So we have at least $25,000 of income in that basket (the subpart F income plus associated 78 gross-up) This means we have at least $5250 of FTC limit in that basket and can credit all $3750 of foreign tax.
  + Final liability for DomCo then would be $5250 - $3750 = $1500.
* In the second instance, the high tax exception is implicated because $10,000/$50,000 = 20%. Since the tax rate is only 95% (20%/21%) of the U.S. tax rate the high tax exception applies. §954(b)(4).

(c) How would your answer to (a) change if Chala Co. in Year 2 derives no income for the year but distributes to Abe and DomCo $25,000 each?

*Answer:*

* This is a section 959 previously taxed income problem. Section 959 has a favorable ordering rule which says actual distributions come out of PTI first. In part a each US shareholder had $25K of subpart F income (recall, no foreign taxes).
* For Abe, this means he can receive $25K actual dividend and none of it will be included in income. Further, his basis goes down by $25K because basis is reduced by amounts treated as PTI.
* DomCo is eligible for the 245A DRD. However, technically what happens here is that the PTI rule means it is never included in income and thus does not give rise to DRD. DomCo also reduces basis by $25K under section 961.

(d) How would your answer to (a) change if Damien, an unrelated United States citizen and resident, owned eight percent of the stock of Chala Co., and Abe and DomCo owned 46 percent each?

*Answer:*

* Still have a CFC and subpart F income is the same, $50K.
* But now pro rata share of that should be 46% instead of 50%. Thus $23,000 each for inclusions.

14-3. On January 1, Year 1, Jonesy, a United States citizen, and USCo, an unrelated domestic corporation, form FiletCo, a calendar year Argentinian corporation that specializes in serving the finest Cajun crusted bone-in filets and exotic wines in Argentina. Jonesy and USCo each contribute $50,000 in exchange for 50 shares of FiletCo's common stock. Using this seed capital, on January l, Year 1, FiletCo purchases inventory of $60,000 and invests the remaining $40,000 in ovens and other tangible equipment used in its restaurant operations. Additions of tangible equipment during Year 1 perfectly offset quarterly depreciation expenses, so that the average quarterly depreciable basis of FiletCo's tangible property is $40,000.

Notwithstanding the stiff competition, FiletCo's business immediately wins over the critics. During Year 1, FiletCo earns a net profit of $150,000, which amounts are reinvested into FiletCo's business for additional capital expenditures during Year 2. To attract new business ventures, the Argentina tax authority provides an exemption from Argentina tax for any profits earned by a newly-formed business during Year 1.

(a) What are the United States income tax consequences for FiletCo, Jonesy, and USCo in Year l?

*Answer:*

* Tested Income = 150K
* QBAI = 40K
* Net Deemed Tangible Income = $40K \* 10% = $4K
* GILTI – 150K – 4K = 146K
* Jonesy:
  + Pro Rated GILTI = $146K \* 50% = $73K
  + No §250 deduction, not FTC
  + Tax = $73K \* 21% = $15.33
  + Basis step-up to $65.33K ($50K + $15.33). §961
* USCo
  + Pro Rated GILTI = $146K \* 50% = $73K
  + §250 Deduction = $73K \* 50% = $36.5K
  + Tax = $36.5 \* 21% = $7.67K
  + Basis step-up to $57.67K ($50K + $7.67). §961

(b) How would your answer to (a) change if FiletCo also earns $100,000 of interest income from unrelated persons?

*Answer:*

* The $100K will be FPHCI. Each shareholder will include pro rata share, or $50K.
* These FPHCI amounts are excluded from tested income so GILTI analysis is exactly the same as in part a.
* Basis increase will now be equal to GILTI inclusion plus subpart F income.
* Jonesy does not get 250 deduction so subpart F income/GILTI taxed at same rate
* US Co gets 250 deduction only for GILTI, so will pay 21% rate on subpart F income but only 10.5% effective rate on GILTI

(d) How would your answer to (a) change if FiletCo incurs a loss of $75,000 during Year l?

*Answer:*

* Taxpayer is not taxed on tested loss. If there were another CFC this tested loss could be used to offset tested income.

# International Tax I&II, Fall 2020, Released Prior Exam Question

I am including below a sample question from a prior exam. This question should give you a sense of what my short answer exam questions look like in general. Where there are elements below that were affected by law changes in the 2017 Tax Act I’ve flagged this in brackets. To give you a sense of time budgeting, I had recommended 70-80 minutes for this question. This is a longer problem than any of the problems on the Fall 2020 exam.

**Sample:**

CarCo is a corporation incorporated under the laws of Delaware. CarCo manufactures cars in Michigan, where all of its production assets are located, and sells these cars to consumers in the United States and in Italy.

For purposes of this Part you should assume that Italy imposes an *identical* set of tax laws as those in the Internal Revenue Code of the United States with conforming changes (i.e., where the Code says “United States” the Italian code says “Italy”), *except* for the individual and corporate rates imposed under Code sections 1 and 11. With respect to rates, you should assume that Italy imposes a flat effective 40% rate on the income of individuals and a flat effective rate of 40% on the income of corporations. You should also assume that the U.S. Model Income Tax Convention (2006) is in force between the United States and Italy.

*Question 1*. CarCo conducts its Italian sales operations through local dealerships in Italy that it owns directly (that is, not through some local Italian corporation). In 2017 CarCo realizes gross income of $10M on its Italian sales. This amount is net of cost of goods sold. Assume that CarCo has no other deductible expenses. What are the tax consequences to CarCo?

*Answer:*

* U.S. Tax Consequences (Outbound)
  + CarCo is a U.S. person because it is a per se corporation incorporated in United States.
  + CarCo is taxed on its worldwide income, including the income earned through its Italian sales operations.
  + However, under §901 CarCo may claim a foreign tax credit for Italian taxes paid or accrued (or withholding taxes paid or accrued).
  + The amount of the foreign tax credit will be limited both by the amount of its income that is foreign source, and by the baskets with which the income is categorized.
  + The income of CarCo from its Italian sales operations is characterized as the sale of inventory property.
    - Under §863(b)(2), income from the sale of inventory sold outside the United States and produced at least partly in the United States is sourced entirely on the basis of “production activities.” No value is attributed to the sales function.
    - Therefore, none of CarCo’s income will be treated as foreign source.
  + Because none of CarCo’s income will be treated as foreign source income, the formula will result in CarCo not receiving any foreign tax credits.
  + The basketing issue is not applicable to this question because CarCo does not have any foreign source income.
    - As a note, if the income were foreign source, this it would be basketed as foreign branch income.
  + The U.S.-Italy treaty should not affect the treaty because under the tie-breaker provision of Art. 4(4) (assuming Italy treats it as an Italian company under local law), CarCo will be treated as a resident of the United States. CarCo is treated as a resident of the United States because it is organized in the United States.
* Italian Tax Consequences (Inbound)
  + CarCo is a foreign person because it is a per se corporation incorporated in the United States.
  + CarCo has an Italian trade or business because its activities in Italy in the United States are regular, continuous, and considerable. Both quantitatively and qualitatively, operating a local dealership in Italy and selling cares through the dealership is enough to constitute an Italian trade or business.
  + CarCo is therefore subject to tax under §882(a) on the income which is effectively connected to the Italian trade or business.
  + Under the residual force of attraction rule under §864(c)(3), Italian source income which is not Italian source FDAP and capital gain/loss is effectively connected income.
  + Under §865(e)(2), income from the sale of inventory property attributable to the Italian trade or business (on sales in Italy) is treated as Italian source.
  + Therefore, the Italian sales are effectively connected income and subject to Italian tax at 40%.
  + Any deemed remittances will be subject to branch profits tax under §884.
  + Under the U.S.-Italy Treaty, CarCo is treated as a resident of the United States because it is organized in the United States. If Italy treats CarCo as an Italian company under local law, it will be treated as a resident of the United States under the tie-breaker provision of Art. 4(4).
  + If CarCo claims treaty benefits, it will have a permanent establishment in Italy because it has a fixed place of business under Art. 5(2).

*Question 2*. From the perspective of the United States are the tax rules operating to provide CarCo a subsidy to export? Explain why or why not.

*Answer:*

* No, the rules are not providing CarCo a subsidy to export.
* Because the source rules deem the income from the Italian sales operations to be U.S. source, CarCo is not receiving a foreign tax credit for Italian taxes paid or accrued.
* Therefore, CarCo is subject to double taxation on income from the Italian sales operations.
* In addition, the tax rate in Italy (i.e., 40%) is higher than in the U.S. (i.e., 21%). Even if CarCo were eligible for a foreign tax credit, the amount of the foreign tax credit would be limited under §904. Therefore, CarCo would not be able to fully offset its U.S. tax with foreign tax credits. Again, CarCo would be subject to double taxation on its income from the Italian sales operations.

*Question 3*. Assume same facts as in *Question 1*. In addition, CarCo has sold to independent distributors the identical number and type of car in the United States as it sold in Italy. These cars are delivered to the distributors at CarCo’s factory and CarCo undertakes no sales activities with respect to these cars. Could this fact improve CarCo’s tax position? Explain why or why not. **[Note that this question is not really relevant under 2017 Tax Act. This question was meant to test understanding of the distinction between the old 50-50 rule for production and sale versus the regulatory “independent factory price” method.]**

*Answer:*

* This fact will not alter the tax consequences to CarCo.
* U.S. Tax Consequences (Outbound)
  + The source of income will still be determined under §863(b)(2).
  + The 50/50 rule was repealed in 2017 with passage of the 2017 Tax Act.
* Italian Tax Consequences (Inbound)
  + The source of income will still be determined under §865(e)(2).
  + The material participation exception under §865(e)(2)(B) will treat the gain on the U.S. sales as foreign source for Italian tax purposes.

*Question 4*. Assume same facts as in *Question 1*. In addition, CarCo earns $100K in interest income on government bonds issued by Italy. What are the tax consequences with respect to the interest income? Does the addition of the interest income change the tax consequences with respect to the income from the sale of cars in Italy? If so, explain how.

*Answer:*

* U.S. Tax Consequences (Outbound)
  + CarCo’s interest income is sourced to the residence of the payor under §861(a)(1).
  + Because the payor is the Italian government, the income is foreign source.
  + CarCo is eligible to claim a foreign tax credit on any Italian taxes paid or accrued.
  + For foreign tax credit purposes, the interest income should be basketed as passive income under §904(d)(2)(B).
  + Under the U.S.-Italy Treaty, the withholding tax rate on any withholding tax may be reduced to 0%. See Art. 11(1).
  + Besides being additional income to CarCo, the interest income should not affect the income from the sale of cars in Italy.
* Italian Tax Consequences (Inbound)
  + The interest income paid by CarCo is Italian source income under §861(a)(1).
  + The interest income is FDAP income under §871(a)(1)(A).
  + Therefore, the interest income is subject to a 30% withholding tax rate on the gross amount of $100K.
  + Under the U.S.-Italy treaty, the withholding tax rate on the interest income will be reduced to zero. Art. 11(1).
  + The interest income is not attributable to CarCo’s Italian trade or business because of the residual force of attraction rule under §864(c)(3). Effectively connected income septically excludes Italian source income treated as FDAP income.
  + Similarly, under the U.S.-Italy treaty, the interest income is not attributable to CarCo’s Italian permanent establishment because there is not force of attraction rule.
  + Besides being additional income to CarCo, the interest income should not affect the income from the sale of cars in Italy.

*Question 5*. Assume that instead of operating in Italy directly through dealerships, CarCo operates in Italy through Sub, a wholly-owned Italian SA (a “per se corporation” under Reg. 301.7701-2(a)(8)). Sub purchases cars from CarCo at an arm’s length price and then sells the cars through dealerships in Italy. Assume that Sub has $5M of earnings and profits, on which it pays $2M of Italian corporate tax. Sub distributes a $3M gross dividend to CarCo. What are the tax consequences? You can ignore any foreign tax credit limitation issues in this *Question 5*. **[Note that this question is substantially easier under current law than under prior law because of the advent of 245A.]**

*Answer:*

* U.S. Tax Consequences (Outbound)
  + CarCo is a U.S. shareholder of Sub under §951(b).
  + Sub is a foreign person under §7704(a)(5), because it is per se corporation incorporated in a foreign country.
  + Because CarCo owns more than 50% of Sub, it is controlled foreign corporation.
  + Sub has potential foreign base company sale income under §954(a)(2), but the transaction does not meet the requirements because cars are not sold for use, consumption or disposition outside Italy (i.e., Sub’s country of incorporation.
  + Under §245A(a), Sub is a specified 10% owned foreign corporation.
  + Because CarCo is a U.S. shareholder of Sub, it is eligible for a 100% dividends received deduction.
  + CarCo recognizes $3M of dividend income and takes a dividends received deduction of $3M.
  + The E&P of Sub is reduced by $3M, the amount of the dividend.
  + CarCo is ineligible to claim a foreign tax credit under §245A(d) because CarCo is eligible for the dividends received deduction.
  + **[Also consider GILTI]**
* Italian Tax Consequences (Inbound)
  + Sub is an Italian person under §7704(a)(4).
  + Sub is subject to Italian axes at graduated rates (i.e., $5M \*40% = $2)
  + CarCo is a foreign person under §7704(a)(5).
  + CarCo does not have an Italian trade or business or permanent establishment as a result of Sub, because Sub is not acting as an agent for CarCo.
  + The dividend by Sub is Italian source under §861(a)(1); 862(a)(1).
  + The dividend is FDAP income subject to a 30% withholding rate on the gross amount (i.e., $3M \* 30% = $900K).
  + However, CarCo is a U.S. resident under the U.S.-Italy Treaty. See Art. 4(1).
  + Therefore, if CarCo claims treaty benefits in Italy, the withholding rate is reduced to 5% under Art. 10(2). The 5% rate applies because this is an intercompany dividend. The amount of withholding tax therefore equals $150K ($3M \*5%).

*Question 6*. Assume that instead of operating in Italy through a wholly-owned subsidiary, CarCo operates in Italy through Sub, an Italian SA, of which CarCo owns 60% of the single class of shares. The remaining 40% share block is held by an unrelated Italian partnership. Sub has $5M of earnings from the sale of cars, as in *Question 5*, and in addition earns $1M of interest income on government bonds issued by an Italian locality. Such interest is exempt from Italian income tax. What are the tax consequences? You can ignore any foreign tax credit limitation issues in this *Question 6*.

*Answer:*

* U.S. Tax Consequences (Outbound)
  + Because CarCo still owns more than 50% of Sub, it is controlled foreign corporation.
  + Sub’s interest income is foreign personal holding company income under §954(c)(1).
    - The de minimis exception does not apply because the amount of income is not under the 5% or $1m threshold.
    - The high tax exception does not apply because the interest income is not subject to foreign taxes.
    - The active banking/financing exception does not apply because this is not qualified banking or financing income.
  + Because CarCo owned 60% of Sub at the end of the year, it will include its pro rata share of the CFC income under §951(a).
  + Therefore, CarCo recognizes $600K of the interest income.
  + The dividend creates PTEP of $600K.
  + Because Sub did not pay or accrue foreign taxes with respect to the interest income, CarCo cannot claim a foreign tax credit under §960(a).
  + Sub has potential foreign base company sale income under §954(a)(2), but the transaction does not meet the requirements because cars are not sold for use, consumption or disposition outside Italy (i.e., Sub’s country of incorporation.
  + When Sub makes a distribution to CarCo of $1.8M ($3M \* 60%), the first $600K is excluded from income to CarCo as previously taxed income under §959(a).
  + The remaining dividend of $1.2M ($1.8M - $600K) is eligible for the dividends received deduction under §245A(a).
  + **[What about GILTI]**
* Italian Tax Consequences (Inbound)
  + The tax consequences are similar to above, with the numbers changed to reflect the differing ownership percentages.