Exam No. __________

Wayne State University
Law School

Winter Term, 2004
Prof. Michael J. McIntyre

International Aspects of U.S. Taxation

LEX 7401

MAXIMUM TIME: 3 HOURS
MAXIMUM POINTS: 100
TUESDAY, MAY 11, 2004, AT 1:30 P.M.

Instructions

1. Write your **Exam Number** in the space provided in the upper right hand corner of this page and also on page 7 (Multiple Choice). Also write your exam number, the name of your instructor (McIntyre), and the name of this course (Int'l Tax) on the cover of your bluebook. Please do this now. If you are typing your exam, you also must put your Exam Number on the top right of every page and the name of the instructor and the name of the course on the first page.

2. Thank you for putting your **Exam Number** and other information in the appropriate spaces. (If you have not done so, please stop reading and do so now.) Please do NOT put your own name or other identifying information (e.g. LL.M. student, graduating senior) on your bluebook or on your copy of the exam.

3. This is an **open book** examination. You are expected to have with you a copy of the Code and Regulations and the course materials distributed in class or posted on the class website. You are permitted to have any books, notes, or other materials you have used during the course. You may use a pocket calculator.

4. This examination has three parts. Answer the questions in Part I in your bluebook, noting the space guidelines. Part II contains fifteen (15) multiple choice questions, and Part III contains fifteen (15) True/False questions. Answer both of those parts *on your copy of the exam* by circling the appropriate choices.

5. In writing in your bluebook, do not use the back side of the pages and please double space (that is, write on every other line). If you are typing, please leave big margins (1½ inches each side) and double space.

Note To Proctor:

All copies of the Examination MUST be returned to you by the end of the examination period. Please check carefully to be sure you can account for all copies. Persons allowed to leave the examination room **for any reason** *must leave their copy of the examination with you to hold until they return.*

Assumptions Applicable to this Examination

Unless a question specifies otherwise, make the assumptions set forth below in answering the questions on this examination:

1. Individual taxpayers are using the cash method of accounting, and corporate taxpayers are using the accrual method of accounting.

2. Taxpayers are using the calendar year as their taxable year.

3. Except for the transactions described in the questions, no transactions relevant to the answers have occurred during the relevant taxable years.

4. Technical terms and words of art are used in their exact tax sense.

5. For persons taxable on their net income under Code sections 1 or 11, the United States employs a flat individual tax rate of 40 percent and a flat corporate tax rate of 35 percent.

6. When a question requires you to consider a tax treaty between the United States and a foreign country, assume that the treaty has terms identical (other than the name, etc., of the treaty partner) to those of the U.S./Canada Income Tax Treaty unless the question states otherwise.

7. All taxpayers have elected to credit rather than deduct foreign income taxes.

8. Any taxpayer identified as a "corporation" qualifies as a corporation for U.S. tax purposes.

9. Taxpayers having base company income or insurance income under subpart F of the Code cannot satisfy the exculpatory provisions of Code sections 954(b)(3) (5 percent de minimis rule) or 954(b)(4) (income subject to high foreign taxes).

10. All stated amounts of taxable income and earnings and profits have been computed according to U.S., rather than foreign, tax concepts. A corporation's earnings and profits equal its taxable income minus its income taxes paid.

11. The various tax acts through 2003 are fully effective and any transitional provisions have lapsed or expired.

12. The taxpayer has no carrybacks or carryforwards of the foreign tax credit.

13. All transactions occur at arm's length.

I. Essay

(maximum points: 40)

(Maximum Length: 5 bluebook pages, double spaced)

Instructions. Answer the following questions in your bluebook. Write in ink and do not write in the margins. **Number your answers clearly**. Please write on every other line (double space), and do not write on the back side of the bluebook pages. Observe the maximum space limitations for each question. *You will suffer a grade penalty, proportionate to the offense, for exceeding the space limitations.* No penalty is imposed for exceeding the space limits by 3 lines or less.

Note on Handwriting: A person with normal-sized handwriting typically gets about 10 to 12 words per line. Make an appropriate adjustment if your handwriting is unusually large or small. Please, do not count your words.

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Note to typists: 1 handwritten line of a bluebook (normal
size writing) is equivalent to 1 line of a typed page
(8½" × 11") with 1½ inch margins (pica) or 2 inch margins
(elite). This notice is typed with a pica font (Courier
12 point) and has 1½ inch margins.
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A. Tax Planning

(Maximum points: 25)

(Maximum Length: 5 bluebook pages, double spaced)

Livingston Tools, Inc. (LT) is a Michigan company that manufactures hammers, saws, wrenches, and other tools in its Detroit factory. The company has only one class of stock, voting common, with 1,000 shares outstanding. Mr. L, the founder and CEO of the company, owns 500 shares. Sally, the company president and long-time associate of Mr. L, owns 100 shares. The remaining 400 shares are owned by the 200 workers in the company, who received the stock under a stock option plan. None of the employees owns, directly, indirectly, or constructively, more than 10 shares of the company. All of the shareholders are U.S. citizens and residents.

Although it has operated profitably for over 40 years, LT has never paid a dividend. As a result, it has accumulated substantial profits, which it has invested in interest-bearing bonds. It earns profits each year of $10 million, of which $5 million comes from sales in the United States and the other $5 million from sales in Canada. It earns an additional $10 million each year from its investment portfolio of $200 million.

The company has been approached by its accounting firm, Anderson Waterhouse (AW), with a plan for taking the company offshore. Under the plan, LT would establish a U.S. company, LT Assets, Inc. (LTA). LT would transfer all of its real property, most of its depreciable property, and all of its investment assets to LTA and then distribute its stock in LTA to its shareholders, resulting in LTA and LT being sister companies. LTA would then lease the operating assets back to LT for an arm's length fee. LT would then cause its shareholders to establish LT Offshore (LTO), a foreign company incorporated and managed in the Barbados. The shareholders of LTO would own stock in that company in proportion to their ownership rights in LT. The shareholders of LTO then would transfer their LT stock to LTO. The result of this set of "inversion" transactions would be that LTO would own all of the stock of LT, and the former shareholders of LT would own the stock in LTO, with no change in their proportional interests.

AW has explained the tax consequences of the set of transactions as follows:

First, AW expects that the transfer of assets to LTA for the stock of LTA, followed by a distribution of the stock to its shareholders will be a tax-free reorganization. You should assume that this advice is correct and that neither the corporations nor the shareholders of LT will be taxable on the reorganization. The purpose of this reorganization is to reduce the value of the LT stock.

Second, AW expects that the formation of LTO by the LT shareholders will be a taxable event but that no gain or loss will be realized because the LTO stock would have no value at the time of the transfer. AW also expects that the contribution of the LT stock by the LTO shareholders to LTO will be a taxable event under IRC § 367. AW expects that the LTO shareholders will recognize aggregate gain of $10 million on the transaction, taxable at the capital gain rate of up to 15 percent. You should assume that these opinions of AW are correct.

Question 1 (5 points).

If the above plan is consummated, LTO will be a controlled foreign corporation (CFC) within the meaning of IRC § 957. Explain why. In addition, explain which shareholders of LTO will be taxable on any subpart F income earned by LTO. Support your answers with appropriate references to the Code and/or Regulations.

Question 2 (10 points).

Assume, *for purposes of this question only*, that Sally marries a gentleman from Haiti and transfers to him her 100 shares in LTO stock as a wedding gift. What effect, if any, will that transfer have on the status of LTO as a CFC? Explain, with appropriate references to the Code and/or Regulations.

Question 3 (5 points)

The long-term plan is for Mr. L to make sufficient transfers of his LTO stock so that LTO is no longer a CFC. Assume, *for purposes of this question and question 4 only*, that LTO does shed its status as a CFC. Once LTO is not a CFC, LT will pay out all of its profits to LTO as a dividend. How will the dividend be taxed, assuming that the U.S. tax treaty with the Barbados follows the OECD Model Treaty?

Question 4 (5 points)

Assume that LTO has shed its status as a CFC, as suggested in question 3. Assume also that LTA distributes the investment assets it received from LT to its shareholders and that those shareholders contribute the assets to LTO as a contribution to capital. AW expects that the transfer of the assets to the shareholders of LTA will be taxable as a dividend at a maximum rate of 15 percent. It expects that the transfer to LTO will not produce any gain because the shareholders will have a basis in the assets equal to their fair market value. You should assume that these opinions of AW are correct. Assuming the transfers are made, how will the income earned by LTO on the investment assets be taxed by the United States? Explain, with appropriate references to the Code and/or Regulations.

B. Tax Policy

(Maximum points: 15)
(Maximum Length: 3 bluebook pages, double spaced)

One of the candidates for president in the 2004 campaign has proposed that the United States should tax all of the income earned by controlled foreign corporations (CFCs) currently whether or not the income constitutes subpart F income. The only exception would be for income earned in the country where the CFC is incorporated and only if the CFC manufactures goods in that country for sale in that country. The revenue raised from this reform would be used to lower the U.S. corporate tax rate. The candidate claims that this proposal, if adopted, would reduce to some degree the flight of jobs from the United States to foreign countries.

Question 5 (15 points)

Discuss this proposal. Why might the proposal, if enacted, reduce the job losses in the United States? Some critics claim that the proposal would result in an additional loss of jobs because it would make U.S.-based multinationals less competitive abroad. Does this claim have merit? Is the suggested exception for manufacturing businesses that are organized in the country where they manufacture and sell goods an appropriate response to this claim? Can the Internal Revenue Service administer that exception, or will it create major administrative problems?

******* End of Part I *******

II. Multiple Choice Questions
(maximum points: 45 — 3 points each)

Mark your choice of alternative answers to each question by circling its identifying letter **on your copy of the exam**. *Do* **Not** *circle more than one alternative answer* per question. Your score will be based on the number of correct answers. No points are deducted for incorrect answers. In answering each question, make the assumptions stated on page two (2) of this examination unless a contrary assumption is stated in the question.

If you believe that unstated facts are crucial to your answer, or if you believe that a question is ambiguous, go ahead and answer the question as best you can. Then circle the number of the question on the question sheet and, on the space provided on the last page of this exam, identify the unstated facts or the ambiguities and explain their relevance to the question. If your grounds for challenging a question are well-founded and if you have properly shown the relevance of an alleged omission of fact or ambiguity to the answer, you will receive full credit for your answer. There are no intentional ambiguities or omissions of necessary facts.

> **Warning***: If you decide to explain your answer, you do so at your own risk. You will receive* **no credit** *for circling what I have judged to be the correct answer to a question if you have challenged that question and your grounds for doing so are unfounded or incorrectly stated.*

III. True/False Questions
(maximum points: 15)

Mark your choice of alternative answers to each question by circling its identifying letter **on your copy of the exam**. Ambiguous questions may be challenged according to the rules set forth in Part II. Again, there are no intentional ambiguities.

***** End of Exam *****

--- Space to Explain Multiple Choice and True/False Answers ---
Use ONLY if necessary

Question (   )____

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Question (   )____

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