Exam No. __________

Wayne State University
Law School

Winter Term, 2010
Prof. Michael J. McIntyre

International Aspects of U.S. Income Taxation

Lex 7401

Maximum Time: 3 hours

Maximum Points: 100

Friday, April 30, 2010, at 9:30 a.m. to 12:30 p.m., Rm 1550

Instructions

1. Write your **Exam Number** (if it is not already there) in the space provided in the upper right hand corner of this page and also on page 8 (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 the essay questions on a laptop computer, please follow the instructions for the use of laptops. Be sure that your Exam Number, the name of the instructor (McIntyre), and the name of the course are on the first page of your answer sheets.

2. Thank you for putting your **Exam Number** and other information in the appropriate spaces. (If you have not already 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 selected sections 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 four (4) questions in Part I in your bluebook, or type your answers on your laptop computer, noting the space (word) guidelines. Part II contains twelve (12) multiple choice questions, and Part III contains fourteen (14) True/False questions. *All students* (including those using laptop computers) must answer Parts II and III *on their 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). Also, write in ink in the bluebook (pencil is fine for the Multiple Choice and True/False).

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 35 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 (2008) 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 2009 are fully effective, and any transitional provisions have lapsed or expired.
12. The taxpayer has no carrybacks or carryforwards of the foreign tax credit.

Part I. Essay

(maximum points: 50)

Instructions. Answer the four (4) questions below in your bluebook or on your laptop computer. Observe the maximum space limitations (lines for handwritten exams, words for laptop users). You will suffer a grade penalty, proportionate to the offense, for exceeding the space limitations. A penalty is not imposed for exceeding the limits by two lines or less (bluebook users) or by 22 words or less (laptop users).

Note to Those Writing in a Bluebook. If you are writing the exam, write in ink on every other line (double space). Do not write on the back side of any page, and do not write in the margins. One page of a bluebook, double-spaced, is 14 lines. 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.

Note to Laptop Users. The space limits for laptop users are expressed as word limits. I estimate that one line of writing is equal to 10-12 words, so I have set the word limit at 11 times the lines allowed to those writing in a bluebook. So, if the maximum bluebook lines allowed is 14, the maximum laptop words allowed is 154.

A.

(Maximum points: 20)

Hal Foster was the creator of the *Prince Valiant* comic strip that appeared in the Sunday papers for several decades (and still appears long after Hal's death in 1982). Foster was famous for his detailed drawings, which won many prizes. Indeed, he is often considered the greatest cartoonist of all time. It turns out that he kept the original ink drawings, in color, of all of his comic strips, which he donated to the University of Syracuse shortly before his death.

Phantographics Books (PB) is a publishing house that specializes in the reproduction of famous comic strips. It has a marvelous book on *Modesty Blaise*, a strip created by Peter O'Donnell (writer) and Jim Holdaway (art), and another book on Alex Raymond's *Flash Gordon*. PB has learned recently of the existence of the Foster originals and is planning a book series that reproduces the first decade of *Prince Valiant*. The comic strip remains popular in the United States and is wildly popular in the United Kingdom and some other parts of Europe, especially Scandinavia (Valiant was the Prince of Thule, located somewhere in the land of the Vikings).

All of the stock of PB is owned by Miss J and Mr. K, both unrelated U.S. persons (both citizens and residents of the United States). Miss J and Mr. K jointly manage PB from their office (a converted brownstone residential building) located in Brooklyn, New York.

J and K have formulated the following tax plan. They already jointly own a corporation, BCo, organized under the laws of the Bahamas. BCo has capital of $1 million, on which it earns income annually of $50,000. It has little in the way of physical property in the Bahamas or elsewhere and no employees. Whatever is done on behalf of BCo is done by Miss J, who is listed as the president of BCo. The Bahamas does not impose an income tax on the income of foreign-owned companies. It does not have a tax treaty with the United States.

The plan is for BCo to arrange to license rights to reproduce the original comic strips from the University of Syracuse for a flat royalty of $50,000, payable one year after the book is published. The royalty would be exempt from tax in the Bahamas, and the University of Syracuse would pay no U.S. income tax on the royalty because it is a tax-exempt educational institution within the meaning of Code section 501(c)(3).

Once it has obtained the license to reproduce the originals of the *Prince Valiant* comic strip, BCo would contract with PB to design the book, with the design work being done exclusively at the Brooklyn brownstone by employees of PB. PB would then create a high-resolution computer file, in Adobe Acrobat (PDF) format, that would contain all of the material for the book. It would transmit that file electronically to BCo in the Bahamas, and BCo would become the owner of the file. It would compensate PB for its work by giving it a royalty of twenty percent (20%) of sales of the resulting book. BCo, using Miss J as its agent, would contract with an independent printing company, CCo, located in China. PB has a long relationship with CCo because CCo did the printing of both the *Modesty Blaise* book and the *Flash Gordon* book.

BCo would transmit the PDF file to CCo for use in producing the book but would retain ownership of the file. After printing the books, CCo would ship them to BCo in accordance with its contract with BCo. BCo would then sell one half of the books to independent book distributors in the United States. The remaining books would be sold to independent European distributors for sale in the United Kingdom and elsewhere in Europe. PB would receive a royalty from BCo of twenty percent (20%) on these sales to the independent distributors.

The management of PB comes to you for some tax advice. Please answer each of the questions below.

Question 1 (10 points, maximum lines, 21, maximum words, 231).

Does BCo have income that is effectively connected with a trade or business in the United States (ECI)? Explain, with appropriate references to authorities (Code, Treasury Regulations, cases in the course materials).

Question 2 (10 points, maximum lines, 21, maximum words, 231).

Are Miss J and Mr. K taxable on any income under subpart F? Explain, with appropriate references to authorities (Code, Treasury Regulations, cases in the course materials).

B.

(Maximum points: 15)

Greece is facing a serious financial crisis. Some experts say that its problems stem from the recent worldwide financial crisis, which greatly limited the government's access to credit, and from its long-term policy of spending far more than its revenues over many years. The European Union and the International Monetary Fund have offered Greece some temporary assistance to ease the crisis, but that assistance has come with strings. In particular, Greece is being forced to cut government spending sharply, which is likely to create some political problems for the government.

To ease the pain of government spending cuts, the government has sought to attract foreign investment into Greece. As one part of its plan, it is offering foreign investors a tax holiday from the corporate income tax if they invest in Greece directly or through a wholly-owned affiliate organized under the laws of Greece. The current corporate income tax is a traditional income tax similar in its main features to the U.S. corporate income tax. The rate is twenty-five percent (25%). Greece does not tax dividends paid to foreign investors, including dividends paid to the foreign parent of a U.S. corporation. The U.S./Greece tax treaty generally does not provide a reduced rate for dividends. For purposes of this question, please ignore all treaty issues.

In place of the normal corporate income tax, foreign corporations eligible for the tax holiday (directly or through their Greece affiliate) would pay a replacement tax annually equal to one percent (1%) of the new capital they invest in Greece (hereafter referred to as the "replacement tax"). The companies may elect, however, to pay the normal corporate income tax, but at the reduced rate of ten percent (10%). A subsidiary of a foreign corporation that pays either the reduced-rate corporate tax or the replacement tax is eligible for a full refund of the corporate income taxes or replacement taxes paid after five (5) years in an amount not to exceed the amount they would pay if they had elected to pay the replacement tax, but only to the extent that they retain their investment, and the profits on that investment, in Greece.

PCo, a U.S. company, has just formed a wholly-owned subsidiary, GCo, organized under the laws of Greece. It plans to invest $100 million in GCo. That investment would qualify for the tax holiday. Thus, GCo would pay tax of $1 million under the replacement tax each year, for a total of $5 million over five (5) years. Alternatively, GCo, at its election, would pay a corporate income tax of ten percent (10%) on its profits each year. The election must be made at the end of the first year and is binding for five (5) years. GCo would be eligible for a refund of the taxes paid over five (5) years in an amount not to exceed $5 million (the amount that would be due under the replacement tax) assuming that it retains in Greece both its investment of $100 million and its income derived from that investment. If any investment (or the income from that investment) is withdrawn from Greece, GCo will lose a proportionate amount of the otherwise allowable refund. For example, if GCo withdraws ten percent (10%) of its capital (investment of $100 million plus earnings) from Greece prior to the end of the 5-year period (by dividend to PCo or otherwise), it would be eligible for a refund of no more than 90% of taxes paid.

Question 3 (15 points, maximum lines, 28, maximum words, 308).

Assume that GCo has income of $5 million in the first year of its tax holiday and elects to pay corporate income tax of $0.5 million(at the reduced rate of 10%) instead of the replacement tax of $1 million. Can PCo claim a foreign tax credit for some or all of the $0.5 million in taxes that GCo paid to the Government of Greece? When, if at all, would that credit be allowable? Explain.

For purposes of this question, **please assume**, if relevant, that the replacement tax **would qualify** as an “in-lieu” tax under Code section 903 for taxpayers paying that tax. Please ignore any possible issues relating to the limitation on the credit or, as noted above, to the U.S./Greece tax treaty.

C.

(Maximum points: 15)

Code section 863(d) provides the following source rule for income derived from activities conducted in space and from certain activities conducted on or under water and outside the jurisdiction of any country.

§ 863(d). *Source rules for space and certain ocean activities.*

(1) *In general.*– Except as provided in regulations, any income derived from a space or ocean activity—

(A) if derived by a United States person, shall be sourced in the United States, and

(B) if derived by a person other than a United States person, shall be sourced outside the United States.

The Treasury regulations issued in 2006 under Code section 863(d) provide as follows (excerpts):

Reg. § 863-8(b). *Source of gross income from space and ocean activity.–*

(1) *Space and ocean income derived by a United States person.*– Space and ocean income derived by a United States person is income from sources within the United States. However, space and ocean income derived by a United States person is income from sources without the United States to the extent the income, based on all the facts and circumstances, is attributable to functions performed, resources employed, or risks assumed in a foreign country or countries.

(2) *Space and ocean income derived by a foreign person.*– [*Editor: Omitted.*]

* * *

(3) *Source rules for income from certain sales of property.*–

(i) *Sales of purchased property.*– When a taxpayer sells purchased property in space or international water, the source of gross income from the sale generally will be determined under paragraph (b)(1) or (2) of this section, as applicable. However, if such property is inventory property within the meaning of section 1221(a)(1)(inventory property) and is sold for use, consumption, or disposition outside space and international water, the source of income from the sale will be determined under § 1.861-7(c) [*Editor: passage of title test.*]

Question 4 (15 points, maximum lines, 28, maximum words, 308).

Do you think that the Treasury regulation quoted above is a sensible (good, appropriate, desirable, etc.) interpretation of Code section 863(d) with respect to space and ocean income derived by a United States person? Discuss.

In particular, discuss whether the source rule set forth in the regulation advances the apparent purpose of the statute it is interpreting. Also discuss whether the resulting source rule is a good or bad source rule under appropriate criteria for evaluating the merits of a source rule.

Please do NOT discuss whether the regulation is a valid regulation — just assume that it is valid for purposes of your answer.

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II. Multiple Choice Questions

(maximum points: 36 — 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. You must mark the answers on the exam even if you writing the Essay portion of the exam on your laptop.

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, in 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, 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.*

[Multiple choice questions omitted.]

III. True/False Questions

(maximum points: 14 — 1 point each)

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.

[True/False questions omitted.]