International Aspects of U.S. Taxation (McIntyre)
Winter 1995
Notes on the Answers

Question 1 (max 25 points). *Leaving aside treaty issues*, J&J will be residents of both the U.S. and Country N. Thus they are taxable on their worldwide income by both countries. The U.S. will give a foreign tax credit for Country N taxes paid with respect to Country N source income (the wages of Jack and perhaps the minor writing income of Jill). The U.S. also will exempt up to $70,000 in wage income (plus certain housing allowances) under IRC § 911. The exemption does no good, however, if the income is being taxed at a 50% rate by Country N. Country N will presumably give a credit for U.S. taxes paid on the investment income. Country N will tax the income from the Ohio bonds. No credit will be available as the bond income is not taxed by the U.S.

Treaty Issues. The treaty will provide a residence tie-breaker rule so that J&J will be residents of only one country for tax purposes. Under the Saving Clause, however, the U.S. can continue to tax J&J as citizens. Thus the goal should be to have J&J residents of U.S. and not Country N. Jack probably cannot avoid being a resident of Country N under the tie-breaker rules. He has a permanent home in both countries (rule #1), but the center of his vital interests (rule #2) probably is Country N, where he is employed and living full time. Jill, however, has a reasonable claim to have the center of her vital interests in the U.S., as her income from her writing is de minimis and her investments etc. are in the U.S. In any event, that test is at best unclear as to Jill. She probably has an abode in both countries (rule #3), so the deciding test is citizenship (rule #4). Thus Jill becomes a resident of the U.S. and not of Country N under the treaty.

Planning. Country N taxes on an individual basis, so income properly attributed to Jill will not be taxed to Jack. Thus Jill should be the owner of all the investment assets (to the extent possible). Since the investment income is U.S. source income, it will not be taxed to Country N. Some of the investment income will be taxed by the U.S., but the income on the Ohio bonds will not be taxed. Note: For U.S. purposes, J&J will file a joint return, and the limit on the credit will apply to their total income. However, if Jill shifts some of the investment income offshore, it will go into the passive basket, whereas Jack's employment income will go into the General basket. As a result, none of the excess credits generated by the 50% tax paid by Jack in Country N can be used to offset the U.S. tax otherwise due on the investment income (even if it is made foreign income).

Question 2 (max 25 points). X has total gross income of $10,000 and total deductions of $5,000, so its total taxable income is $5,000. The question asks how much of that taxable income has a foreign source. To determine the foreign source taxable income, it is necessary to determine the amount of foreign source gross income and the amount of foreign source deductions.

Issue #1. Source of Gross Income. The first issue is to determine the amount of foreign source and U.S. source gross income. There is $4,000 of U.S. source gross income from the oil extraction and $3,000 of foreign source gross income from the manufacture of electric motors in France and their sale in Europe. The source of the gross income from the sale of motors manufactured in France and sold in the U.S. is unclear. Under the office rule of § 865(e)(3), the income is U.S. source income to the extent attributable to the office. That may be $3,000. Alternatively, the apportionment formula of Reg. § 1.863-3T(b)(2)(Ex. 2) might attribute 1/2 of the $3,000 to foreign sources. Thus foreign source gross income is **either $3,000 or $4,500** (I gave full credit for either answer). The calculations below generally assume the correct answer is $3,000.

Issue #2. Source of Deductions. This is the main focus of the question, for which most of the points were assigned.

a. Interest Expense. The interest deduction of $1,000 is allocated and apportioned under the assets method. [Note that the fact that the money was used in the United States for the oil extraction business is *not* relevant. Unless one of the narrow exceptions applies (none do here), the asset method must be used without reference to the place of use of the borrowed money.]

Under the assets method, \$400 (\$4,000/\$10,000 × \$1,000) is allocated to the gross income produced by the oil extraction assets and \$600 (\$6,000/\$10,000 × \$1,000) is allocated to the gross income produced by the electric motor assets. All of the \$400 attributable to the oil extraction assets is apportioned to U.S. source gross income because all of the oil extraction income has a U.S. source. The remaining \$600 is apportioned between U.S. and foreign sources based on the source of the gross income generated by the electric motor assets. Thus \$300 (\$3,000/\$6,000 × \$600) of the \$600 is apportioned to foreign source gross income. The total interest expense apportioned to foreign source gross income is **\$300**.

b. Electric Motor Overhead. The electric motor overhead should be allocated to the electric motor gross income and then apportioned between U.S. and foreign sources based on the factual link between the expenses and the income generated. One reasonable way to apportion would be pro rata to gross receipts. This method would result in \$1,000 (\$10,000/\$20,000 × \$2,000) being apportioned to foreign source gross income. Thus an apportionment of **\$1,000** of electric motor overhead expenses to foreign source gross income seems very reasonable. [Note: In some instances, the assets method can be used for allocating and apportioning overhead expenses. It should not be used here, however, because the overhead expenses clearly should be allocated to the electric motor gross income.]

c. Oil Extraction Overhead. The oil extraction overhead expense should be allocated to gross income from oil extraction. All of that overhead should be apportioned to the U.S. because all of the assets, gross receipts, and gross income relating to oil extraction are linked to the U.S. Thus **\$0** of the oil extraction overhead expense should be apportioned to foreign source gross income.

d. Electric Motor R&D. All of the R&D expense should be allocated to gross income in the SIC major group 36 (Electrical and electronic machinery, equipment and supplies). Assumption # 11 from page 2 of exam states that 50% of the deduction should be is attributed to the place where the R&D was conducted. Thus \$250 (50% of \$500) is initially apportioned to U.S. source gross income. The remaining 50% is apportioned using the sales (gross receipts) method under the assumptions of the question. Thus **\$125** (\$10,000/\$20,000 × \$250) of the total R&D deduction is apportioned to foreign source gross income.

e. Final Calculation. The total of deductions apportioned to foreign source gross income is \$300 + \$1,000 + \$0 + \$125 = \$1,425. The total **foreign source taxable income is \$1,575** (\$3,000 foreign source gross income – \$1,425 foreign source deductions).