Exam No. __________

Wayne State University
Law School

Fall Term, 1996
Prof. Michael J. McIntyre

INTERNATIONAL ASPECTS of U.S. TAXATION

Maximum Time: 3 hours

Maximum Points: 100

Monday, December 16, 1996

Instructions

1. Write your **Exam Number** in the space provided in the upper right hand corner of this page and also on page 6 (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 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. LLM 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 those portions of the Regulations that were distributed, the McIntyre treatise, and the Workbook. 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 two parts. Answer the four (4) questions in part I in your blue-book, noting the space guidelines. Part II contains twelve (12) multiple choice questions. Answer that part *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 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 36 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 minimus 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. For purposes of computing the allocation of research and development expenses, assume that one-half of the expenses are allocated to the place where the research is conducted and the other on-half is allocated in accordance with the sales (gross receipts) method.

12. The 1993 and 1996 tax acts (and all previous tax acts) are fully effective and any transitional provisions have lapsed or expired.

I. Essay
(maximum points: 52)

Instructions. Answer the following two 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.*

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. A double-spaced page of a bluebook has 25 lines.

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.

A.
(Maximum points: 16)
(Maximum Length: 2 bluebook page, double spaced)

Everett and his younger brother, Dan, are Canadian residents and citizens who have lived all of their lives on Prince Edward Island, Canada. Their main line of work is fishing for lobsters during the fishing season (April to June). The rest of the year they do various odd jobs. Everett owns and lives on a farm on which many evergreen trees grow wild. He has a few cows and chickens on his farm but does not cultivate the land. This fall, he decides to cut the evergreen trees, bundled them up, load them onto his truck, and sell them in the United States as Christmas trees. With Dan's help, Everett cuts and bundles 200 trees. He and Dan drive the truck to Boston, Massachusetts, where they sell the trees to a Christmas tree distributor for $2,000. Everett and Dan then return to P.E.I. Everett pays Dan $500 for his contribution to the enterprise.

Question 1. Are Everett or Dan (or both) taxable in the United States on the sale of trees under the Code? Are they entitled to protection against U.S. income tax under the U.S./Canada tax treaty? Explain.

B.
(Maximum points: 26)
(Maximum Length: 3 bluebook pages, double spaced)

Some Canadian taxpayers have attempted to shift income to a tax haven corporation and avoid both U.S. and Canadian taxation through the use of a tax haven entity that would constitute a partnership under U.S. tax law and a corporation under Canadian tax law. The following example illustrates a typical such transaction.

> C-1 and C-2 are Canadian resident individuals. They organize TH, a hybrid entity, in the Bahamas, where it is exempt from taxation. TH generally is treated as a corporation under Canadian tax law and as a partnership under U.S. tax law. It invests $400 million in the United States, earning annual interest and dividends of $35 million. Absent treaty protection, the interest and dividends would be subject to a U.S. withholding tax of 30 percent. C-1 and C-2 assert that TH should be treated as a partnership for U.S. tax treaty purposes and that they should be entitled to a reduced withholding rate under the U.S./Canada tax treaty on the ground that they are qualified residents of Canada and are the beneficial owners of the $35 million.

The United States has issued proposed withholding tax regulations that would require U.S. payors to withhold the 30 percent U.S. withholding tax in the above circumstances. Treasury argues that the "beneficial owner" of the U.S. investment should be determined, for purposes of the U.S./Canada tax treaty, under Canadian law. The proposed regulations would treat TH in the above example as the beneficial owner of the $35 million and would subject the income to the 30-percent withholding tax. Because TH is the beneficial owner under Canadian law, no reduction in withholding tax would be permitted, in that TH is not entitled to treaty benefits.

Question 2 (16 points). The U.S. proposed withholding tax regulations have been heavily criticized by the international tax avoidance community. Central to their argument against the regulations is their belief that it is the Canadian tax that is being avoided through the dual-character entity and that the United States should not attempt to be the international tax avoidance policeman. Give your best defense of the regulations on tax policy grounds.

Question 3 (10 points). If the Canadian CFC rules were similar to the U.S. subpart F rules, would this tax avoidance scheme work? Explain.

C.

(Maximum points: 10)
(Maximum Length: 1 bluebook page, double spaced)

P, a U.S. corporation, is in the greeting card business. It has established a subsidiary, N, in the Netherlands to design the cards. The cards are printed in France by another subsidiary, F. F sells the cards in the European Union and in North America. N is organized under the laws of the Netherlands, and F is organized under the laws of France. All countries mentioned in this question have bilateral tax treaties with each other.

For the current year, F earned taxable income of $1 million from the manufacture and sale of cards. F makes sales to independent distributors in Spain, Italy, and United Kingdom. These sales make up 40 percent of total sales. The price to these distributors is $.50 per card. F's unit cost of producing the cards is $.25. The cards sell to retail shops for $1.00 each. F does not have a permanent establishment in these countries. Under French tax law, F is taxable in France on these sales. F also sells cards to retail shops in France and is taxable on those sales. The French sales make up 10% of total sales.

F also makes sales to retail shops in Germany and the United States. It has a permanent establishment in both countries. The U.S sales make up 40 percent of total sales and the German sales make up 20 percent of total sales. Because F has a permanent establishment in those countries, it is not taxable by France on the income attributable to the German and American permanent establishments. It is taxable on that income, however, by Germany and the United States.

N receives $200,000 from F for its design work. That aount is exactly enough to cover N's costs without any profit. P and F have been informed by the Dutch tax authorities that they intend to reallocate $100,000 of income from F to N under the Dutch equivalent of Code section 482 on the ground that 10 percent of the profits from the card sales are due to the design work undertaken in the Netherlands. The Dutch tax rate is 50%. You should assume that this adjustment is appropriate under the arm's length standard.

P comes to you for tax advice about its transfer pricing problem. It wants to know what it can do to avoid double taxation as a result of the Dutch adjustment. It also wants your advice on what it might do in the future to minimize the risk of a future adjustment by the Dutch without creating transfer pricing problems in other countries. You should assume that the business aspects of the arrangements cannot be changed. That is, design must be done in the Netherlands, manufacturing must be done in France, and sales must remain in the current market states.

Question 4. What advice do you give to P? Explain.

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II. Multiple Choice Questions
(maximum points: 48)

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.*

[Multiple Choice Questions are not made public.]

--- Space to Explain Multiple Choice Answers ---
Use ONLY if necessary

Question (   )____

Question (   )____

Question (   )____