Exam No. _________

Wayne State University
Law School

Winter Term, 2002
Prof. Michael J. McIntyre

International Aspects of U.S. Taxation

Lex 7401

Maximum Time: 3 hours
Maximum Points: 100
Tuesday, April 30, 2002 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 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 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. 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 (1 1/2 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. For purposes of computing the allocation of research and experimental expenses, assume that one-half of the expenses is allocated to the place where the research is conducted and the other one-half is allocated in accordance with the sales (gross receipts) method.

12. The various tax acts through 2002 are fully effective and any transitional provisions have lapsed or expired.

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

14. All transactions occur at arm's length.

I. Essay
(maximum points: 40)

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.*

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.

> 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. Short Answer
(Maximum points: 20)
(Maximum Length: 1 bluebook page, double spaced)

Question 1

If a case like *U.S. Steel* were to arise today, how would the IRS attempt to prevent the tax avoidance that occurred in that case? Explain, with reference to the Code and any relevant Treasury Regulations.

Question 2

If a case like *CCA, Inc.* were to arise today, how would the IRS attempt to prevent the tax avoidance that occurred in that case? Explain, with reference to the Code and any relevant Treasury Regulations.

B. Tax Planning

(Maximum points: 20)
(Maximum Length: 2 bluebook pages, double spaced)

Flowers, Inc., is an S corporation, organized under the laws of Delaware. As a result of its S election, its profits are not subject to the U.S. corporate tax but are taxable (whether or not distributed) to its two shareholders, Mr. and Mrs. Flowers. Flowers, Inc.,has operated a flower farm and nursery in Northville, Michigan, for many years, selling evergreens and flowering shrubs imported from Canada and bedding plants grown in its own greenhouse in Northville. Its annual profits exceed $200,000. For all relevant purposes, you should assume that Flowers, Inc., cannot change its place of incorporation or otherwise change its U.S. tax status without incurring prohibitive U.S. taxes. Flowers, Inc., is now planning to expand its operations in two ways.

First, Flowers, Inc., intends to set up a company, CCo, in Canada to grow evergreens and flowering shrubs. CCo would sell the plants to Flowers, Inc., replacing the independent growers that Flowers, Inc. had dealt with in the past. To spread its overhead, CCo would also sell plants to independent nurseries in Wisconsin and Ohio. For all relevant purposes, you should assume that the establishment of a separate corporation in Canada is a business necessity.

Second, Flowers, Inc., intends to set up a mail order business for tulip, daffodil, and other spring bulbs, which it would purchase from independent growers in the Netherlands and sell through a catalogue, primarily to its regular U.S. nursery customers. The bulbs would be made available, however, to any U.S. customers who wished to buy them.

AA,PLC, the accounting firm used by Flowers, Inc., has presented the management of the company with the following tax plan:

(1) Flowers, Inc. would establish HCo, a wholly-owned foreign subsidiary, in the Netherlands Antilles, a tax haven country. HCo would purchase the bulbs in the Netherlands and sell them at a high markup to Flowers, Inc., resulting in large profits in the Netherlands Antilles. The idea is that HCo would not be taxable in the Netherlands under the tax treaty between the Netherlands and the Netherlands Antilles. It would not be taxable in the United States under code section 882 because it would avoid having a U.S. office or other fixed place of business and would pass title to the bulbs outside the United States. HCo's profits would not be taxable in the Netherlands Antilles because the Antilles does not impose income taxes on foreign sales income. HCo would not distribute any of its profits to Flowers, Inc. The United States has a tax treaty with the Netherlands but does not have a treaty with the Netherlands Antilles.

(2) Flowers, Inc., would establish CCo, the Canadian subsidiary, by contributing $500,000 in capital in exchange for all of the stock of CCo. The capital would be used by CCo to acquire land and other assets for its nursery business. Flowers, Inc. would obtain the $500,000 by taking out a loan from an unrelated U.S. bank. Interest would be due on the loan at the market rate of seven percent. CCo would be taxable in Canada at a rate of 45 percent (including provincial income taxes). Because that rate is higher than the applicable U.S. rate (assumed to be 35 percent for purposes of this problem), CCo would try to minimize its Canadian profits by selling the plants to Flowers, Inc. at cost plus 20 percent.

Question 4

What dangers, problems, or just bad tax planning do you see in the above plan? How would you modify the plan to obtain a better tax result? Explain, with reference to authorities.

***Note**: In formulating your revised plan, you are not free to change the business elements of the plan, to change the corporate structure of Flowers, Inc., or to eliminate the separate corporation in Canada.*

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

[Multiple Choice and True/False Not Disclosed]