Exam No. ________

Wayne State University
Law School

Winter Term, 1999
Prof. Michael J. McIntyre

International Aspects of U.S. Taxation

Maximum Time: 3 hours

Maximum Points: 100

Thursday, May 13, 1999 at 9:30 a.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 those portions of the Regulations that were distributed, the McIntyre treatise and Workbook, and the supplements to those materials. 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 three (3) questions in part I in your bluebook, noting the space guidelines. Part II contains ten (10) 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 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 development expenses, assume that one-half of the expenses are 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 1993, 1996, 1997, and 1998 tax acts (and all previous tax acts) are fully effective and any transitional provisions have lapsed or expired.

I. Essay
(maximum points: 50)

Instructions. Answer the following three 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. Foreign Tax Credit
(Maximum points: 15)
(Maximum Length: 2 bluebook page, double spaced)

Q is a U.S. corporation. It owns 80 percent of the stock of S, a Swiss corporation. S owns 50 percent of the stock of F, a French corporation.

F earns gross income from normal business activities of $400 and has deductible expenses of $100. It has taxable income under French and U.S. tax concepts of $300 ($400 – $100). It pays taxes of $100 to France. Its after-tax profits (and accumulated earnings and profits) are $200 ($300 – $100). None of the income is subpart F income or any other special category of income. F pays a dividend of $100 to its shareholders. Thus S receives a dividend of $50 from F.

S has income of $230 from leasing real property to an unrelated business located in Switzerland under a net lease, with the lessee responsible for paying all expenses and managing all repairs. It also has interest income of $20 from its Swiss bank account. Thus its total income is $300 ($50 + $230 + $20). It pays tax to Switzerland on its net income of $300 at a rate of 10 percent, for a tax of $30. It distributes all of its after-tax profits (and accumulated earnings and profits) of $270 to its shareholders, with Q being entitled to $216 (80% of $270).

Question 1. How much gross income should Q report as a result of the transactions described above? What is the amount of the foreign tax credit that Q can claim, leaving aside limitation issues? What is the limitation on the credit? Show your calculations. Ignore all possible treaty issues.

B. Tax Planning

(Maximum points: 20)
(Maximum Length: 3 bluebook pages, double spaced)

FCo is a Canadian company that manufactures outdoor wooden furniture, such as picnic tables and benches, in London, Ontario, Canada. It sells much of that furniture in the United States under the brand name Northern Rustics®. Over the past two years, FCo has been facing very difficult competition from furniture produced in China and exported to Canada and the United States. In response to that competition, FCo has entered into a joint venture with CCo, an unrelated Chinese company. Under the joint agreement, CCo will manufacture furniture in China for FCo in accordance with the specifications set by FCo.

In the past, FCo has sold its furniture in the United States to large retail establishments, such as Sears, K-Mart, and Wal-Mart. FCo has a few sales people who regularly travel to the United States, but it does not have an office in the United States. Sales to the large U.S. retail outlets are made in London, Ontario, with title passing in Canada. The goods are shipped to the United States on trucks owned or leased by the buyers. FCo has not been filing a U.S. tax return but has been paying Canadian national and provincial income taxes at an aggregate rate of 45 percent.

In conjunction with the joint venture arrangement with CCo, FCo intends to set up a U.S. subsidiary, UCo, to make its U.S. sales. UCo would buy furniture from CCo under the joint venture agreement and resell it to Sears and other U.S. retailers. The furniture would have the Northern Rustic® brand name stamped onto the furniture. UCo would also purchase furniture made by FCo for resale. FCo intends to pursue the U.S. market aggressively. It will add to its U.S. sales force and will utilize UCo's facilities as the headquarters for its U.S. sales force.

Question 2. Discuss the U.S. tax aspects of FCo's business plan, including the impact, if any, of the U.S./Canada tax treaty. In particular, comment on the following points:

(a) The potential tax benefits from the plan to establish UCo as a U.S. affiliate.

(b) The transfer pricing issues that might arise on the purchases by UCo from Cco and FCo.

(c) The likelihood that FCo is taxable in the United States, both before the establishment of UCo and after the new plan is put into effect. Your answer should state clearly how you think FCo will be taxed by the United States, with appropriate references to the Internal Revenue Code.

(d) The tax benefits that might be obtained from changes or clarifications in the current plan, assuming that the business aspects of the plan are set.

C. Tax Policy

(Maximum points: 15)
(Maximum Length: 2 bluebook pages, double spaced)

Canadian and American tax officials currently are engaged in discussions about the possible reduction in the maximum withholding rate on interest income of 10-percent provided in Article XI of the U.S./Canada tax treaty. U.S. and Canadian companies engaged in businesses in the United States and Canada have been urging the countries to agree to a withholding rate of zero. They claim that reduction of the rate would stimulate business in both countries and make them more competitive in the global marketplace. The increase in business, they assert, would more than offset any reduction in tax revenues resulting from the cut in interest rates.

Canada currently collects around $100 million in withholding taxes on interest payments made to U.S. residents. The United States collects about $70 million in withholding taxes on interest income paid to Canadian residents. Both countries exempt significant amounts of interest income paid to unrelated persons under their domestic tax laws. Most of the tax revenue collected by both countries comes from interest paid to related persons. Canada exempts its residents on business income earned in the United States or in other countries with which it has a tax treaty. In other circumstances, it provides a credit for foreign taxes paid by its residents.

Question 3. You have been asked by representatives of the Canadian and American governments to give them advice on whether they should recommend a reduction in the withholding tax rate on interest income. What do you tell them? In particular, comment briefly on the following issues:

(a) The possibility that the revenue loss that Canada and the United States would suffer from lower rates might be offset, in whole or in part, by higher tax revenues resulting from an increase in business in Canada and the United States?

(b) The type of tax avoidance that U.S. and Canadian companies might attempt in response to an elimination of the withholding tax on interest.

(c) The treaty-shopping problems that Canada might expect if it reduces its withholding rate to zero on interest paid to U.S. residents while retaining the 10 percent rate on interest paid to residents of other treaty countries. Discuss, in particular, whether the Limitation on Benefits article of the current U.S./Canada treaty will be helpful to Canada in this regard.

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II. Multiple Choice Questions
(maximum points: 50)

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 not made public.]

*** End of Exam ***

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

Question (   )

Question (   )

Question (   )