Exam No. _________

Wayne State University
Law School

Winter Term, 2003
Prof. Michael J. McIntyre

International Aspects of U.S. Taxation

Lex 7401

Maximum Time: 3 hours
Maximum Points: 100
Wednesday, May 7, 2003, at 9:30 a.m., Room 1550

Instructions

1. Write your **Exam Number** in the space provided in the upper right hand corner of this page and also on page 7 (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 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 questions in part I in your bluebook, noting the space guidelines. Part II contains thirteen (13) multiple choice questions, and Part III contains sixteen (16) 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 2003 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: 45)

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: 30)
(Maximum Length: 5 bluebook pages, double spaced)

PCo is a U.S. corporation, organized under the laws of Delaware. It has a wholly-owned subsidiary, SCo, that is organized under the laws of Sweden and is treated as a foreign corporation for U.S. tax purposes. SCo manufactures steel springs used for various industrial purposes; it sells the springs to manufacturers located in Europe and the United States. SCo has organized a wholly-owned subsidiary, HCo, which is organized under the laws of Panama, a tax-haven country. HCo charters boats used to transport the springs manufactured by SCo to the countries of sale. HCo is treated as a Panama corporation for U.S. tax purposes.

During the current taxable year, HCo earns $90,000 from its shipping operations. It also earns interest income of $10,000 on its cash reserves. It pays a dividend to SCo of $50,000. HCo does not pay any income taxes. The dividend paid by HCo to SCo is not taxable by Sweden.

SCo earns gross income of $400,000 from the manufacture and sale of springs and is taxable on that amount in Sweden. Of that amount, $100,000 is from the sale of springs in the United States. SCo has an office in the United States, and it makes the sales in the United States through that office. It pays U.S. income taxes of $35,000 on the U.S. income of $100,000. The remaining $300,000 of income is derived from sales in Europe. SCo pays no income taxes in the European countries of sale, but it does pay income taxes of $90,000 (30%) to the Government of Sweden on that income. The income of $100,000 earned by SCo in the United States is taxable by Sweden at a rate of 30 percent. Sweden, however, allows a credit for the U.S. tax under its tax treaty with the United States. As a result, no additional Sweden tax is due, and SCo has an excess credit for Swedish tax purposes of $5,000 ($35,000 U.S. tax – $30,000 allowable credit).

In the manufacture of the springs, SCo uses various metals, including manganese. It obtains the manganese from deep-sea mining of manganese nodules from the ocean floor in the North Sea, outside the territorial waters of any country. During the current taxable year, SCo has a surplus of manganese nodules, so it sells the surplus to an unrelated steel producer for a profit of $150,000. That income is treated under Swedish law as Sweden source income, under a source rule similar to the one contained in IRC § 863(d). Sweden imposes an excess profits tax on income earned on or under the high seas. The combination of the regular income tax and the excess profits tax results in a combined tax rate on such income of 50 percent. As a result, SCo pays a Sweden tax on the manganese-nodules income of $75,000 (50% of $150,000). In answering the questions in this Section I,A below, other than Question 1, you should assume that the excess profits tax is a creditable income tax under U.S. tax concepts.

In summary, SCo had total income for the current year of $600,000 ($50,000 dividend from HCo, $400,000 springs profits, and $150,000 from manganese nodules). For simplicity, assume that SCo had no deductible expenses. You may assume that it has earnings and profits (its after-tax income) for the year of $400,000 ($600,000 income – $35,000 U.S. tax – $90,000 Sweden tax on springs profits -- $75,000 Sweden tax on manganese modules).

During the taxable year, SCo pays a dividend to PCo of $400,000 out of its earnings and profits of $400,000. That is, SCo distributes all of its after-tax income.

Question 1 (3 points)

Is the excess profits tax imposed by Sweden on the income from manganese nodules a creditable income tax under U.S. tax concepts? What authority can you cite to support PCo's claim that it is a creditable income tax. You should cite the Treasury Regulations and relevant case law studied in this course.

Question 2 (3 points)

Which of the separate limitation baskets are relevant in determining the amount of foreign tax credit that PCo may claim? That is, in which baskets does PCo have taxable income? List all of the relevant baskets and no others.

Question 3 (6 points)

Is PCo taxable on any subpart F income? If so, state the amount of that income taxable to PCo and label each item of subpart F income, stating the type of income and the company that earned it. Explain your answer, with appropriate references to the Code.

Question 4 (3 points)

Compute PCo's gross-up amount. Show your work.

Question 5 (5 points)

Compute the amount of income in each of the separate baskets that you listed in your answer to Question 2. Show your work. Clearly label each item of income in each basket, stating the type of income and the company that earned it.

Question 6 (5 points)

Compute the amount allowable to PCo as a credit, after application of the credit limitation rules. Show your work.

Question 7 (5 points)

Assume, for purposes of this question only, that PCo arranges to have HCo check the box to be an ignored entity, so that it is treated under U.S. tax laws as a branch of SCo. Assume also that this election has no effect under foreign law. What effect, if any, would this check-the-box election have on the computation of HCo's subpart F income? Explain the effect, or, if there is no effect, explain why there is no effect.

B. Tax Policy
(Maximum points: 15)
(Maximum Length: 3 bluebook pages, double spaced)

Under the Code, a foreign person is taxable on its business profits that are effectively connected with a U.S. trade or business (ECI). U.S. tax treaties provide that a foreign person resident in a treaty country is taxable by the United States on its business profits if the taxpayer has a permanent establishment (PE) located within the United States and its profits are earned through that PE. Because tax treaties are relieving only, the taxpayer may pick the more favorable of the ETI rule and the PE rule.

Question 8

Assuming that the United States is prepared to revise its Code rules for taxing foreign corporations and is free to renegotiate its tax treaties to conform with the new Code rules, which of the two rules, the ETI rule or the PE rule, should it adopt? Discuss *as a matter of tax policy* which of the two rules is better. As part of your answer, list what you consider to be the strengths and weaknesses of the two rules, note how one rule or the other may be more or less favorable to the taxpayer, and then give an overall evaluation of the two rules with a specific recommendation for action by Congress. Do not discuss problems that might arise in getting other countries to go along with the new rules — just assume that other countries will see the wisdom of your recommendation and will go along with it.

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

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II. Multiple Choice Questions
(maximum points: 39 — 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.

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 and true/false questions omitted**.]