Notes on the Answers
International Tax, Winter 2007
Prof. McIntyre

Question 1 (10 points, maximum length: 1 bluebook page, double spaced).

Is FCo taxable in the United States? Discuss both the tax treatment under the Code and under the U.S./France tax treaty. You may assume that this treaty follows the OECD Model Convention and has no special features.

Yes. FCo has a dependent agent, HCo, that has a U.S. office, through which it is conducting business. Two results of this relationship:

First, FCo is engaged in a trade or business in the U.S.

Second, the income from sales through HCo's office to U.S. customers is U.S. source income under the office rule of IRC § 865(e).

As a result, FCo's income from the sale of cheese in the U.S. is income effectively connected with a U.S. trade or business (ECI).

The treaty answer is the same. HCo is FCo's dependent agent, and that dependent agent is a PE of FCo under Article 5(5) of the treaty. This answer assumes that HCo has the power to make contracts in FCo's name, but HCo must have that power to be able to sell the cheese to U.S. customers on behalf of FCo.

All of FCo's income from the sale of the cheese is U.S. source income. The applicable source rule is IRC § 861(a)(6) (purchase of inventory property outside the U.S. and sale within). As stated in the question, FCo bought the cheese from an unrelated manufacturer in France. (Note: If FCo had produced he cheese itself, then the 50/50 splitting rule of IRC § 863(b) might have applied.)

Under the treaty, only the income attributed to the PE is taxable by the U.S. The treaty encourages the use of transfer-pricing principles. Since HCo received a market-value commission for its work, all of FCo's income from the sale should be U.S. source income under the treaty — same result as under the Code.

Question 2 (15 points, maximum length: 1 bluebook page, double spaced).

How is ACo taxed on the dividend of $1,324 received from FCo? Compute ACo's taxable income and the allowable foreign tax credit that ACo can claim for the foreign income taxes it paid directly or indirectly to a foreign government. Also compute the limitation on the credit. Show your work and explain how you reached your result. Ignore the possible application of any tax treaty.

Taxable income. ACo's taxable income equals the dividend of $1,324 plus the gross-up amount. The gross-up amount is the amount of taxes deemed paid by ACo ($276, see below). Thus, ACo has taxable income of $1,600. Its tentative U.S. tax is $560 ($1,600 × .35).

Ownership requirements. The ownership requirements are met with respect to FCo and GCo. ACo owns 10% or more (100%) of the voting stock of FCo, FCo owns 10% or more (60%) of the voting stock of GCo. and ACo's indirect ownership of the GCo stock is 5% or more (100% × 60% = 60%). See IRC § 902(b).

Allowable Deemed-paid (indirect) credit. The deemed-paid credit is the $36 income tax paid by FCo to France plus the amount deemed paid on account of the dividend that FCo received from GCo. That latter amount is 60% of one half of the income tax paid by GCo to Germany. The tax paid to Germany was $800, so the tax associated with the dividend from GCo to FCo was $240 ($800 × 60% × 50%). The total allowable credit is $276 ($36 + $240). This is also the gross-up amount.

Credit Limitation. The general basket limit on the credit is the foreign source income in the general basket multiplied by 35%. All of ACo's income comes from a dividend from FCo. So, the problem is to compute the portion of the dividend that is foreign source income.

The general rule is that dividends from a foreign corporation are foreign source income. IRC § 862(a)(2). However, an exception applies if 25% or more of the income of the foreign corporation paying the dividend is income that is effectively connected to a U.S. business (ECI). See IRC § 861(a)(2)(B). As discussed in Question 1, above, FCo has income of $1,000 that is U.S. source income, derived from the sale of cheese in the U.S. It also has income of $360 from the dividend from GCo, so FCo's total income is $1,360. The exception applies because 25% or more of FCo's gross income is ECI.

Under the exception, the amount of the dividend that is foreign-source income is $1,324 × ($360/$1,360) = $350.47. (Note: I'm treating FCo as having $1,000 of gross income and net income from the cheese sales.) The limitation on the credit equals $122.66 ($350.47 × .35).

U.S. Tax. To compute its U.S. tax liability, ACo subtracts the allowable credit, after application of the limitation, from the tentative U.S. tax, resulting in a U.S. tax due of $437.34 ($560 – $122.66).

Question 3 (15 points).

Evaluate the Dorgan-Levin proposal. In particular, discuss whether the proposal, if adopted and administered effectively, would achieve a fair result and whether it would have negative or positive consequences for the U.S. economy. Also discuss whether you believe it would be likely to achieve its objective of combating offshore tax-haven abuses. What changes, if any, would you make to the proposal to better achieve its professed goal?

The effect of the proposal, by making a "tax-haven CFC" a U.S. corporation, is to tax that corporation on its worldwide income at the U.S. rate. As a result, the use of such a corporation would no longer be an effective for avoiding U.S. tax. Assuming that companies did not find other ways of sheltering foreign source income, the likely result would be to remove an incentive for moving profits from the U.S. to a tax haven. It would also reduce the benefits for U.S.-based multinationals of avoiding taxes in other industrialized countries

A key to the effectiveness of the provision working is having a good list of tax-haven countries and keeping that list up to date. One can assume that countries not on the list will suddenly find themselves with opportunities to become a tax haven. So the IRS probably needs to have the authority to add countries to the list, based on some criteria.

The exception for foreign corporations that earn substantially all of their income in their home country means that it will still be okay for a country like Ireland to offer tax holidays as long as the income being excepted is earned in Ireland. The apparent point of this exception is to allow U.S.-based multinationals to compete in tax-haven countries with foreign corporations that are not taxable in their home country. That is, it tries to respond to the concern about competitiveness without creating tax-haven abuses. It does create problems for a CFC engaged in cross-border manufacturing.

In contrast to subpart F, which only affects U.S. shareholders of a CFC, this proposal would have an adverse effect on the foreign shareholders of a tax-haven CFC. I'm not sure if this is good or bad.

We can expect all of the strains we now see under Subpart F to come into play. U.S.-based multinationals will try to have non-controlled foreign companies or to operate through a trust or partnership. I think the IRS needs to have broad powers to issue regulations to prevent avoidance of the purpose of the section. The current CFC definition is not working well for offshore insurance and for captive insurance companies. In such cases, it has been necessary to have a broader rule — only 25% ownership is enough and ownership by any U.S. person counts, not just U.S. shareholders. I would not want a 25% rule here, but getting rid of the 10% requirement for a U.S. shareholder might be a good idea. I also would want some safeguards against using tax-haven CFCs to import foreign losses.