

International Aspects of U.S. Taxation

Lex 7401

Maximum Time: 3 hours

Maximum Points: 100

Friday, April 25, 2008, at 1:30 p.m. to 4:30 p.m., Rm 1550

Instructions

1. Write your **Exam Number** (if it is not already there) 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 the essay questions on a laptop computer, please follow the instructions for the use of laptops. Be sure that your Exam Number, the name of the instructor (McIntyre), and the name of the course are on the first page of your answer sheets.
2. Thank you for putting your **Exam Number** and other information in the appropriate spaces. (If you have not already 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 selected sections 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 six (6) questions in Part I in your bluebook or type your answers on your laptop computer, noting the space guidelines. Part II contains twelve (12) multiple choice questions, and Part III contains fourteen (14) True/False questions. *All students* (including those using laptop computers) must answer Parts II and III *on their 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). Also, write in ink in the bluebook (pencil is fine for the Multiple Choice). If you are typing, please leave big margins (1½ 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 35 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 (1997) 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. The various tax acts through 2007 are fully effective, and any transitional provisions have lapsed or expired.
12. The taxpayer has no carrybacks or carryforwards of the foreign tax credit.

I. Essay

(maximum points: 50)

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

Instructions. Answer the following questions in your bluebook, or type your answers on a laptop computer, following the instructions for laptop use during exams. 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.* No penalty is imposed for exceeding the space limits by 3 lines or less.

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-sized 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: 30)

(Maximum Length: 3 bluebook pages, double-spaced)

Ideal Homes, Inc. (Ideal) is a Canadian company that “manufactures” houses at its plant outside Toronto. The houses are then shipped and installed at locations all over North America. It has tax credits in Canada that have the effect of eliminating all Canadian income taxes for the next five years. Many of the houses are sold in the United States.

Here is how business is conducted in the United States. A potential buyer contacts Ideal, by phone or email, at its headquarters in Canada. Ideal has a website, unfortunately down during this exam, that shows various model homes and the many options available to the buyer. The buyer enters into a contract with Ideal to fabricate the home in Canada according to the buyer’s specifications. Because Ideal ships all over the United States, all of its houses must meet the building code of all of the major markets, resulting in some loss of flexibility for the buyer. Still, the buyer can decide on such things as the number of rooms, whether or not to have a door to a porch or deck, the type of heating and A/C unit, and so forth. The buyer also must contract with a local contractor for digging and preparing the foundation, hooking up the local electricity and other utilities, and building any attached structures, such as a garage, deck, or porch.

Before Ideal will begin fabricating a house for a buyer, it insists on one of its employees visiting the intended location to see that the location is suitable. The employee typically arranges for a local engineer to test the drainage of the house site and otherwise makes sure that the installation of the house will go according to plan. The employee also meets the buyer, discusses the buyer's plans, and explains which features are available and what compromises must be made. The employee also gives advice on a color scheme that is consistent with the buyer's location. The employee, however, does not sign any contracts or ask the buyer to sign anything. All of the actual orders are done over the Internet with the Toronto office. The employee will continue to have contact with the buyer after the site visit to let the buyer know how the house is progressing and to deal with the many late changes that are typical in the construction of a house. The employee is authorized to agree to color changes and other changes in the plans as long as the changes do not increase the overall price or are items with fixed prices, such as the installation of certain equipment.

Ideal ships the house by truck from Toronto to the buyer's location, using a common carrier. The buyer pays the actual shipping costs. Ideal gives a five-year warranty on all equipment that it includes in the house, including the heating and A/C unit. In 2007, Ideal sold 8,000 houses in the United States for gross proceeds of \$2 million. It has expenses relating to the U.S. production of \$1.5 million and net profits of \$500,000. Before Idea will begin the fabrication of a house, the buyer must make a down payment equal to 25% of the final price. An additional 25% is due prior to shipping, and the final 50% is due when the house arrives at the buyer's location. Title to the house passes in Toronto at the time of shipping. Most buyers finance their purchase through a local lending institution. Ideal does not provide any financing.

Question 1 (10 points). Is Ideal engaged in business in the United States? Discuss, with references to the Code and relevant case law.

Question 2 (15 points). For purposes of this Question 2, assume that Ideal is engaged in business in the United States. Does Ideal have any income that is effectively connected with a U.S. trade or business? If so, how much? Discuss, with appropriate references to the Code.

Question 3 (5 points). For purposes of this Question 3, assume that Ideal has some ECI. Can it gain any protection from U.S. taxation under the U.S./Canada (1997) income tax treaty? Discuss.

B.

(Maximum points: 20)

(Maximum Length: 2 bluebook pages, double-spaced)

Molly and Jeff (M&F) are research engineers at the University of Massachusetts (UMass). They have invented a biofuel that could cost as little as \$1 per gallon and could serve as a replacement for gasoline. Using a revolutionary process that rapidly heats, then cools wood, grass or other plants to extract hydrocarbons, M&F and their team of graduate assistants are

able to produce a liquid identical to gasoline in a brief, single-step process. The process works perfectly on a small scale. Further improvements are needed to prove its viability on a large scale. If those improvements are made successfully, the biofuel could become an economically viable alternative to gasoline. The research project has been funded by UMass and by grants from several foundations.

Under their contract with the UMass, M&F are expected to apply for a patent, in their own names, for any discoveries made as researchers at UMass. They are entitled to one-third of the royalties (one-sixth each) that may be generated from such patents. UMass is entitled to the other two-thirds.

Two years before beginning work on the biofuel project, M&F established a corporation, BCo, organized under the laws of Bermuda. For all relevant purposes, Bermuda has no income tax. M&F transferred to BCo all of their rights under any patents that may be awarded to them as a result of joint research projects at UMass. At that time, they valued those rights at \$1,000 and paid U.S. income tax on the transfer. For purposes of the questions below, you should assume that M&F can justify the valuation placed on the rights transferred to BCo and that BCo will be treated as the owner of M&F's share of the patent rights.

Molly is a Canadian citizen and is not a citizen of the United States. She lives in Amherst, Massachusetts, for most of the year, but returns to Canada for short visits with her family (mother, father, and two siblings). She is not married and has no children. She was born in Canada, went to college at McGill University in Montreal and to graduate school at the University of Toronto. She has retained, with pride, her Canadian accent and views herself as a Canadian. She even roots for the Toronto Blue Jays and the Toronto Argonauts. Jeff is a U.S. citizen and resident, born in Saline, Michigan.

Question 4 (5 points). Is BCo a CFC? Explain.

Question 5 (10 points). Assume, for purposes of this Question 5 and Question 6, that BCo is a CFC. Assume also, for purposes of this Question 5 and Question 6, that the biofuel project is highly successful and that M&F develop a commercially viable way of making biofuel at a cost under \$2 per gallon. With the consent of UMass, M&F license the technology to Dutch Biofuels, NA (DB), an unrelated corporation organized in the Netherlands and owned by Dutch shareholders. In 2008, BCo receives a royalty of \$50 million from DB. BCo does not distribute any of its income to M&F. Is BCo's royalty income subpart F income, taxable to BCo's U.S. shareholders as a deemed dividend? Discuss, with appropriate references to the Code.

Question 6 (5 points). Assume that the Netherlands imposes a withholding tax of 5% on the royalty payment from DB to BCo. Under what circumstances can M&F get a foreign tax credit for the withholding tax of \$2.5 million paid to the government of the Netherlands?

Exam No. _____

II. Multiple Choice Questions (maximum points: 36 — 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, in 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, 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 Omitted]

III. True/False Questions (maximum points: 14)

Mark your choice of alternative answers to each question by circling its identifying letter **on your copy of the exam**. Ambiguous questions may be challenged according to the rules set forth in Part II. Again, there are no intentional ambiguities.

[True/False Questions Omitted]