EXAM NO. ___________

Wayne State University
Law School

Fall 2003
Prof. Michael J. McIntyre

INTERNATIONAL TAX TREATIES

Maximum Time: 2 hours
Maximum Points: 100
Tuesday, December 9, 2003
1:30 – 3:30 p.m., Room 1550

Instructions

1. **Write your examination number**, the name of this course (Int'l Tax Treaties), and the name of the instructor (McIntyre) in the appropriate spaces on your **bluebook** . Please do this now. Do **not** put your own name or any information about your personal status (i.e., graduating senior, graduate student) anywhere on the bluebook.

2. *Thank you for putting your exam number and other information in the appropriate spaces*. This is an **open book** examination. You are expected to have with you the course materials, including a copy of the OECD Model Convention and the U.S. Model Convention. You are permitted to have any books, notes, commercial outlines, or other materials you have used during the course. You may use a pocket calculator.

3. This examination has two (2) parts. Part I has essay questions, and Part II has True/False questions. The answers to the essay questions go in your bluebook. The answers to the True/False questions should be marked directly on your copy of the examination.

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.

I. Essay

Instructions. Answer the following two (2) questions (and subquestions) in your bluebook. Write in ink on every other line (double space), do not write on the back side of any page, and **do not write in the margins**. Observe the maximum space limitations. *You will suffer a grade penalty, proportionate to the offense, for exceeding the space limitations*. (As a practical matter, a penalty is not imposed for exceeding the limits by two lines or less.) One page of a bluebook, double spaced, is 14 lines.

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*: Put your exam number in the upper right hand corner of each page of your answer sheets. Number your answers clearly and observe the space limits. One handwritten line of 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.
(Maximum Points: 20)

Miss J is a resident of Country J and a high-ranking executive of KCo, a company organized and resident in Country K. Country J and Country K have entered into a tax treaty based on the UN Model Convention. Country A and Country B have no tax treaties. Under its domestic tax legislation, Country J taxes its residents on their worldwide income. Country K taxes nonresidents on all income, from whatever source derived, that it is permitted to tax under its tax treaties. Miss J does not have a permanent establishment or fixed base in Country K and has no real property (immoveable property) located in Country K. She earns the following items of income:

(1) A dividend of $1,000 received from ACo, a corporation organized and resident in Country A. Country A is an island tax haven. Miss J does not have a fixed base or permanent establishment in Country A.

(2) Gambling winnings of $20,000 won at the Casino Royale, a gambling establishment located in Country K.

(3) A consulting fee of $30,000 received for consulting work done in Country B and paid by BCo, a corporation resident in Country B. Country B is a developing country. Miss J does not have a fixed base or permanent establishment in Country B.

(4) A salary of $10,000 for performing services for KCo. The services were performed in Country B.

Question 1. (maximum lines: 24) How is Miss J taxed by Country K on each of the four items of income described above after application of the tax treaty between Country J and Country K? Your answer should indicate the provision(s) of the UN Model Convention that you believe support your position.

B.
(Maximum points: 60)

PCo is organized and resident in Country P, an industrialized country. PCo manufactures heavy electrical equipment in that country according to its own designs. Some of its technology is patented, and some is knowhow that it keeps secret from potential competitors. It exports heavy electrical equipment to most of the major industrial countries of the world.

In year 1, PCo is approached by LCo, an unrelated corporation organized and resident in Country L, a large developing country. LCo asks PCo to construct a "turnkey" plant in Country L that LCo could use to manufacture heavy electrical equipment according to PCo's designs. LCo would pay PCo $40 million dollars for designing and constructing the plant and training LCo workers to operate the plant. The plan would be for PCo to complete construction of the plant in year 1 and to operate the plant in year 2 while training the LCo employees. At the start of year 3, the plant would be turned over to LCo, and PCo would have no further role in the operation. PCo also would give a limited license to LCo to use its designs in the construction of heavy electrical equipment. LCo would pay PCo an annual royalty of $1 million under the license agreement. Under the terms of the license, LCo would not be permitted to sell goods produced under the license outside of Country L.

PCo agreed in principle to the arrangement, to the $40 million contract price, and to the $1 million royalty. It has decided, however, that it is not in a position to do the actual plant construction. For that purpose, it intends to contract with NCo, a construction firm organized and resident in Country N. NCo would do all of the construction in County L, using plans developed by PCo. NCo would be paid $14 million by LCo for its work.

In addition, PCo plans to establish a wholly-owned subsidiary, TCo, to operate the plant in Country L. TCo would be organized and resident in Country L. To give TCo the capacity to operate the new plant for a year and to train the LCo employees, LCo would transfer some of its key employees to TCo. Those employees would be "on loan," in the sense that they would be paid by TCo and would be listed as employees by TCo but would be guaranteed their old jobs back at PCo after they have completed their work in Country L. PCo would pay TCo its costs, plus 20% profit, to supervise the operations of NCo, to operate the newly constructed plant for a year, and to train the employees of LCo so that they can operate the plant beginning in year 3. These arrangements are acceptable to LCo. It is anticipated that TCo would incur expanses of $5 million and would receive a payment of $6 million (120% of $5 million). As a result, PCo would earn a net profit on the "turnkey" arrangement of $20 million ($40 million – $14 million – $6 million).

Country P has a tax treaty with Country L based primarily on the OECD Model Convention (2003). The treaty provides, however, that the source country can impose a withholding tax on royalties of 10 percent — the same rate applicable to interest. In addition, a construction site operated for at least 6 months is deemed to be a PE for purposes of Article 5 of the treaty. Country P also has a tax treaty with Country N. It is based entirely on the OECD Model Convention. Country N has a tax treaty with Country L based on the UN Model Convention (2001) except that a construction site is not deemed to be a PE unless it is present in the host country for at least 18 months.

The corporate tax rate in Country L is 40%, The rate in Country P and Country N is 30%. PCo is in an excess foreign tax credit position in Country P. That is, it has paid creditable foreign income taxes in prior years in excess of the credit limitation, and it may use those excess credits to offset the Country P tax otherwise due on its foreign source income. As a result, PCo would not pay any net taxes to Country P with respect to any foreign income (business profits, capital gains, royalties, and interest) it may earn in Country L under the proposed arrangement.

Under the contract that PCo and LCo intend to sign, LCo will make an interest-free loan to PCo of $20 million at the start of the project. Repayment of the principal of the loan is due at the start of year 3, when the project is scheduled to be completed. During the construction period and the first year of operation, PCo will be the legal owner of the plant (but not the underlying land). On the first day of year 3, PCo will sell the plant to LCo for $40 million. The expectation, however, is that LCo will pay $20 million to PCo and cancel PCo's loan obligation of $20 million.

Question 2a. (10 points, maximum lines: 14) Does PCo have a PE in Country L under the tax treaty between Country L and Country P? Discuss, with reference to the provisions of the relevant model tax convention.

Question 2b. (10 points, maximum lines: 14) Does NCo have a PE in Country L under the tax treaty between Country L and Country N? Discuss, with appropriate references to the relevant provisions of the relevant model tax convention.

Question 2c. (10 points, maximum lines: 14) PCo expects that the sale of the turnkey factory to LCo at the start of year 3 will be treated as a capital gain for purposes of the tax treaty between Country L and Country P. Assuming that PCo is correct, will PCo be exempt from tax in Country L under the tax treaty between Country P and Country L? Discuss, with appropriate references to the relevant provisions of the relevant model tax convention.

Question 2d. (15 points, maximum lines: 24) Evaluate PCo's assumption that the sale of the turnkey plant will be treated as a capital gain for purposes of the tax treaty between Country L and Country P. In particular, discuss argument(s) that might be made for treating some of the payment as interest or as royalty income or as "other income" under the tax treaty between Country L and Country P. Provide appropriate references to the relevant provisions of the relevant model tax convention.

Question 2e. (15 points, maximum lines: 24) Discuss the risks that the tax plan presents under the Country L and Country P tax treaty and discuss any missed opportunities that you see for minimizing the taxes of the enterprise in Country L. Provide appropriate references to the relevant provisions of the relevant model tax convention.

II. True/False

(Maximum points: 20)

Mark your choice of alternative answers to each question by circling its identifying letter **on your copy of the exam**. Each right answer is worth 1 point. There is no penalty for wrong answers.

True/False Questions Omitted