CHAPTER 24

TAXATION OF INTERNATIONAL TRANSACTIONS

SOLUTIONS TO PROBLEM MATERIALS

Question/ Problem	Topic	Status: Present Edition	Q/P in Prior Edition
1	Tax treaties	New	
2	Sourcing of income	Unchanged	2
3	Sourcing of income	Unchanged	3
4	Section 482	Unchanged	4
5	Foreign currency	Modified	5
6	QBUs	Unchanged	6
7	Section 367	Unchanged	7
8	Foreign Personal Holding Company	Unchanged	8
9	CFC status	Unchanged	9
10	CFC status	Unchanged	10
11	Foreign tax credit (FTC)	Unchanged	11
12	Section 78 gross up	New	
13	FIRPTA	New	
14	U.S. taxation of foreign corporation	Unchanged	14
15	Income sourcing	Unchanged	15
16	Income sourcing	Unchanged	16
17	Income sourcing	Unchanged	17
18	Interest expense allocation	New	
19	Foreign exchange gain or loss	Modified	19
20	Foreign exchange gain or loss	Unchanged	20
21	Section 367	Unchanged	21
22	Subpart F income	New	
23	Pro rata share of CFC income	Unchanged	23
24	Foreign Personal Holding Company	Unchanged	24
25	Foreign tax credit (FTC)	New	
26	Foreign tax credit (FTC)	Unchanged	26
27	Foreign tax credit (FTC)	Unchanged	27
28	Indirect FTC	Unchanged	28

Question/ Problem	Topic	Status: Present Edition	Q/P in Prior Edition
29	Foreign tax credit (FTC)	Unchanged	29
30	Measuring deemed-paid taxes in foreign currency	New	
31	Losses and FTC	Unchanged	31
32	Analyze foreign investment opportunities	Modified	32
33	Tax liability of foreign corporation	Unchanged	33
34	Branch profits tax	Unchanged	34
35	NRA's sale of USRPI	New	
36	Expatriation to avoid tax	Unchanged	36

CHECK FIGURES

15.a.	$1,200 U.S.-source.
15.b.	$2,600 U.S.-source.
15.c.	$425 U.S.-source.
15.d	$300 U.S.-source.
15.e.	$2,500 foreign-source.
16.	$50,000 U.S.-source income subject to U.S. taxation.
18.	$44,100 (tax book value)
19.	$0.
20.	$12,500 dividend; $0 exchange gain/loss.
22.	$390,000 Subpart F income.
23.	$99,288.
25.	$102,000.
26.	$68,300 U.S. tax liability
28.	Allowed in d. only.
29.	$181,818.
30.	$27,174.
31.	$3,400.
32.	Invest in the stock Exco (6% return vs. 4.62% return).
33.	$4,123,000.
34.	$24,000 BPT.
35.	Taxed on gain realized on sale of Jeff stock.

DISCUSSION QUESTIONS

1. Investment income such as dividends and interest typically is subject to a withholding tax when earned by a nonresident of a country. Income tax treaties reduce the rate of withholding. p. 24-6

2. Generally, dividends paid by a foreign corporation are foreign-source income. Certain exceptions apply, however, when the dividends are paid by the U.S. branch of a foreign corporation where 25% or more of the foreign corporation's gross income for the prior three years is effectively connected with a U.S. business. In this case, a portion of the dividends paid by the foreign corporation constitutes U.S.-source income. Example 6

3. TAX MEMORANDUM

   Date: December 7, 2003

   To: U.S. Corporations

   From: Jean MacKay

   Subject: Sourcing internet income

   Sections 861-865 and the regulations thereunder provide specific rules for sourcing different types of income. These rules provide a basis for sourcing interest, dividends, rents, royalties, personal services income, transportation income, space and ocean income, inventory sales, and international communication income. However, the sourcing of income derived from internet activities is not specifically addressed by the Code or regulations. Although not specifically addressed, internet income can be sourced by analogy to the rules for other types of income.

   Two questions must be addressed to determine the source of internet income.

   - What is the nature of the income?

   - Where does the economic process generating the income take place?

   If the internet income is related to the sale of products, the income should be sourced using the inventory rules, or where title to the inventory passes. If the internet income is related to the performance of a service, the income should be sourced using the service rules, or where the services are performed. If the internet income is from the use of an intangible asset, the income should be sourced using the royalty rules. Unfortunately, the nature of internet income is often uncertain leaving application of these specific rules awkward at best.

   Tax authorities around the world are just beginning to grapple with the 21st century issue of tax policy and cyberspace. Until more specific guidance is provided, careful application of existing sourcing rules to internet income will be required. pp. 24-5 to 24-9

4. Section 482 is used by the IRS to prevent taxpayers from arbitrarily manipulating the source of income and the allocation of deductions. This provision gives the IRS the power to reallocate gross income, deductions, credits, or allowances between or among

organizations, trades or businesses owned or controlled directly or indirectly by the same interests. This can be done whenever the IRS determines that reallocation is necessary to prevent the evasion of taxes or to reflect income more clearly. pp. 24-10 and 24-11

5. A qualified business unit is required to use the U.S. dollar as its functional currency under § 985 unless it can demonstrate that a different currency should be used. p. 24-12

6. A qualified business unit (QBU) is a separate and clearly defined unit of a taxpayer's trade or business. A separate branch is usually a QBU. A single taxpayer may have multiple QBUs. For example, one corporation may have a manufacturing branch that is a QBU and a sales branch that is a separate QBU. Each QBU may use its own functional currency. pp. 24-12 and 24-13

7. If a U.S. taxpayer transfers assets outside the U.S., gain may be recognized as a result of appreciation in these assets. The general rule under § 367 is that any gain will be recognized in such a transfer. However, several exceptions exist, including an exception for assets used in a trade or business outside the United States. Even with this exception, certain assets will trigger gain. These include inventory and accounts receivable. Example 14

8. TAX MEMORANDUM

Date: November 1, 2003

To: U.S. Client

From: Karen Whelan

Subject: Foreign corporation as a tax shelter

U.S. taxpayers have attempted to avoid U.S. taxes by placing their activities inside foreign corporations. Whether this approach shelters any income for the U.S. taxpayer depends on the nature of the income/activities.

If a U.S. taxpayer places investments inside a foreign corporation, this corporation is likely to be a Controlled Foreign Corporation (CFC) or a Foreign Personal Holding Company (FPHC) if controlled by five or fewer U.S. individuals. The investment income from the FPHC or CFC will be taxed each year to the U.S. shareholder, thus disallowing any deferral (or sheltering of income from U.S. taxes). If the activity is an active business carried on outside the United States, the U.S. owner of the foreign corporation may achieve deferral from U.S. taxes so long as the profits are not repatriated back to the United States. However, special rules exist under Subpart F that may cause current taxation in the United States of the CFC's income attributable to the U.S. shareholder.

In summary, a U.S. taxpayer may use a foreign corporation to hold certain activities/assets in order to avoid current U.S. taxation. However, several provisions exist that will remove this deferral benefit if the purpose of the foreign corporation is simply to avoid current U.S. taxation.

pp. 24-20 to 24-25

9. For a foreign corporation to be a CFC, more than 50 percent of the total combined voting power of all classes of stock entitled to vote or the total value of the stock of the corporation must be owned by U.S. shareholders on any day during the taxable year of

the foreign corporation. For purposes of determining if a foreign corporation is a CFC, a *U.S. shareholder* is defined as a U.S. person who owns, or is considered to own, 10 percent or more of the total combined voting power of all classes of voting stock of the foreign corporation. Stock owned directly, indirectly and constructively is counted. If each unrelated shareholder owned 1/11, or approximately 9 percent, of the foreign corporation, none of the shareholders would be *U.S. shareholders* and the corporation would not be a CFC. Example 17

10.
- If Joanna's son becomes a 15% shareholder, is he a U.S. shareholder subject to the Subpart F provisions?
- Will Fred's ownership be attributed to Joanna, causing her to be classified as a U.S. shareholder subject to the Subpart F provisions?
- Will Fred's stock acquisition cause Axel's resale of goods received from him to be foreign base company sales income?
- Will the § 1248 provisions apply to Joanna's gain on the sale of her stock?

pp. 24-20 to 24-25

11.
- Is the entire tax withheld by PJ creditable or is part of it a soak-up tax?
- Must more than one basket limitation be calculated?
- Does Molly qualify to take the § 902 deemed-paid foreign tax credit?

pp. 24-25 to 24-31 and Examples 27 and 28

12. The gross income inclusion is $700 because the $400 dividend must be "grossed up" under § 78 due to the $300 deemed paid foreign tax credit. The § 78 gross up is required in order to place the dividend income on a "pre-tax" basis so that the taxpayer does not receive both a foreign tax credit and a deduction for the foreign taxes. p. 24-27 and Example 24

13. A U.S. real property interest includes both direct interests in real property and indirect interests. A domestic corporation that holds U.S. real property interests that equal or exceed 50% of the aggregate fair market value of the total of its U.S. and foreign real property interests plus its trade or business assets, is considered a U.S. real property holding corporation. As such, the interest in the domestic stock itself is considered a U.S. real property interest and disposition of the stock is subject to FIRPTA tax in the United States. pp. 24-37 and 24-38

14.
- The branch profits tax may be levied on this additional U.S.-source income.
- The additional U.S.-source income is subject to the U.S. Federal income tax.
- The 25% rule regarding income effectively connected with a U.S. trade or business may apply, causing dividends paid to Old Gear's shareholders to be partially U.S. source and, thus, taxable by the United States.
- Are there treaty provisions to alleviate the possibility of some of these unfavorable tax consequences?

pp. 24-6, 24-35 and 24-36 and Example 33

PROBLEMS

15. a. $1,200 U.S.-source. Dividends from a domestic corporation other than one that has a § 936 election in effect are U.S.-source. Example 6

    b. $2,600 U.S.-source. Dividends from a domestic corporation other than one that has a § 936 election in effect are U.S.-source income. The foreign business exception does not apply to dividends from a U.S. corporation. Example 6

    c. $425 U.S.-source. Dividends from a foreign corporation that has 25% or more of its gross income for the immediately preceding three tax years effectively connected with the conduct of a U.S. trade or business are U.S.-source to the extent of the amount of such dividends times a ratio equal to the effectively connected income for the three-year period over the total gross income for the three-year period [i.e., $750 X ($1,700,000 ÷ $3,000,000)]. Example 6

    d. The $300 is U.S.-source income because it is received from a domestic bank. p. 24-6

    e. $2,500 foreign-source. Rolan Corporation is a domestic corporation that meets the 80% foreign business requirement. Of its gross income for the immediately preceding three-year period, 83.3% ($3,000,000 ÷ $3,600,000) was from the active conduct of a foreign trade or business. Example 5

16. Willis, Hoffman, Maloney, and Raabe, CPAs
5191 Natorp Boulevard
Mason, OH 45040

November 3, 2003

Rita Taxpayer
Av. Rio Branco
1424-4#
Rio de Janeiro, RJ 22421
Brazil

Dear Rita:

Your participation in the seven tournaments in the U.S. will result in $50,000 of U.S.-source income. The general rule is that income from services is sourced where the services are performed. Physical performance, such as playing golf in a tournament, is categorized as personal services performed by an athlete. Where the funds are deposited is irrelevant for sourcing purposes. There is a "commercial traveler" exception available if all of the following requirements are met.

- The services must be performed by a nonresident alien who is in the U.S. for 90 days or less during the taxable year;

- The compensation may not exceed $3,000 in total for the services performed in the U.S.; and

- The services must be performed on behalf of:
  - a nonresident alien, foreign partnership, or foreign corporation that is not engaged in a U.S. trade or business, or
  - an office or place of business maintained in a foreign country or possession of the U.S. by an individual who is a citizen or resident of the U.S., a domestic partnership, or a domestic corporation.

The “commercial traveler” exception does not apply. You are not in the U.S. for more than 90 days during the tax year, but the income attributable to your services performed in the U.S. *exceeds* $3,000. Furthermore, you are not performing in the capacity of an employee. You are subject to U.S. taxation on the $50,000. Some income tax treaties allow a greater amount in making the “commercial traveler" test and some provide an exception for professional athletes as long as the earnings do not exceed a certain amount specified in the treaty.

Sincerely,

Tomas Suarez
Tax Consultant

p. 24-7 and Example 7

17. a. The gain is foreign-source income. Gain from the sale of personal property is generally sourced at the residence of the seller, in this case an NRA. An exception to this rule provides that the gain on sale of stock is taxable if the gain is attributable to an office or other fixed place of business that the NRA maintains in the U.S. Use of a broker in the U.S. does not constitute a U.S. trade or business. p. 24-8

    b. Same as a. Gain is foreign source because seller is NRA, and sourced based on residency of seller.

    c. The source of income from the sale of inventory manufactured in the U.S. and sold in another country is determined by allocating a portion of the income to the manufacturing activity and a portion to the sales activity. The sales activity portion is generally sourced based on where title passes. In this case, half the income is sourced in the U.S. (based on manufacturing) and half is sourced as foreign based on title passage. § 863(b) and p. 24-7

    d. Same as c. Manufacturing income is foreign source and sales income is U.S. source (assuming title passes in the U.S.).

18. a. Interest expense is allocated and apportioned based on location of assets.

	Book Value	FMV
Assets producing foreign-source income	$3,000,000	$8,000,000
Assets producing U.S.-source income	400,000	100,000

Tax Book Value Method: $50,000 (expense) X $3,000,000/$3,400,000 = $44,100 (foreign-source interest expense).

FMV Method: \$50,000 X \$8,000,000/\$8,100,000 = \$49,400 (foreign-source interest expense).

b. To minimize the amount of interest allocated against foreign-source income (the optimum answer in most cases), ERP should use the Book Value method. Example 9

19. No foreign currency exchange gain or loss is recognized until the payment is made. The cost of \$500,000 (¥75,000,000 ÷ ¥150) will be recorded for the equipment. If payment is made on February 15, 2004, when the foreign exchange rate is ¥250:\$1US, the foreign exchange gain recognized for 2004 would be \$200,000 (\$500,000 – \$300,000*). Weight pays only \$300,000 for the 75 million yen needed to make payment.

*¥75,000,000 ÷ ¥250

Example 10

20. Harold's dividend income in U.S. dollars is \$12,500 (i.e., 10,000k ÷ .8k). The dividend is translated at the exchange rate on the date of payment, thus there is no exchange gain or loss. If Harold retains the foreign currency (which is now property with a basis of \$12,500) and disposes of it at a later date when the exchange rate has changed, Harold would have an exchange gain or loss on disposition of the foreign currency. This, however, does not affect the amount of dividend income included in gross income. The separate transaction doctrine applies. Because Harold is a less-than-10-percent shareholder of Forrest, it cannot claim any deemed-paid taxes. Harold can claim an FTC for any foreign taxes withheld on the dividend. p. 24-13

21. TAX MEMORANDUM

Date: November 4, 2003

To: CFO

From: Dale Mittler

Subject: Incorporation of Canadian branch

Incorporation of a foreign branch falls under the provisions of § 367. First, the § 351 rules would normally treat the incorporation of a branch as a tax deferred event with basis carryover. However, because the assets are leaving the U.S. taxing jurisdiction, § 367 overrides § 351 and causes this incorporation to be a taxable event.

However, because the assets are being transferred to a foreign corporation to be used in a trade or business outside the United States, § 367 contains an exception that allows certain assets to be transferred with no current tax (i.e., basis carryover and any gain/loss is deferred). Assets that do not qualify for this trade or business exception include inventory, accounts receivable, foreign currency, and certain leased property. Additionally, depreciation recapture related to the use of the property in the United States is subject to immediate taxation upon transfer.

Accordingly, the taxation of the incorporation of the Canadian branch depends on the nature of the assets transferred. Other than the tainted assets mentioned above, the branch assets can be transferred to the Canadian corporation with no current taxation. Note that the depreciation should not be a problem as the depreciation was based on use outside the

United States. Furthermore, the prior branch losses will not trigger gain recognition as these losses have been offset with subsequent profits.

Finally, the incorporation of the branch at this time is a potentially good planning technique as future profits of the Canadian Subsidiary will not be subject to tax in the United States until actually repatriated (unless the subsidiary earns Subpart F income).

pp. 24-17 to 24-19

22. Aussie's Subpart F income for the current year (before any expenses) is $390,000, made up of $300,000 in foreign base company sales income, $60,000 in foreign base company services income, and $30,000 in foreign personal holding company income.

  a. Because the sales are to customers outside Australia, this income constitutes foreign base company sales income. This is true even though the inventory was manufactured outside Australia and acquired from a related party.

  b. Even though the products are purchased from Snowball (a related party), they are sold to customers in Australia; thus, this $500,000 in income does not constitute foreign base company sales income.

  c. None of this income is Subpart F income because there is no related party on at least one side of the transaction. In this case, location of the manufacturing and customer is not relevant.

  d. Aussie is considered the manufacturer of this inventory. Accordingly, this income is not Subpart F income without regard to where the customers are located.

  e. Because Aussie earned $60,000 for the performance of warranty services on behalf of a related person (Snowball), and these services were performed outside Australia, this $60,000 is foreign base company services income.

  f. This $30,000 in dividend income represents foreign personal holding company income and will constitute Subpart F income.

pp. 24-23 and 24-24

23. $99,288 [$600,000 X 40% X (151 days ÷ 365 days)]. Radio must include a portion of TV's Subpart F income in gross income as a constructive dividend because Radio was a shareholder of TV on the last day of the year in which TV was a CFC, and current E & P is not less than Subpart F income. Radio is taxed on its share of Subpart F income for the portion of the tax year that TV was a CFC. Examples 15 and 16

24. Willis, Hoffman, Maloney, and Raabe, CPAs
5191 Natorp Boulevard
Mason, OH 45040

November 7, 2003

Dear Mary Beth:

You asked me to address the U.S. tax consequences of placing your investments inside a Cayman Island corporation. It appears that this approach has allowed you to reduce your overall tax liability because the Cayman Island corporation is now earning the investment income and it is not subject to U.S. taxation. However, Congress anticipated these type arrangements and enacted the Foreign Personal Holding Company (FPHC) rules to tax U.S. individuals that hold their investments in such foreign corporations.

Because the foreign corporation is owned more than 50% by five or fewer U.S. individuals and the corporation's primary source of income is passive, your share of the foreign corporation's income will be included in your U.S. tax return and subject to immediate U.S. taxation. This is true even if you do not repatriate any of the income back to the U.S. in the form of a dividend.

Because this structure is not achieving your goal of U.S. tax reduction, you should consider unwinding the foreign corporation in order to avoid the administrative costs of operating the Cayman corporation. Please contact me if I can be of any further assistance.

Yours Truly,

Harold Bloom

p. 24-25

25. Ben's FTC allowed for the tax year is $102,000. The FTC is the lesser of the actual foreign taxes, $130,000, or the statutory limit of $102,000 as determined under the general limitation formula.

$$[\$400{,}000 \text{ X } 34\% = \$136{,}000] \quad \text{X} \quad \frac{\$300{,}000}{\$400{,}000} = \$102{,}000$$

In this case, the statutory limit applies. Example 25

26. The deemed paid foreign tax credit related to the dividend paid by Correy to Elmwood is $15,000 ($30,000 dividend/$400,000 post-86 E & P X $200,000 foreign income tax pool). The $30,000 dividend is "grossed up" under § 78 by the deemed paid credit of $15,000, resulting in an inclusion in Elmwood's U.S. taxable income of $45,000. Elmwood's resulting taxable income is $245,000 ($200,000 in other income and $45,000 related to the dividend from Correy).

Elmwood's U.S. tax liability before the FTC is $83,300 ($245,000 X 34%). The allowed FTC is the lesser of (1) $15,000 (the foreign taxes deemed paid) or (2) $15,300 (the FTC limit of $83,300 X $45,000/$245,000). Accordingly, Elmwood is allowed the entire $15,000 of foreign taxes deemed paid as a FTC. Elmwood's total U.S. tax liability is $68,300 ($83,300 – $15,000). Examples 24 and 25

27. TAX MEMORANDUM

Date: November 1, 2003

To: John, CFO
Nashville Cats, Inc.

From: Donna Young

Subject: Overall Foreign Losses and the FTC

Nashville Cats has generated net losses from its foreign operations in Singapore in the amount of $200,000. This year, the foreign operation began producing profits. Ordinarily, these positive profits from foreign operations would result in the availability of an FTC for any foreign taxes paid to Singapore. Any foreign-source income increases the FTC limitation calculation. However, because the foreign operation has reduced U.S.-source income in the past through the deduction of losses, any subsequent profits must be recharacterized as U.S. source to the extent of prior overall foreign losses. This provision prevents the taxpayer from receiving a double benefit from the foreign losses (once from the offset against U.S. income and second, from the increase in the FTC limitation formula from subsequent foreign profits).

At the taxpayer's election, the $200,000 of overall foreign losses is recharacterized as U.S. source over a period of time, with not more than 50% of current year foreign-source income being recharacterized as U.S. source in any given year until the $200,000 is completely recharacterized.

pp. 24-29 and 24-30

28. a. Interest income from a 5% owned foreign corporation does not trigger a deemed paid FTC because such credits are only available with regard to dividend payments.

b. Same as a. Interest income does not generate a deemed paid FTC at any level of ownership.

c. No deemed paid FTC is generated by this dividend. The U.S. corporation must own at least 10% of the foreign corporation directly in order to qualify for the deemed paid FTC.

d. A deemed paid FTC is allowed for this dividend because the 10% ownership test is met.

pp. 24-25 and 24-26

29. Harold can earn up to $181,818 in foreign sales income without generating any excess foreign tax credits. Foreign sales income and manufacturing income fall into the same FTC limitation basket. Because the $500,000 is taxed at a foreign rate of only 30%, this income generates a $20,000 excess limit [the limit is $170,000 ($500,000 X .34), and the actual tax is $150,000]. The $181,818 of foreign sales income is taxed at a 45% rate, producing foreign taxes of $81,818. Blending the two sources of income (one high-tax and one low-tax) results in using Harold's excess limit. Combined, Harold has $681,818 in foreign-source income and $231,818 ($150,000 + $81,818) in foreign income taxes.

The U.S. tax on this $681,818 is $231,818, all of which is offset by the $231,818 FTC. Example 27

30. The deemed-paid taxes are $27,174 (25,000 € ÷ .92). The entire amount of $27,174 is an indirect foreign tax credit because the entire amount of E & P is distributed (75,000 € ÷ 75,000 € X $27,174). The foreign taxes are translated at the average exchange rate for the year to which the taxes relate. The exchange rate on the dividend payment date is irrelevant for this purpose. Examples 12 and 24

31. Partin earned net foreign source income for the year of $10,000. Partin incurred a loss of $50,000 in the general limitation basket and profits of $60,000 in the financial services income basket. Before calculating the FTC limit for each basket, the loss in the general basket must be allocated to the profits in any other baskets. In this case, the entire $50,000 loss is allocated against the financial services basket. This results in $10,000 in foreign source taxable income in the financial services basket and $0 in foreign source taxable income in the general basket.

- Partin has no foreign taxes related to the general limitation basket (and would be limited to $0 in any case because of the $0 foreign source taxable income related to this basket).

- For the financial services income basket, Partin is allowed a FTC equal to the lesser of (1) $15,000 in foreign taxes actually paid or (2) $3,400 FTC limit ($10,000 X 34%).

Consequently, Partin is allowed a $3,400 FTC for the current year. The $11,600 not allowed may be carried back two years or forward five years (but only for use within the financial services income basket). Example 25

32. TAX MEMORANDUM

Date: November 5, 2003

To: Money, Inc.

From: Mike Caldwell

Subject: Foreign investment alternatives

It would be more profitable for Money, Inc., to invest in the stock of Exco. The following analysis shows that the stock investment would yield a 6% return, while the bond investment would yield a 4.62% return. The difference in returns probably reflect a "risk premium" involved in investing in the stock instead of the bonds.

Stock investment

Gross dividend income = $30,000 ($3 X 10,000 shares) per year
Deemed-paid foreign taxes = $22,222 [$4,000,000 X ($30,000 ÷ $5,400,000*)]
Gross up dividend income to $52,222 ($30,000 + $22,222)
U.S. tax before FTC = $17,755 ($52,222 X .34)
FTC = $17,755 (lesser of $22,222 or U.S. tax)
Net U.S. tax = zero
Total tax *actually* paid by Money on dividend = zero
Net return = $30,000, or 6% ($30,000/$500,000)

In addition, if excess foreign taxes were incurred within the next 5 years, $4,467 of excess FTC limitation is available for a carryback of the foreign taxes.

*The $5,400,000 E & P *after taxes* is determined by taking $9,400,000 minus $4,000,000 taxes (i.e., $10,000,000 X 40% tax rate).

Bond investment

Gross interest income = $35,000 ($500,000 X 7%)
Foreign tax withheld = $8,750 ($35,000 X .25)
No deemed-paid taxes are allowed on interest income
U.S. taxable income from interest = $35,000
U.S. tax before FTC = $11,900 ($35,000 X .34)
FTC = $8,750 (lesser of $8,750 or U.S. tax)
Net U.S. tax = $3,150
Total tax *actually* paid by Money on interest income = $11,900
Net return = $23,100 ($35,000 – $11,900), or 4.62% ($23,100/$500,000 = 4.62%)

The U.S. taxes on the gross interest income are not as great as the U.S. taxes on the grossed-up dividend income. However, a greater FTC is allowed for the taxes on the dividend income, since the deemed-paid taxes increase the amount of foreign taxes paid or treated as paid by Money.

pp. 24-25 to 24-30

33. The taxable income from the U.S. sales is U.S.-source income taxable at § 11 rates. In addition, the interest on certificate of deposit is U.S.-source income *and* is not exempt from U.S. taxation because the funds on deposit are effectively connected with the U.S. trade or business (working capital). The security trading and resultant capital gains are foreign-source income because this activity is attributed to the home office, and the residence of the seller rule applies. These items are tax free in the United States. The dividends, however, are U.S.-source income subject to withholding since the payors are U.S. corporations. IrishCo's U.S. income tax liability would be computed as follows.

Taxable income from U.S. sales	$12,000,000
Interest income effectively connected with U.S. trade or business	100,000
Effectively-connected income taxed at § 11 rates	$12,100,000
Tax on effectively-connected income (34%)	$ 4,114,000
15% tax withheld on dividends of $60,000	9,000
Total U.S. tax liability	$ 4,123,000

pp. 24-35 and 24-36

34. TAX MEMORANDUM

Date: November 4, 2003

To: Tax VP, ForCo

From: Cindy Cuccia

Subject: Branch Profits Tax

In addition to regular U.S. income tax on any branch earnings, ForCo will incur a Branch Profits Tax (BPT) liability of 30% of any dividend equivalent amount (DEA). The DEA is determined as follows.

Current year U.S. Effectively Connected E & P	$180,000
Less: Increase in U.S. Net Equity	(100,000)
DEA	$ 80,000

The BPT liability is $24,000 (30% of the $80,000 DEA).

Several methods exist for reducing ForCo's BPT liability for the year. First, ForCo should consider increasing its U.S. net equity by $80,000 (thereby reducing the DEA amount to zero). It could reduce distributions to the home office or increase reinvestment of profits in the U.S. Second, ForCo might consider restructuring its operations so that the branch is operated by a foreign corporation in a country which has a treaty with the U.S. that reduces the BPT rate from 30%. Third, ForCo might consider incorporating its U.S. branch as a U.S. subsidiary. This last choice should be evaluated carefully, as additional tax costs could arise as a result of the incorporation and operation of the U.S. activity as a corporation rather than a branch.

Example 33

35. Brenda would have no U.S. tax consequences unless (1) the gain on the sale of the stock is effectively connected with a U.S. trade or business or (2) treated as effectively connected with a U.S. trade or business under § 897. In order for (2) to apply, Jeff, Inc. must be a U.S. real property interest (USRPI). Thus, it must be determined whether Jeff is a U.S. real property holding company (USRPHC). Jeff's U.S. real property interests represent 84.4% of its total assets ($5,400,000 ÷ $6,400,000). This causes Jeff to be classified as a USRPHC and a USRPI. Brenda would be taxed on the $5,900,000 gain realized on the sale of Jeff stock. pp. 24-37 to 24-39

36. Willis, Hoffman, Maloney, and Raabe, CPAs
5191 Natorp Boulevard
Mason, OH 45040

November 6, 2003

Dear John,

You have asked me to address the tax consequences of you giving up your U.S. citizenship and moving to Bermuda where you will continue to operate your law practice via the internet. First, § 877 provides that you will be taxed in the United States on all of your U.S.-source income for 10 years following your abandonment of citizenship if it can be demonstrated that you gave up your citizenship to avoid U.S. taxation. This 10-year provision is likely to apply in your case.

The question then becomes whether you will generate any U.S.-source income within this 10-year window. Operation of your law practice via the internet may or may not create U.S.-source income. The taxation of internet activities is very ambiguous under current law. If the IRS considers the activity to be a provision of services, the place those services are provided will determine the source. It is an open question as to whether those services are provided at your end of the computer (Bermuda) or at the client's end of the computer (the United States). If your legal services take the form of some sort of packaged product that is sold within the United States via the internet, the sourcing rules are likely to treat this income as U.S.-source income based on the passage of title to this inventory within the United States.

Sincerely,

Melissa Knechel

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