

Tax Law Certification Exam Sample Questions

Disclaimer: The following questions are provided to the public as examples of the types of questions that appear on Tax Law certification exams, as well as the subject areas that are tested. All questions have been pulled from previous exams and were correct and factual at the time of administration; however, the Tax Law Certification Committee acknowledges that some questions and/or answers may no longer be accurate due to the passage of time since administration. None of these questions will appear on future exams.

Short Answer Essay Question– State and Local Taxation

Emily owns 100% of ABC Inc. ABC Inc. was incorporated in Delaware in 1985 and has its principal place of business in Tampa, Florida. ABC Inc. was originally operated as a C corporation, subject to the Florida corporate income tax, and made an election in 2014 to be taxed as an S corporation. ABC Inc. has retained earnings of \$1,000,000 as of December 31, 2013. ABC Inc. is registered with the Florida Department of Revenue (Department) as a dealer and remits sales tax to the Department on a monthly basis.

ABC Inc. is currently being audited by the Department for Sales Tax relating to a 36-month period beginning January 2011 through December 2013. ABC Inc. and the Department entered into an agreement to extend the statute of limitations through June 30, 2016. The Department issued a Notice of Intent to Make Audit Changes (NOI) that indicates that additional Sales Tax of \$150,000 plus interest and penalty will be assessed. The Department has 70 days remaining on the statute of limitations as of today and is asking for an additional extension of the statute of limitations. Emily agrees with the points addressed in the Department's NOI.

- 1. As Emily's tax attorney, what advice should you give Emily regarding the current Sales and Use Tax Audit?**
- 2. Would your advice change if the time remaining on the statute of limitations is 59 days instead of 70? Discuss.**

3. **Is ABC Inc. required to file a Florida corporate income tax return for calendar year 2014? Discuss.**
4. **Would your advice change if ABC Inc. sold its building in 2014 for a gain of \$500,000? Discuss.**

Model Answer for Short Essay Question – State and Local Taxation

1. The Department has 70 days remaining on the statute of limitations. However, the Notice of Proposed Assessment (NOPA) must be issued with 60 days remaining on the statute of limitations. If it is issued at day 59, then the NOPA is not timely. See Verizon Business Purchasing LLC v. Fla. Dep't of Revenue, 164 So. 3d 806 (Fla. 1st DCA 2015). I would recommend that my client wait to see if the Department issues the NOPA timely. **(5 points)**
2. Yes. The Department failed to timely issue an assessment within the statutory period, because there are only 59 days remaining on the statute of limitations. I would review the actual language of the extension agreement to see if the entire 36-month period has expired or if the agreement extended each individual period. See Verizon. If the agreement did preserve a portion of the 36-month period, I would recommend that we meet with the Department to discuss possible settlement. **(5 points)**
3. No. Only corporation subject to subchapter C are subject to the Florida Corporate Income Tax. ABC Inc. timely elected to be an S corporation. **(3 points)**
4. Yes. S corporations that are subject to tax under IRC section 1374 and 1375 are subject to the Florida corporate income tax. In this case, the sale of the building within 1 year of electing S status will trigger a built-in gains tax that is subject to subchapter C and the Florida Corporate Income Tax. **(3 points)**

Subspecialty Long Essay – International Taxation

1. DP is a domestic (Florida) partnership with a foreign partner, Jose Perez, an individual who is neither a tax resident nor a citizen of the U.S. Jose resides in a country with whom the U.S. does not have an income tax treaty. In 2016, DP's income consists of (i) rental income from a commercial property it owns in Florida; (ii) dividend income from stocks it owns in U.S. corporations; (iii) dividend income from stocks it owns in foreign corporations; (iv) interest income from registered U.S. corporate bonds; (v) interest income from a U.S. bank account (unrelated to rental activities); and (vi) interest income from a foreign bank account.
 - (a) **What, if any, are DP's tax withholding obligations with respect to Jose's distributive share of each type of DP's income?**
 - (b) **What, if any, are DP's reporting obligations with respect to its foreign bank account?**
 - (c) **What, if any, would be DP's tax withholding obligations with respect to Jose's distributive share of any gain realized by DP on the sale of its commercial rental property?**
2. Jorge and his wife are residents and citizens of a foreign country ("FC"). Jorge owns 100% of a corporation that is organized under the laws of FC through which he conducts his business in FC. Jorge's FC corporation has a wholly owned U.S. subsidiary through which the U.S. business is conducted. Jorge oversees both the FC and U.S. business operations. Jorge and his wife spent the following number of days in the U.S. during the calendar years indicated:

<u>Calendar Year</u>	<u>Number of Days</u>
2013	80
2014	90

2015	132
2016	126

Jorge and his wife spent the rest of their time in FC. They own homes in both the U.S. and FC, in which they maintain furniture and other personal belongings. They also maintain automobiles in both locations. Jorge's parents and siblings live in FC. His wife has relatives in both the U.S. and FC. They maintain bank and brokerage accounts in both the U.S. and FC. Jorge belongs to country clubs in both the U.S. and FC. Jorge and his wife vote only in FC, have FC passports and have provided Forms W-8BEN to their U.S. banks. One half of Jorge's annual compensation is paid by the FC corporation and one half is paid by the U.S. subsidiary. Jorge has always filed 1040-NR returns with the IRS in which he reports only his U.S. source income.

- (a) Is Jorge a tax resident of the U.S. in 2016? Explain.**
- (b) Explain the significance, for U.S. tax purposes, of Jorge's U.S. tax residency status?**
- (c) If there were an income tax treaty (based on the U.S. Model Treaty) between FC and the U.S., would Jose's U.S. tax liability on his compensation from the U.S. subsidiary be reduced? Why or why not?**
- (d) If Jorge died unexpectedly, which of his assets, if any, would be included in Jorge's estate for U.S. estate tax purposes?**
- (e) Assuming there is no estate tax treaty between FC and the U.S., if Jorge left all of his assets outright to his wife under his Last Will & Testament, would Jorge's estate be entitled to a marital deduction for the property passing to his wife? Why or why not? If so, how is the amount determined?**

- (f) Assuming there is no estate tax treaty between FC and the U.S., what, if any, is the amount of unified credit to which Jorge's estate will be entitled?**
3. Foreign Corp is organized under the laws of a foreign country with whom the U.S. does not have an income tax treaty. Foreign Corp has purchased a commercial rental property in Florida through its wholly-owned Florida limited liability company ("LLC"). No "check-the-box" election has been made for the LLC. Foreign Corp has no other U.S. source income.
- (a) What, if any, are the U.S. income tax withholding obligations of the tenant of LLC's commercial rental property with respect to the rentals it pays?**
- (b) Will Foreign Corp be subject to U.S. income tax on its rental income? If so, assuming no elections are made, how will its U.S. tax liability be computed? How and when should its U.S. tax liability be reported and paid?**
- (c) What, if any, elections are available to reduce the U.S. income tax liability on the rental income? How would the election affect Foreign Corp's U.S. income tax liability?**
- (d) If the commercial rental property is sold, what, if any, tax withholding obligations are imposed on the purchaser? What, if anything, can Foreign Corp do to reduce or eliminate the withholding obligation?**
4. PharmCo is a U.S. pharmaceutical corporation. It has developed a vitamin supplement that is manufactured by combining various of PharmCo's proprietary compounds. PharmCo believes that there is a substantial market for the supplement both within and without the U.S. PharmCo's accountant suggested that PharmCo manufacture the new vitamin supplement in FC, a foreign country whose income tax rate is much lower than the U.S. tax rate, through a wholly owned FC (corporate) subsidiary ("FC Sub"). He suggested that FC Sub's officers

and directors be the same as PharmCo's officers and directors and that the supplement be manufactured and sold under the PharmCo brand. PharmCo is prepared to (i) contribute the working capital that FC Sub will require until it becomes self-sustaining (including compensation to its employees and rent for manufacturing and warehousing facilities); (ii) contribute such quantities of its proprietary compounds that FC Sub will require until it becomes self-sustaining; (iii) contribute partially depreciated equipment that FC Sub will need to manufacture, package and ship the supplement; and (iv) contribute the formula, know-how and technical expertise ("IP") that FC Sub will need to manufacture the supplement.

- (a) What are PharmCo's tax consequences on its contribution of cash to FC Sub? Explain.**
- (b) What are PharmCo's tax consequences on its contribution of the compounds to FC Sub? Explain.**
- (c) Assuming that PharmCo's basis in the equipment is less than its fair market value, what are PharmCo's tax consequences on the contribution of the equipment to FC Sub? Explain.**
- (d) What are PharmCo's tax consequences on its contribution of the IP to FC Sub? Explain.**

PharmCo will arrange for the sale of the supplement to PharmCo's established U.S. distributors (for ultimate consumption by U.S. consumers) and foreign distributors (for ultimate consumption by non-U.S. consumers). PharmCo will also cause FC Sub to ship a stock of supplement to PharmCo which PharmCo will hold and use to fill orders on FC Sub's behalf. Once FC Sub becomes self-sustaining, PharmCo will sell its proprietary compounds to the FC subsidiary at its cost. For the foreseeable future, PharmCo will cause FC Sub to retain its earnings and profits and invest them in expansions of its manufacturing capabilities.

- (e) Is the proposed pricing for the sales of PharmCo's compounds to FC Sub at PharmCo's cost appropriate? Why or why not?**
- (f) Assuming that all documents governing sales of the supplement by FC Sub to the U.S. and foreign distributors pass the risk of loss to the distributor in FC, will any of FC Sub's income from those sales be subject to U.S. tax? Explain.**
- (g) Will PharmCo incur a U.S. tax liability on any of FC Sub's undistributed earnings & profits? Explain.**
- (h) If FC Sub has earnings and profits and makes a loan to PharmCo, what will be the tax consequences to FC Sub and/or PharmCo? Explain.**
- (i) Will PharmCo's U.S. tax liabilities be affected by the income taxes, if any, that FC Sub pays to FC? Explain.**
- (j) Assume that PharmCo liquidates FC Sub after several years of accumulating its earnings and profits. How will PharmCo's gain on such liquidation be taxed?**

Model Answer – Sub-specialty Long Essay – International Taxation

1. (a) Rental income – effectively connected income, highest ordinary individual income tax rate (39.6%), §1446 **(3 points)**
 - Dividends / U.S. corps – 30%, §1441 **(2 point)**
 - Dividends / foreign corps – None, not U.S. source **(2 point)**
 - Interest/U.S. bonds – None, portfolio interest. §871(h) **(2 point)**
 - Interest / U.S. banks – None, §871(i) **(2 point)**
 - Interest / foreign banks – None, not U.S. source **(2 point)**
- (b) FBAR, FATCA, §6038D, FinCEN Form 114, Form 8938. **(3 points)**
- (c) §1445(e), tax on gain realized on sale. LTCG portion withheld at 20%. §1.1446-3(a)(2)(ii). **(3 points)**
2. (a) Jorge satisfies the substantial presence test of §7701(b) - (126, plus 1/3 of 132, plus 1/6 of 90 = 185) - but might qualify for "closer connection" exception in §7701(b)(3)(B). Analyze factors weighing on both sides of that issue. **(6 points)**
- (b) If Jorge is a U.S. tax resident, his worldwide income will be subject to U.S. tax (subject to foreign earned income exclusion, §911, and foreign tax credits paid to the countries in which the income is earned. §901, et seq.). If Jorge is not a U.S. tax resident, only his U.S. source income will be subject to U.S. tax. **(4 points)**
- (c) No. Treaty relief is not available to exempt compensation for services performed in the U.S. by an employee of a U.S. corporation. **(4 points)**
- (d) Jorge's share of the U.S. situated assets (§2103) (based on contribution of purchase price, §2040(a) - his wife's interest is not excluded, §2056(d)(1)(B))

- including Jorge's share of the U.S. residence, automobiles and brokerage accounts (to the extent they consist of stocks in U.S. corporations, §2104(a)) - would be subject to U.S. estate tax. Bank accounts and bonds of U.S. corporations are not subject to U.S. estate tax (§2105(b)). **(6 points)**

(e) No marital deduction for amounts bequeathed to non-citizen spouse, §2056(d)(1)(A), except through a QDOT described in §2056A. **(3 points)**

(f) The estate will be entitled to a unified credit of \$13,000. §2102(b)(1). **(3 points)**

3. (a) The LLC is a "disregarded entity" so the foreign corporation will be treated as having earned the rental income directly. Reg. § 1.1441-1(b)(2)(iii). Tax on U.S. source rental income that is not effectively connected with a U.S. trade or business is equal to 30% of gross income. §881(a). Accordingly, in the absence of a §882(d) election, the Tenant must withhold tax equal to 30% of rentals under §1441 and remit it to the IRS. **(4 points)**

(b) Yes. If no §882(d) election, rental income not effectively connected. Tax is equal to 30% of gross rental income, §881, which is withheld at source, §§1442, 1441. No return is required. No branch profits tax under §884 is imposed. **(4 points)**

(c) The §882(d) election results in rental income being effectively connected with U.S. trade or business. The election eliminates the tenant's withholding obligation and allows FC Corp to compute taxable income on net basis, after all allowable deductions, and imposes tax at graduated rates. It also results in application of the branch profits tax under §884. **(4 points)**

(d) Since LLC is a disregarded entity, FC Corp is considered the seller. Under FIRPTA, §897, gain on disposition of U.S. real property by foreign corporation is effectively connected income. The purchaser is required to withhold and remit 15% of the sales price. §1445(a), §1.1445-2(b)(2)(iii). If

the seller's tax liability is less than the amount subject to withholding, the seller can apply for an exemption certificate. §1.1445-3(a). **(4 points)**

4. (a) No U.S. tax consequences on contribution of cash to a foreign corporation. **(3 points)**
- (b) Compounds are treated as inventory. §1.367(a)-5T(b)(1). Inventory does not qualify for §367(a)(3) active business exception. Since, under §367, FC Sub is not treated as a corporation for §351 purposes, PharmCo treated as having sold the compounds to FC Sub for their fair market values. **(5 points)**
- (c) Contribution of equipment will qualify for §367(a)(3) active business exception (if reporting requirements are satisfied) and will therefore qualify for nonrecognition under §351. **(4 points)**
- (d) Under §367(d), PharmCo will be treated as having received royalties from FC Sub of an amount that would have been received in an arm's-length license under §482. §1.367(d)-1T(c)(1). **(3 points)**
- (e) Prices for which property is sold between related parties is subject to adjustment under the transfer pricing rules of §482 if they do not reflect the arms'-length fair market value. **(3 points)**
- (f) Sales to U.S. distributors will be sourced to U.S. under §865(e)(2)(A) because the supplement they buy will be sold for consumption in the U.S. Under §864(c)(5), PharmCo's U.S. office will be attributed to FC Sub because PharmCo will maintain a stock of inventory from which it will fill orders on FC Sub's behalf. (Also, because PharmCo and FC Sub have the same officers and directors who reside in the U.S., PharmCo will likely be considered to have the authority to conclude contracts in FC Sub's name.) Sales to foreign distributors will not be sourced to U.S. under §865(e)(2)(A) if FC Sub materially participates in the sale because the supplement they buy will be sold for consumption outside the U.S. **(6 points)**

- (g) FC Sub is a CFC under §957(a). Income from foreign sales of inventory acquired from a related party constitutes subpart F income (i.e., foreign base company sales income under §954(d)) to the extent it is sold for consumption outside FC, unless it has been manufactured by the CFC. It will be considered manufactured by the CFC if the property acquired from PharmCo is considered "substantially transformed" by FC Sub. §1.954-3(a)(4). Whether mixing various compounds constitutes "substantial transformation" is a factual issue. If it is not considered substantial transformation (and the goods sold by FC Sub are considered the same goods that it acquired from PharmCo), FC Sub's income from those foreign sales will be subpart F income. PharmCo will be required to include that subpart F income in its U.S. taxable income in the year in which it is earned by FC Sub under §951 even though it has not been distributed. Income that is sourced to the U.S. will not be subpart F income. §952(b). **(6 points)**
- (h) If FC Sub's income is not subpart F income, it will not be included in PharmCo's income unless and until it is distributed or is invested in U.S. property under §956. §951(a)(1)(B). U.S. property includes an obligation of a U.S. person, such as PharmCo. §956(c)(1)(C). Accordingly, PharmCo will realize taxable income to the extent FC Sub's earnings and profits are loaned to PharmCo. FC Sub's earnings and profits are reduced by the amount that they are included in PharmCo's income. **(3 points)**
- (i) PharmCo would be entitled to a foreign tax credit for any foreign income taxes that are paid by FC Sub on the earnings and profits it actually distributes)or is deemed to have distributed under section 951 or 956). The credit is limited to the lesser of the U.S. or foreign income taxes imposed on those distributed earnings and profits. §901 et seq. **(3 points)**
- (j) Under §1248, gain realized by a U.S. shareholder on the disposition of its stock in a CFC must be recognized as an ordinary dividend to the extent of the CFC's earnings and profits. Any excess gain will be taxed as capital

gain. In the case of a corporate shareholder, the tax on capital gains is limited to the rate prescribed by §1201. **(3 points)**