Technical Corrections Comments Relating to Shipping Income
Submitted by

Kenneth J. Kies
Clark Consulting
101 Constitution Ave., NW
Suite 701 East
Washington, DC 20001
(202) 772-2482

Stephen Fiamma
Allen & Overy LLP
One New Change
London EC4M 9QQ
United Kingdom
44 (0) 20 7330 3657

Warren Dean
Thompson Coburn LLP
1909 K Street, N.W., Suite 600
Washington, D.C. 20006
(202) 585-6908

Alex Trostorff
Jones Walker
201 St. Charles Place
51st Floor
New Orleans, LA 70170
(504) 582-8232

August 31, 2005

The Honorable Charles Grassley
Chairman
Committee on Finance
United States Senate
Washington, DC 20510

The Honorable Max Baucus
Ranking Member
Committee on Finance
United States Senate
Washington, DC 20510

Dear Chairman Grassley and Senator Baucus:

We are submitting these comments regarding the technical corrections legislation (S. 1447) on behalf of the Subpart F Shipping Coalition and certain additional shipping companies (the "Shipping Coalition"), a group of the United States ("U.S.") controlled foreign-flag shipping companies that are affected by U.S. international taxation policy. The Coalition supports strongly the shipping provisions of the American Jobs Creation Act of 2004 (the "Act").

PROPOSED TECHNICAL CORRECTION RELATING TO REPEAL OF SUBPART F FOREIGN BASE COMPANY SHIPPING INCOME RULES

Section 415 of the Act repealed the subpart F rules with respect to "foreign base company shipping income" to restore the competitiveness of U.S.-owned foreign subsidiaries engaged in shipping operations. Despite the repeal, the income of many of these U.S.-owned foreign shipping companies could (depending on the future shape of Treasury regulations) still become subject to subpart F's rules as "foreign base company services income," thereby frustrating Congress's expressed intent. In a similar fashion, dividends, interest, or gains that would have been foreign base company shipping income under prior law could still become subject to subpart F taxation as "foreign personal holding company income," equally frustrating Congress's intent. We propose that Congress adopt a technical correction, described below, clarifying that (i) income that would have been foreign base company shipping income prior to the Act will not be treated as foreign base company services income and (ii) certain dividends, interest, and gains that would have been foreign base company shipping income under prior law, will not be treated as foreign personal holding company income, after the effective date of the Act.

Background

The American Jobs Creation Act of 2004 (the "Act") represents the most far reaching and significant effort in recent history to restore the international competitiveness of U.S. shipping. This industry has experienced a significant and steady decline over the last twenty-five years, and the nation's technical and support capabilities for this important sector have been eroded as a result. In its 2002 Report on Corporate Inversion Transactions, Treasury specifically identified the current taxation on income earned by U.S.-owned foreign shipping subsidiaries as a competitive disadvantage relative to foreign-owned corporations. The repeal of subpart F's rules concerning foreign base company shipping income in Section 415 of the Act (accompanied by

the enactment of a tonnage tax system in subchapter R of the Act) was intended to reverse this decline and to restore the competitiveness of the industry for both economic and national security reasons.

In repealing the foreign base shipping company rules, Congress sought to end the competitive disadvantage of the U.S.-owned shipping subsidiaries that fell within anti-deferral rules of subpart F. The House Ways and Means Committee noted[1]:

> In general, other countries do not tax foreign shipping income, whereas the United States imposes immediate U.S. tax on such income. The uncompetitive U.S. taxation of shipping income has directly caused a steady and substantial decline of the U.S. shipping industry. The Committee believes that this provision will provide U.S. shippers the opportunity to be competitive with their tax-advantaged foreign competitors.

Unfortunately, there are several regulations that if applied without deference to the intent of Congress in the Jobs Act could frustrate the realization of the objective of the Jobs Act. The first of those, involving the potential application of Treasury's regulations under Section 883 of the Code, was addressed constructively by Treasury earlier this month. These regulations govern the exclusion from gross income of the income derived from the international operation of ships and aircraft by certain corporations organized in qualified foreign countries. In a recent notice, Treasury stated that the regulation's anti-abuse provision (commonly referred to as the income inclusion test) would be applied without regard to the repeal of the foreign base shipping income rules by the Jobs Act, so that U.S.-owned foreign subsidiaries would not be unfairly penalized under those regulations.

The industry faces a comparable challenge through the potentially inappropriate application of IRS regulations designed to capture services income. In order to compete effectively, U.S. shipping companies provide certain services to their foreign subsidiaries. For instance, while the principal asset generating income is the ship owned by the foreign subsidiary, the U.S. parent often assists in providing or arranging for legal, engineering, marketing and other similar services with respect to the vessel's operation. That should not lead to the taxation of the vessel's operating income under subpart F through the recharacterization of that income as services income. Just like Treasury's approach to the Section 883 regulations, U.S.-owned shipping subsidiaries benefitting from this assistance should not be penalized merely because of the Jobs Act's changes. This is particularly the case where the foreign subsidiary has procured those services through an arms-length arrangement with its parent.

For limited liability and other purposes, shipping companies generally conduct their shipping operations through the use of multiple subsidiary corporations that own and register the vessels.

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[1] H. Rpt. 108-548 at 209.

In some cases, these companies are joint ventures where one of the owners is a foreign subsidiary of a U.S.-based shipping company. An additional challenge to the industry is the inappropriate possible application of the foreign personal holding company income rules to dividends, interest, and gains attributable to shipping income that foreign subsidiaries of U.S.-based shipping companies may receive or realize with respect to the lower-tier subsidiaries.

The overall purpose of the Jobs Act was to create jobs in the United States, particularly in sectors where sophisticated and high technology U.S. workers could be competitive in international markets. It would be contrary to the purpose of the Act to tax the ship operating income of foreign corporations under subpart F merely because U.S. workers from affiliated companies are able to provide technical and managerial assistance to those corporations, or because of the fact that ships are held in lower-tier subsidiaries.

Foreign Base Company Services Income

Foreign base company services income of a controlled foreign corporation ("CFC") is defined as income (whether in the form of compensation, commissions, fees, or otherwise) derived in connection with the performance of technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial, or like services which (1) are performed for or on behalf of any related person and (2) are performed outside the country under the laws of which a CFC is created or organized.[2]

Under Treasury regulations, services subject to the foreign base company services income rules include services performed by a CFC where "substantial assistance" contributing to the performance of such services has been performed by a related person or persons.[3] For this purpose, assistance furnished by a related person or persons to the CFC includes, but is not limited to, direction, supervision, services, know-how, financial assistance (other than contributions to capital), and equipment, material, or supplies.[4] This has the effect of subjecting all of the CFC's operating income to taxation under subpart F merely because of the activities of its parent or other affiliates.

Assistance furnished by a related person or persons to a CFC in the form of direction, supervision, services, or know-how is generally not considered to be "substantial" unless either (1) the assistance provides the CFC with skills which are a principal element in producing the income from the performance of such services by the CFC or (2) the cost to the CFC of the assistance equals 50 percent or more of the total cost to the CFC of performing the services

[2] Code section 954(e).
[3] Treas. reg. sec. 1.954-4(b)(1)(iv).
[4] Treas. reg. sec. 1.954-4(b)(2)(ii)(a).

performed by the CFC.[5] Also, assistance furnished by a related person or persons to a CFC in the form of direction, supervision, services, or know-how is not taken into account unless the assistance assists the CFC directly in the performance of the services performed by the CFC.[6] The regulations contain various examples demonstrating the potential application of these rules in cases where a parent corporation provides assistance to its CFC.[7]

Prior to the Act, the Code statutorily provided that foreign base company shipping income would not be considered foreign base company income under any other category of such income.[8] That provision was repealed as a "conforming amendment" in connection with the Act's repeal of the foreign base company shipping income rules.[9]

Foreign Personal Holding Company Income

The foreign personal holding company income ("FPHCI") rules subject to immediate subpart F taxation a CFC's dividends, interest, royalties, rents, and annuities, and its gains (net of losses) from the sale or exchange of property giving rise to such income.[10] Prior to the Act, dividends, interest, and gains relating to foreign shipping income were treated as foreign base company shipping income and not as foreign personal holding company income.[11]

The Potential Problems

The foreign base company services income rules, as they have been expansively interpreted by the Treasury "substantial assistance" regulations, raise a concern regarding their potential application to CFC shipping income. U.S.-owned shipping operations may have involvement of the U.S. parent corporation in the operation of foreign shipping subsidiaries. This involvement by the parent company is also the case for foreign-based competitors.

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[5] Treas. reg. sec. 1.954-4(b)(2)(ii)(b).
[6] Treas. reg. sec. 1.954-4(b)(2)(ii)(e).
[7] See, Treas. reg. sec. 1.954-4(b)(3). See, also, GCM 38065, TAM 8127017, and PLR 8114015.
[8] Code section 954(b)(6) (as in effect prior to the Act).
[9] Act section 415(c)(2)(B).
[10] Code section 954(c)(1)(A), (B).
[11] Code section 954(f) (as in effect before the Act) provided that foreign base company shipping included:

(1) dividends and interest received from a foreign corporation in respect of which taxes are deemed paid under section 902, and gain from the sale, exchange, or disposition of stock or obligations of such foreign corporation to the extent that such dividends, interest and gains are attributable to foreign base company shipping income, and

… Except as provided in paragraph (1), such term shall not include any dividend or interest income which is foreign personal holding company income (as defined in subsection (c).

Prior to the Act, the Code clearly provided that foreign base company shipping income would not be treated as foreign base company income under any other potentially applicable category of such income. But for the current regulatory provision discussed below, the Act's conforming amendment could open the possibility that shipping income will become subject to immediate subpart F taxation as foreign base company services income in the future.

Current Treasury regulations provide that foreign base company services income does not include, for taxable years beginning after December 31, 1975, foreign base company shipping income (as determined under Treas. reg. sec. 1.954-6).[15] However, there is a concern that in light of the "conforming amendment" discussed above, the Treasury Department may consider modifying this regulatory provision.

This concern results from the fact that international shipping operations are generally global in scope, and may involve the services of many related and unrelated companies. Vessel owners typically employ the assistance of brokers, agents, technical managers and economic managers. They should not be prohibited from employing the assistance of related U.S. companies that may be engaged in those services, since the purpose of the Jobs Act was to restore those capabilities in the United States. Obviously, the goal of Congress in repealing the subpart F shipping income rules would be frustrated if U.S. shipping companies remained subject to immediate subpart F taxation on their shipping income under some other provision of the foreign base company income rules.

The FPHCI rules may present a problem with respect to foreign shipping income earned through lower-tier foreign subsidiaries. The use of lower-tier subsidiaries for conducting shipping operations is typical in the industry. When lower-tier foreign subsidiaries pay to the CFC that owns them dividends or interest attributable to shipping income, the FPHCI rules, absent a technical correction, could, in certain circumstances, cause the dividend or interest income to become subject to immediate federal income taxation even though it has not been paid to the ultimate U.S. parent. Similarly, when the CFC sells or disposes of a lower-tier subsidiary, the FPHCI rules could subject the gain to immediate federal income taxation. It should be noted that these foreign personal holding company income problems would not arise if foreign shipping operations were conducted through a single CFC entity rather than through lower-tier subsidiaries. Obviously, the goal of Congress, in repealing the subpart F shipping income rules would also be frustrated if U.S. shipping companies remained subject to immediate taxation under the FPHCI rules because of the corporate structure they have typically used.

The proposed technical correction below would clarify that income that a CFC can show would have been foreign base company shipping income prior to the Act, will not be treated as foreign base company services income. This change will protect the operating income of the CFC from

[15] Treas. reg. sec. 1.954-4(d)(3).

recharacterization. It is without prejudice to the ability of the Service by regulation or otherwise to require the related U.S. company to recognize income reflecting the value of any assistance it may provide to its foreign shipping subsidiary. The proposed technical correction would also clarify that dividend, interest, and gain income that would have been foreign base company shipping income under prior law will not be treated as foreign personal holding company income.

Draft Technical Correction

AMENDMENT RELATED TO SECTION 415 OF THE AMERICAN JOBS CREATION ACT OF 2004 –

Section 954(b) is amended by adding at the end thereof the following new paragraph:

(7) Special Rules for Certain Shipping Income. – Income of a corporation that would have been foreign base company shipping income under paragraph (4) of subsection (a) (as in effect before its repeal in the American Jobs Creation Act of 2004) shall not be considered foreign base company income of such corporation under paragraph (3) of subsection (a) and income that would have been foreign base company shipping income under paragraph (1) of subsection (f) (as in effect before its repeal in the American Jobs Creation Act of 2004) shall not be considered foreign base company income under paragraph (1) of subsection (a).

PROPOSED TECHNICAL CORRECTION RELATING TO INCENTIVES TO REINVEST FOREIGN EARNINGS IN THE UNITED STATES

The Act creates a one-time opportunity for U.S. companies to repatriate earnings from their foreign subsidiaries at a reduced rate of tax. In order to qualify for this one-time opportunity, U.S. companies must utilize such repatriated earnings as part of a "domestic reinvestment plan" designed to encourage domestic employment. With the exception of certain related party indebtedness, increased leverage is an accepted method of raising funds to facilitate the repatriation of the benefited foreign earnings. Certain foreign corporations engaged in international shipping, however, are severely limited in the amount of indebtedness that they may efficiently incur due to the application of an historic tax provision that has little, if any, further relevance. We propose that Congress adopt a technical correction, described below, clarifying that distributed amounts related to previously excluded subpart F income withdrawn from foreign base company shipping operations will qualify for the reduced tax rate, thereby expanding the potential domestic reinvestment of foreign earnings, in accordance with Congressional intent.

Background

Domestic corporations generally are taxed on all income, whether derived in the United States or abroad. Income earned by a domestic parent corporation from foreign operations conducted by foreign corporate subsidiaries generally is subject to U.S. tax when the income is distributed as a dividend to the domestic corporation. Until such repatriation, the U.S. tax on such income generally is deferred, and U.S. tax is imposed on such income only when repatriated. However, under certain anti-deferral rules, the domestic parent corporation may be taxed on a current basis in the United States with respect to certain categories of passive or highly mobile income earned by its foreign subsidiaries, regardless of whether the income has been distributed as a dividend to the domestic parent corporation. One of the main anti-deferral provisions in this context is the CFC rules of subpart F. The U.S. tax owed on foreign-source income, whether earned directly by the domestic corporation, repatriated as a dividend from a foreign subsidiary, or included in income under the anti-deferral rules, may be reduced through foreign tax credits, if any.[12]

Dividends received by a domestic corporation from its foreign corporate subsidiaries are ordinarily not eligible for a dividends-received deduction. Under section 965 of the Code, however, certain cash dividends received by a United States corporate shareholder of a CFC which are to be reinvested in the United States by such shareholder are eligible for an 85-percent dividends-received deduction.[13] Section 965 of the Code was introduced by the Act as an incentive to repatriate and reinvest domestically foreign earnings that would otherwise likely remain offshore. The deduction provided by section 965 of the Code is available only for a limited time.[14] The deduction does not apply to items that are not included in gross income as dividends, such as subpart F inclusions or deemed repatriations under section 956 of the Code. Further, cash dividends excluded from gross income under section 959(a) of the Code are ineligible for the 85-percent dividends-received deduction of section 965. The deduction is allowed, however, for cash distributions excluded from gross income under section 959(a) of the Code to the extent of subpart F income resulting from dividends received by the CFC or a lower tier CFC.[15] Without this exception, a U.S. shareholder of a second tier or lower CFC would generally be unable to avail itself of section 965 of the Code simply because the distributions themselves generated subpart F income.

The Problem

U.S. shareholders of foreign shipping companies who wish to reinvest their foreign earnings in the United States under section 965 of the Code may be prohibited from doing so because a

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[12] Code sections 901, 902, 960, 1291(g).
[13] Code section 965(a)(1).
[14] Code section 965(f).
[15] Code section 965(a)(2).

distribution of those earnings can result in non-qualifying subpart F income. As described below, the subpart F income can result from a reduced "net investment in qualified shipping assets" which may occur as a result of this dividend.[16] In such a case, the distribution is excluded from gross income under section 959(a) of the Code and will not benefit from the 85-percent dividends-received deduction provided by section 965.

For taxable years beginning after 1975 and before 1987, the subpart F income of a CFC generally did not include foreign base company shipping income to the extent that such shipping income was reinvested during the taxable year in certain qualified shipping investments.[17] To the extent that, in a subsequent year, a net decrease in qualified shipping investments occurred, however, the amount of previously excluded subpart F income equal to such decrease was itself considered subpart F income.[18] For taxable years beginning after 1986, the exclusion for reinvested foreign base company shipping income was repealed.[19] The provisions relating to the pre-1987 net investment in qualified shipping assets, however, were retained. These rules continue to apply even after the Act's repeal of the subpart F rules applicable to foreign base company shipping income.

As a consequence of these rules, qualified shipping investments are a category of earnings permanently invested abroad which, uniquely, are potentially ineligible for the benefits of section 965 of the Code if repatriated. Further, and again uniquely, a CFC which maintains such investments may be prevented from borrowing from third-party sources to fund a dividend which qualifies under section 965 of the Code, since such a borrowing will, post-dividend, result in a decrease in the amount of such investments. We believe that this result was not intended by Congress, since it is caused by the residue of a statutory scheme which was repealed almost 20 years ago and which has been largely forgotten since. As a result, we believe that it is an appropriate candidate for a technical correction.

The proposed technical correction below clarifies that a United States shareholder of a CFC will be allowed to qualify for the 85-percent dividends-received deduction for cash distributions that are excluded from gross income under section 959(a) of the Code to the extent of any amount included in the United States shareholder's income for the taxable year under the rules relating to the inclusion of previously excluded subpart F income withdrawn from foreign base company shipping operations (section 951(a)(1)(A)(iii) of the Code). It tracks the mechanics of existing section 965 of the Code, which addresses a similar problem which could have arisen in the case of dividends paid up a multi-tiered chain of CFCs.

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[16] Code section 955; Treas. Reg. sec. 1.955A.
[17] Former Code section 954(b)(2).
[18] Code section 955(a).
[19] Section 1221(c)(1) of the Tax Reform Act of 1986.

Because of the short remaining time to bring dividends back under section 965 (i.e., until December 31, 2005), we would urge an extension through December 31, 2006, of the period to repatriate earnings covered by this shipping income technical correction.

Section 965 Draft Technical Correction

AMENDMENT RELATED TO SECTION 422 OF THE AMERICAN JOBS CREATION ACT OF 2004 –

Section 965(a)(2) is amended to read as follows:

(2) DIVIDENDS PAID INDIRECTLY FROM CONTROLLED FOREIGN CORPORATIONS AND PREVIOUSLY EXCLUDED SUBPART F INCOME WITHDRAWN FROM FOREIGN BASE COMPANY SHIPPING OPERATIONS.—If, within the taxable year for which the election under this section is in effect, a United States shareholder receives a cash distribution from a controlled foreign corporation which is excluded from gross income under section 959(a), such distribution shall be treated for purposes of this section as a cash dividend to the extent of

(A) <u>any amount included in income</u> by such United States shareholder under section 951(a)(1)(A) as a result of any cash dividend during such taxable year to—
  (i) such controlled foreign corporation from another controlled foreign corporation that is in a chain of ownership described in section 958(a), or
  (ii) any other controlled foreign corporation in such chain of ownership, but only to the extent of cash distributions described in section 959(b) which are made during such taxable year to the controlled foreign corporation from which such United States shareholder received such distribution; and

(B) any amount included in income <u>for such taxable year by such United States shareholder under section 951(a)(1)(A)(iii) (relating to previously excluded subpart F income withdrawn from foreign base company shipping operations).</u>

<u>An amount included in income under section 951(a)(1)(A)(iii) in respect of a controlled foreign corporation in a chain of ownership described in section 958(a) other than the controlled foreign corporation from which the United States shareholder receives the cash</u>

> distribution shall be taken into account for purposes of subparagraph (B) only to the extent of cash distributions described in section 959(b) which are made during such taxable year through such chain of ownership to the controlled foreign corporation from which the United States shareholder receives the cash distribution.

Very truly yours,

Kenneth J. Kies
Clark Consulting

Stephen Fiamma
Allen & Overy LLP

Warren Dean
Thompson Coburn LLP

Alex Trostorff
Jones Walker