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ANALYSIS & CONTROL UNIT

February 22nd, 2005

BY LEGAL COURIER.

Order No. 343854

The Hon. Mark W. Everson
Commissioner of Internal Revenue
ATTENTION: CC:LR:T
1111 Constitution Ave., NW, Room 3000
Washington, DC 20224

Re: Petition to Amend Treas. Reg. §1.883-4

Honorable Sir:

Enclosed you will find an original and three copies of a petition pursuant to 26 CFR §601.601(c) to amend Treasury Regulations §1.883-4. The details of the changes sought and the reasons for seeking them are set forth in the Petition.

Treasury Regulations §1.883-1 through §1.883-5, Exclusions from Gross Income of Foreign Corporations [T.D. 9087, 68 FR 51394-51417, Aug. 26, 2003] became effective as of September 24, 2004 and apply to tax years beginning on or after that date. As a practical matter, the regulations will affect tax returns filed for the calendar year of 2005, which must be filed by June 15, 2006.

The petition seeks to change an administrative detail of the regulations with a view to improving the overall effectiveness of compliance with Section 883. It would most helpful if a decision on the petition could be made within the next six months, but certainly before the end of this calendar year so that taxpayers can adjust to changes or the lack of changes made as a result of the petition.

Thank you for your consideration. If you have any questions regarding any matter presented in the petition, please contact me at your convenience.

Yours truly,

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Stephen Flott
Enclosures (4)

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SUBMITTED TO
THE COMMISSIONER OF INTERNAL REVENUE

PETITION PURSUANT TO 26 CFR §601.601(c) TO AMEND
TREASURY REGULATION §1.883-4

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Filed: February 22nd, 2005

**PETITION PURSUANT TO 26 CFR §601.601(c)
TO AMEND TREASURY REGULATIONS §1.883-4**

Overview of Petition

This Petition is being filed pursuant to 26 CFR §601.601(c) to amend Treas. Reg. §1.883-4. Treasury Regulations §1.883-1 through §1.883-5, Exclusions from Gross Income of Foreign Corporations, were published on August 26, 2003 [T.D. 9087, 68 FR 51394-51417].¹ The Regulations implement Section 883 of the Internal Revenue Code.

Treas. Reg. §1.883-4(e)(2) requires disclosure on a schedule to Form 1120-F (Tax Return of a Foreign Corporation) of the identities of the persons who are the ultimate beneficial owners of a controlling interest in any corporation which claims the exemption provided by Section 883.

This Petition seeks to remove subparagraph (e)(2) from Treas. Reg. §1.883-4 or, in the alternative, to add a paragraph to permit a formal certification of qualification and compliance to be included with the Form 1120-F as an optional method of satisfying the requirements of §1.883-4(e)(2).² If adopted, the change proposed in this Petition will improve and strengthen implementation of the tax policy underlying Section 883 and the administration of the Regulations.

Petitioner

This Petition is filed by Stephen Flott of Flott & Co. PC (the “Petitioner”). The Petitioner has been advising foreign shipping corporations subject to the four percent tax on US source gross transportation income imposed by Section 887 of the Internal Revenue Code (“IRC”)³ (“Section 887 Tax”) since 1988. Today, Petitioner’s clients collectively operate more than 600 cargo vessels, many of which call at US ports from time-to-time. In 2004 Petitioner assisted with the preparation and filing of over 400 tax returns for corporations which qualify for exemption from the Section 887 Tax by reason of the reciprocal exemption set out in Section 883. Petitioner also advises companies which qualify for exemption from the Section 887 Tax by virtue of tax treaties and which are not affected by the Regulations.

Many of Petitioner’s clients are tramp operators, meaning their ships primarily transport dry and liquid cargo in bulk in irregular patterns around the world in response to the dictates of charterers. Some own container ships which are chartered out to liner operators. These vessels call regularly at the US when they are assigned to US routes and not at all when assigned to other routes. As a result, the vessels may call once or several times at US ports in

¹Treasury Regulations §1.883-1 through §1.883-5, which will be referred to hereafter as the “Regulations” or the “Section 883 Regulations”, became effective as of September 24, 2004. Section 423 of the American Jobs Creation Act of 2004, [P.L. 108-357 Oct. 22, 2004, 118 Stat. 1418], extended the original effective date set out in Treas. Reg. §1.883-5 from September 25, 2003 to September 24, 2004. For most foreign corporations this effectively changed the effective date to the tax year beginning 1 January 2005.

²Treas. Reg. §1.883-4(e)(2) will be hereinafter referred to as “(e)(2)”.

³Section 887 was enacted by the Tax Reform Act of 1986 [P.L. 99-514, Title XII, Sec. 1212(b)(1), Oct. 22, 1986, 100 Stat. 2537] (“TRA 86”). The amendments to Sections 883(a) and (c) that the Section 883 Regulations implement were adopted as part of TRA 86 [P.L. 99-514, Title XII, Sec. 1212(c)(3)-(5), Oct. 22, 1986, 100 Stat. 2538]. TRA 86 took effect for the most part as of tax years beginning on or after December 31, 1986.

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one year and not call at all in others. In virtually all cases, Petitioner's clients hire out their vessels either on a bareboat basis for defined periods of time (called time or period charters) or on shorter specific voyages (called voyage charters).

Tax Policy and Sound Tax Administration

Meeting the tax policy objectives of Section 883, which the Section 883 Regulations are intended to implement, can only be achieved (and therefore monitored and validated) if corporations which qualify for the reciprocal exemption set out in Section 883, file US tax returns as required by law.⁴ Although compliance with the return filing obligation may not, strictly speaking, be viewed as a tax policy issue, the filing compliance rate of companies subject to Section 883 cannot be ignored when Treasury and the Internal Revenue Service (the "Service") evaluate the potential impact of the Regulations on the effective operation of Section 883 tax policy.

More importantly, any benefit to the Service of requiring the disclosure as specified in (e)(2) must be weighed against the broader detriment taxpayers believe will be created for them as a result of making the disclosure. In practice, the (e)(2) disclosure adds nothing to the Service's ability to verify the validity of a claim of reciprocal exemption under Section 883 based on the return alone. The Service has always had the right to require that a corporation claiming a Section 883 exemption on its tax return demonstrate it qualifies for the exemption claimed. Thus, the Service has had the power to demand to know the identity of the ultimate beneficial owner ("UBO") of the controlling interest in the taxpayer.⁵ However, without auditing the return to verify the truth of the statements made in it, the (e)(2) disclosure can be no more effective than the far more general statement of exemption specified in Rev. Proc. 91-12.⁶

This Petition emanates from a profound concern that, unless Treasury policymakers and IRS tax administrators take into account both the detrimental effect on the controlling UBO's of shipowning corporations and the consequent potential impact of the (e)(2) disclosure requirement on filing compliance, the disclosure requirement is far more likely to further erode filing compliance than it is to advance the tax policy of Section 883.

Description of Proposed Changes to Treas.Reg. §1.883.4

Petitioner proposes two alternatives to effect changes to Treas.Reg. §1.883.4, either of which would alleviate the concerns of the controlling UBO's of shipowning corporations. The first

⁴A foreign corporation, which has a vessel lift or discharge cargo at a US port in any tax year, is obligated to file a US tax return on Form 1120-F whether or not the corporation qualifies for exemption under Section 883. See Section 6.01 of Rev. Proc. 91-12 [1991-1 C.B. 473, February 11, 1991].

⁵In this Petition, we refer to a single controlling UBO for simplicity. It is understood that, in many cases, several persons may own an interest in the shipowning corporation and, as a result, the identification of more than one qualified UBO would be needed in order for the corporation to satisfy the exemption requirement that more than 50% of its shares be owned by qualified shareholders.

⁶See footnote 14 *infra*.

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option will not impair the effective operation of Section 883. The second is likely to benefit it.

The first (and preferred) alternative is to remove the disclosure requirement set out in (e)(2) from the Regulations because it adds nothing to the Service's ability to implement Section 883 policy or verify the validity of an exemption claim.

Removing (e)(2) would not weaken the position of the Service to determine from the face of the return itself that the company qualifies for exemption. Treas. Reg. §1.883-4(e)(3) requires the taxpayer to name the country in which the UBO of more than 50% of the corporation resides. Identifying the country in which the controlling UBO of the taxpayer resides gives the Service the threshold information it needs to determine from the face of the return if the corporation qualifies for the claimed exemption. Requiring the name and address of the controlling UBO adds nothing to the Service's ability to determine from the face of the return if the exemption is valid unless an audit is conducted. When filed, the tax return is all the Service has to support the claimed Section 883 exemption. Thus, in the absence of an audit of the return, the (e)(2) disclosure adds no validation value of the tax return to the Service.

Conversely, those taxpayers making the (e)(2) disclosure as part of their return will increase the risks faced by themselves and their controlling UBO's (as will be explained further below), and thus, will, in all likelihood, have the effect of further eroding filing compliance.

As a second alternative, if the Service is not prepared to remove the (e)(2) disclosure requirement, Petitioner proposes that a certification process modeled along similar lines as the process employed by the Service's ITIN program⁷ be added to the Regulations as an optional filing method to overcome the detrimental effect on owners of making the (e)(2) disclosure on the schedule to Form 1120-F (Tax Return of a Foreign Corporation) ("Form 1120-F"). A detailed proposal for such a certification process is described later in this Petition, but in essence it would permit a corporation to include as part of its Form 1120-F instead of the (e)(2) disclosure, certifications made under oath that (1) the corporation qualifies for exemption and has obtained the documentation required by Treas. Reg. §1.883.4(d);⁸ and (2) the corporation will maintain and update the documentation as required by the Regulations and will provide it to the Service within sixty days of being requested to do so.⁹

⁷ITIN means Individual Tax Identification Number. The Service requires any foreign person who has US source income, but does not qualify for the issuance of a social security number to obtain an ITIN by filing Form W-7. As will be detailed later in this Petition, the Service permits tax professionals to serve as acceptance agents to file Form W-7 on behalf of foreign persons. In essence, acceptance agents act as an extension of the Service in verifying the identity of foreign persons filing Form W-7. Persons needing an ITIN do not have to use an acceptance agent. They may file Form W-7 directly with the Service if they wish.

⁸This first certification will have to be signed by a practitioner subject to 31 CFR Part 10, Regulations Governing the Practice of Attorneys, Certified Public Accountants, Enrolled Agents, Enrolled Actuaries and Appraisers before the Internal Revenue Service, published as Treasury Department Circular No. 230 (Rev. 7-2002), as amended by T.D. 9165 [69 FR 75839, December 20, 2004] ("Circular 230").

⁹See Treas. Reg. §1.883-1(c)(3)(ii) which stipulates the sixty day limit on production of substantiation. This certification will have to be signed by the person signing the return

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Not only would this alternative give the Service a pre-filing verification from a person over whom it has authority pursuant to Circular 230 that the corporation is entitled to the exemption claimed on its return, but would also allow the Service to obtain comfort that the ownership statements required by Treas. Reg. §1.883.4(d) to document and substantiate that exemption have been prepared and that they would be made available promptly upon request. The change proposed in this Petition would still allow a taxpayer the option to make the (e)(2) disclosure and comply with Treas. Reg. §1.883-4(e)(3) on its 1120-F, instead of providing the proposed certification. Adopting this proposal will provide the Service with an expeditious, cost effective means of implementing its Section 883 policy without unnecessarily punishing the taxpayers complying with their filing obligations and without the risk of weakening policy implementation by exacerbating return filing non-compliance.

As is explained below, disclosure of the identity of the UBO of a controlling interest in the filing corporation on the Form 1120-F is perceived by virtually all shipowners as an unwelcome and potentially detrimental change to the longstanding requirements for obtaining exemption under Section 883.

The Risks to Shipowners of Making the (e)(2) Disclosure

Petitioner takes for granted that the Service is entitled to know the identity of the UBO of the controlling interest in a corporation when it wants to verify the validity of a Section 883 exemption claim. However, an (e)(2) disclosure made as part of a corporation's US tax return gives rise to an unwelcome (and we believe, unintended) increase in risk to the shipowner.

US tax returns are not necessarily available only to the Service. While IRC Section 6103 seeks to ensure the confidentiality of returns provided to the Service (except in extraordinary circumstances not likely to be relevant in the case of a Section 883 exemption claim) the taxpayer cannot protect its tax return from disclosure to an adversary in litigation. The court rules of the US and other foreign jurisdictions give plaintiffs wide latitude in discovery to obtain documents from defendants, including copies of tax returns. As soon as the maritime plaintiffs bar realizes that the identity of the controlling UBO of a shipowning company can be obtained from the company's Form 1120-F, it is hard to imagine that demanding disclosure of such returns will not become standard discovery practice in maritime cases. It will also become commonplace for plaintiffs to attempt to name or join the controlling UBO as a party to the action. This consequence runs entirely contrary to the role and function of the corporate entity.

As the Service will be aware, one of the main reasons for trading through a corporation is to benefit from the distinct legal personality that such a corporation enjoys, separate from its shareholders. Making the (e)(2) disclosure is tantamount to piercing the corporate veil of not

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just a single private company but of tiers of private companies, all of which generally are entitled to disclose the identity of the controlling UBO only on a need to know basis.¹¹ There are times when information about the controlling UBO must be provided to governmental agencies, such as the Service, but otherwise it is at the discretion of the corporation when information about the controlling UBO is provided and to whom. Furthermore, requiring disclosure of the identity of the controlling UBO of a multi-tiered corporate group of private companies is not required of domestic corporations on their 1120's. There is certainly no precedent for imposing this requirement on legitimate foreign corporate groups, especially when the information is of limited, if any, value to the Service. In essence, Petitioner believes that the negligible value which the Service might obtain from such disclosure is disproportionate to the increased risk to corporations (and their controlling UBO's) in making it.

The characteristic of distinct legal personality is of particular importance in the shipping industry. As ships must compete for business internationally, the nature of the trade they undertake requires them to travel to many different countries with many different legal systems, some friendly, some not.

Over centuries maritime law has created unique mechanisms to balance the need for mobility of ships against proper and responsible enforcement of owners obligations.¹² The structure of the ownership of vessels has evolved along with maritime law and has enabled shipping to provide effective service on a global basis, for example, by allowing owners to manage the commercial risks associated with shipping through use of single-ship companies, thereby ensuring that claims and potential liabilities arising from the operations of one vessel are limited to that vessel-owning company. In addition, the use of such structures has served to maintain the separation between owner and corporation, including for private companies, confidentiality as to the identity of the controlling UBO.

The Service needs to understand the risks that (e)(2) disclosures represent to shipowners and how that disclosure could change the nature of the commercial risks they face, not only in the US, but everywhere their ships operate. By way of example, in certain parts of the world, the approach to trade is not as straightforward as in the US. Timely performance of voyages is extremely important to shipowners (and charterers), so it is not uncommon to have a ship arrested on spurious grounds in order to exert commercial pressure on the owner. Unlike in the US, many overseas jurisdictions require very scant evidence of a claim against the owner

¹¹During the editing process, the consecutive numbering of the footnotes was interrupted. As a result, there is no footnote 10. The text of footnote 11 follows: There are legal bases upon which courts can pierce or disregard the corporate veil and require the identity of the UBO to be disclosed and to be liable for corporate obligations. However, in the United States and elsewhere piercing the corporate veil is difficult. It is well established that corporations are legal persons distinct from the persons who own them. Many states no longer require the names of shareholders to be listed in public documents, only the identifies of the officers and directors.

¹²Maritime law allows legal action to be taken in admiralty courts against the ship, even if the owner cannot be found or even if the ship has been sold to another owner without notice of the claim. Maritime liens can be enforced by arresting the vessel as security for payment of the claim. Furthermore, some jurisdictions, including the US, permit the arrest of "sister ships" – ships owned by the same owner – as security for the debt of another ship owned by the same owner.

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or the vessel before granting an arrest order. Certainly, it is not unheard of that unscrupulous persons use bribes and other measures to “help” some foreign courts with their decision making. Making the identity of the controlling UBO more easily available (following, for example, the making of an (e)(2) disclosure on Form 1120-F) will increase the likelihood of such events occurring more frequently in the future.

The Service should not underestimate how problematic shipowners consider disclosure of the identity of the controlling UBO on Form 1120-F. The (e)(2) disclosure will not help the Service establish the validity of the Section 883 exemption any more than the general claim of qualification does now, as both must still be verified to be confirmed. More to the point, if return filing non-compliance is high now, when the filing requirement is relatively innocuous and non-intrusive, the Service should not ignore what is likely to happen to compliance, in the absence of meaningful enforcement, when returns containing these highly sensitive (e)(2) disclosures are required to be filed in June 2006.

Indeed, Petitioner’s proposal that the Service either remove the (e)(2) disclosure requirement or, in the alternative, make available to taxpayers the option of adopting a certification process to confirm that the corporation is entitled to the exemption claimed on its return arises directly as a result of the genuine, legitimate concerns of shipowners concerning the risks of (e)(2) disclosure.

Claiming the Section 883 Exemption Prior to the Section 883 Regulations

Foreign corporations subject to the Section 887 Tax, whether or not exempt under Section 883, are required to file Form 1120-F. From 1988 through 2004,¹³ returns filed by foreign corporations claiming the reciprocal exemption provided by Section 883 are supposed to include the name, address and employer identification number of the taxpayer, answers to the questions on Form 1120-F, and a statement of the basis of the exemption claimed.¹⁴ The tax return is also supposed to include a statement of the amount of income excluded if “readily determinable”.¹⁵

There is no disclosure of information about the person or persons who ultimately own the corporation. Indeed, nothing required on the return can tie the filer to a person or persons.

¹³The Section 883 Regulations do not take effect until tax returns have to be filed for tax years beginning on or after September 24, 2004.

¹⁴The following statement satisfies the requirements of Section 8.02(3) of Rev.Proc. 91-12 to claim exemption under Section 883: ABC Corporation is subject to tax in the United States pursuant to 26 USC §887 only. As a Cypriot corporation without a place of business in the United States, the corporation is exempt from tax by virtue of the exchange of diplomatic notes between Cyprus and the United States; and, as required by 26 USC §883(a), more than 50% of the value of the corporation’s stock is beneficially owned by persons who are resident for tax purposes in countries that qualify for exemption from this tax.

¹⁵Under Treas. Reg. §1.6012-1(b)(i) and Treas. Reg. §1.6012-2(g)(i), if a foreign corporation has no gross income for the taxable year by reason of any section of the Code, the Form 1120-F schedules do not need to be completed. However, a statement must be attached to the return indicating the types of US source gross transportation income excluded and the amounts of such exclusions to the extent readily determinable.

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Certainly, if the Service selects a “reciprocal exemption” return for examination, the foreign corporation that filed the return would have to demonstrate to the Service’s satisfaction that it satisfies the requirements for the exemption claimed on the return. However, the disclosure on the tax return, as is currently required, is itself innocuous.

Non-Compliance with the Filing Obligation

Notwithstanding what is under the existing regime a modest, non-intrusive filing requirement to claim the Section 883 exemption and the fact that virtually every country in which shipowners and charterers of any significance reside qualifies for the reciprocal exemption, compliance with the tax return filing requirement has been poor. More to the point, the Service appears to have expended little, if any, effort to enforce the filing requirement among tramp operators, many of which have been calling at US ports for years without either filing a return or being penalized for not filing one.

It is fundamental to proper tax administration that taxpayers file required tax returns.¹⁶ It is also a matter of fundamental fairness to taxpayers who comply with the return filing requirement that a reasonably high percentage of required tax returns be filed. Petitioner asserts that non-compliance among those subject to the filing requirement of Rev. Proc. 91-12 constitutes a strong argument for adopting at least one of the changes to Treas. Reg. §1.883-4(e) proposed in this Petition.

Concern about return filing compliance by foreign companies subject to Section 887 was raised during consideration of the section in 1986. Indeed, Congress asked its tax writing committees and the Treasury to track compliance and make recommendations if compliance did not prove adequate.¹⁷ What was described as “an extremely high level of non-compliance with the U.S. tax rules by foreign persons that have U.S. source shipping income”¹⁸ prompted

¹⁶A discussion of the importance of filing compliance to sound tax administration is attached as Appendix B. Filing compliance is particularly important in the context of Section 883, because filing compliance is reporting compliance.

¹⁷Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS-10-87), May 4, 1987, p. 930. Congress almost immediately moved to enhance enforcement for non-filing by increasing the amount of the applicable penalty from \$100 to \$10,000 for taxpayers who were exempt under Section 883 but failed to file a return to claim exemption. Section 6114 was added in 1988 for treaty based returns [P.L. 100-647, Title I, Sec. 1012(aa)(5)(A), Nov. 10, 1988, 102 Stat. 3532]. Treas. Reg. §301.6114 [T.D. 8292 55 FR 9440, Mar. 14, 1990; 55 FR 10237, Mar. 20, 1990] was published to implement that section. Failing to file a return under Section 6114 is subject to a penalty of \$10,000 for each such failure. See Treas. Reg. §301.6712 [T.D. 8292 55 FR 9440, Mar. 14, 1990]. Section 6038A was amended in 1989 [P.L. 101-239, Title VII, Sec. 7403(a)-(d), Dec. 19, 1989, 103 Stat. 2358, 2359] and Treas. Reg. §1.6038A [T.D. 8353, 56 FR 28056-28075, June 19, 1991] was published to implement that section. Treas. Reg. §1.6038A-1(c)(5)(ii) provides a reporting exemption for a foreign corporation whose gross income is exempt from US taxation under Section 883, provided that “the corporation timely and fully complies with the reporting requirements set forth in Rev. Proc. 91-12 to claim the exemption under Section 883.” Failure to file the required return is subject to a penalty of \$10,000 for each such failure.

¹⁸S.Rept. 105-84, September 24, 1997, p. 28.

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the Senate to add a section to the *OECD Shipbuilding Agreement Act* (S.1216) that denied the exemption to any foreign corporation that did not satisfy the filing requirements.¹⁹

At the Baltic International Maritime Council (BIMCO) course on U.S. tax matters entitled, *Counting the Cost – Current Developments in Tax and Accounting Issues in the International Shipping Industry*, held in New York on October 28, 2004, William Pfeil, IRS Shipping Industry Technical Advisor, Large and Mid-Size Business Division, acknowledged that the level of non-compliance that so troubled the Senate in 1996 is still prevalent. Mr. Pfeil reported that, when he compared the number of companies with a Certificate of Financial Responsibility (“COFR”), which every vessel that enters a US port must have on board as a condition of entry,²⁰ with the number of corporations that have filed US tax returns, it appears likely that filing compliance for shipowners may not exceed 35%.

This comparison is at best a rough measure of compliance. If anything, the COFR-to-tax return comparison probably understates filing non-compliance.²¹ The Section 887 Tax applies not only to owners of vessels, but also to charterers, who hire the vessels on a time or period basis, to transport cargo for others on a for-hire basis.²² There is no COFR equivalent for charterers.²³ As a result, identifying the number of foreign corporations that should be filing an 1120-F to claim a Section 883 exemption or to pay the tax is difficult at best.

Yet, despite the factors supporting noncompliance among operators of tramp vessels and the apparent lack of enforcement by the Service, many foreign shipowners conscientiously file the required tax returns. Ordinarily, it would be expected that they would continue to do so.

¹⁹Section 201. S.1216 did not become law because of opposition to the *OECD Shipbuilding Agreement* itself, thus the provision never became effective.

²⁰The names of foreign shipping companies which have obtained COFR’s are available from the Coast Guard’s National Pollution Funds Center website: <http://www.npfc.gov/cofr/default2.asp>.

²¹A COFR is generally obtained by vessel corporations as a matter of course. COFR’s are particularly necessary for tramp operators since their vessels must be able to trade to any country in the world at the instruction of a charterer. As a result, they obtain COFR’s for all of their vessels regardless of their employment. COFR’s are valid for a period of three years, during which the vessel may never actually lift or discharge a cargo in the United States. Thus, the correlation between the number of corporations holding a COFR and the number legally obligated to file a US tax return would not be 100%.

²²The Section 887 Tax is a gross tax. As such it applies even if another entity in the transportation chain is also subject to the tax. For example, a shipowner, which earns timecharter hire from a charterer on a voyage that lifts or discharges cargo in the United States, is subject to 4% tax on 50% of the gross hire it receives. The charterer is also liable to 4% tax on the hire or freight it receives from the cargo owners and cannot deduct the amount paid to the shipowner for use of the vessel. In this respect, the Section 887 Tax is a double (or even triple) tax in that it can result in the multiple taxation of income on a gross basis because it applies separately to each entity in the chain of transportation. As such, all entities that earn hire from the use of the vessel are required to file a Form 1120-F to claim exemption if they qualify or to pay the tax, if they do not.

²³It remains to be seen if the recently enacted Automated Manifest System that the Customs and Border Protection Agency has implemented to enforce Section 343 of the Trade Act of 2002 creates another source of publicly available information from which to track companies that should be filing US tax returns to claim a Section 883 exemption.

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However, if a foreign shipowner suffers no harm when it fails to file a tax return to claim its Section 883 exemption, that shipowner not only enjoys the *de facto* benefit of an exemption without the cost or trouble of filing a return to claim it, but it also provides no tax return for the Service to use to test the validity of its exemption and in addition, will not be subjecting itself (or its UBO) to the inherent risks in making the (e)(2) disclosure.

As matters stand now, whatever the rate of return filing compliance is, it is far below what can be considered close to an acceptable level. This “filing gap” and the absence of enforcement efforts to reduce it put those who do file returns in the unenviable and inequitable position of being the only ones against whom the Regulations can be enforced, and, in light of the proposed (e)(2) disclosure, the only ones who will bear the additional risks described above.

This is hardly a situation that will support sound administration of Sections 883. If anything it is far more likely to lead to greater noncompliance.

Petitioner’s Proposals to Modify Treas. Reg. §1.883-4

Petitioner prefers that (e)(2) be deleted from the Regulations. The rationale for such deletion has already been explained and no further detail as to implementation is required.

If the Service is unwilling to remove §1.883-4(e)(2) from the Regulations, Petitioner proposes in the alternative that a certification process be added to the Regulations as an optional filing method for taxpayers. It is proposed that this be achieved by adding a new subsection (f) to Treas. Reg. §1.883-4 as follows:

(f) Optional Certification. A foreign corporation relying on the qualified stock ownership test of this section to meet the stock ownership test of §1.883-1(c)(2) may attach the certifications described in this paragraph (f) to its Form 1120-F, “Tax Return of a Foreign Corporation”, in lieu of the schedules specified in paragraphs (e)(2) and (3) of this section.

(1) Certification of Qualification by Tax Practitioner: A certification signed under penalties of perjury by a practitioner authorized to practice before the Internal Revenue Service pursuant to §10.3(a)-(c) of Treasury Department Circular 230 stating that (1) the corporation has obtained the documentation specified in §1.883-4(d) from qualified shareholders, as defined in §1.883-4(b), who own more than 50% of the value of its outstanding shares; (2) the practitioner has reviewed said documentation; and (3) that such documentation establishes that the corporation satisfies the relevant qualified shareholder stock ownership test set out in §1.883-4.

(2) Certification by Taxpayer regarding Documentation: A certification signed under penalties of perjury by the taxpayer stating that (1) it has obtained the documentation specified in §1.883-4(d) from qualified shareholders, as defined in §1.883-4(b), who own more than 50% of the value of its outstanding shares; (2) it will update this documentation as required by §1.883-4(d)(2)(ii); (3) it will maintain the documentation as required by §1.883-4(d)(5); and (4) it will make such documentation available to the Commissioner promptly upon request for it at the time and place designated by the Commissioner.

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Petitioner's proposed alternative certification option does not change any of the substantive provisions of the Section 883 Regulations. It creates a method of pre-certification of the validity of the exemption claimed on the return, verification of the existence of the required documentation and an agreement to make it available upon request.

The certification under proposed paragraph §1.883-4(f)(1) can only be made by a practitioner authorized to practice before the Internal Revenue Service under subsections (a) through (c) of Section 10.3 of Circular 230. Limiting the persons who can make the certification to those subject to the practice standards of Circular 230, particularly Sections 10.21,²⁴ 10.22²⁵ and 10.34,²⁶ incorporates a strict standard of review into the certification. It requires the practitioner making the certification to have reviewed the documentation required by the Regulations in order to make the certification. Lastly, it requires the practitioner to draw an informed judgment regarding satisfaction of the applicable stock ownership test.

Precedent for this type of "pre-filing" certification can be found in the regulations governing the issuance of individual taxpayer identifying numbers (ITIN) under Section 6109 of the Code. Appendix A to the Petition contains a brief explanation of the ITIN's acceptance agent program whereby the Service uses non-Service persons to certify documentation supporting an application for an ITIN on Form WS-7.

In the case of the certification proposal set forth in this Petition, the ITIN acceptance agent program provides an example, not a template. Here, the certification proposal builds on the existing legal obligations of tax practitioners, who already assume liability for the accuracy and reasonableness of positions taken on returns to the extent of their actual knowledge.

The advantages to the Service of pre-filing certification in these circumstances are evident. First, the Service obtains the certification of a tax professional over which it has authority by virtue of Circular 230. Second, that professional certifies compliance with the requirements of the Regulations, thus verifying the validity of the exemption claimed on the return as part of the return itself. Third, the Service gains assurance that the required documentation has been completed and is being maintained up-to-date by the taxpayer. Fourth, the taxpayer affirmatively agrees to provide that documentation to the Service upon request.

²⁴Practitioners with knowledge of a client's omission from or error in any return, document, affidavit, or other paper submitted or executed under the revenue laws of the United States must advise the client of such omission, error or noncompliance and its consequences under the Code.

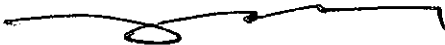
²⁵Practitioners must exercise due diligence in preparing or assisting in the preparation and filing of tax returns, documents, affidavits with the Service, in determining the correctness of oral and written representations made by the practitioner to the Department of the Treasury; and in determining the correctness of oral and written representations to clients with reference to any matter administration by the Service.

²⁶Practitioners may not sign tax returns as a preparer if the return contains a position that does not have a realistic possibility of being sustained on its merits. The section contains further provisions regarding adopting frivolous positions and advising clients of the risks of potential penalties for taking a position on a return.

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The last, but not least important, benefit of this certification approach is that it eliminates the intrusive disclosure requirement which most shipowners find extremely prejudicial and problematic and which may well push noncompliance higher. Enabling those who wish to take advantage of pre-filing certification of compliance with the Section 883 Regulations instead of (e)(2) disclosure is a trade-off that benefits the Service and the foreign shipowner and enhances implementation of the tax policy behind Section 883 and the Regulations.

All of which is respectfully submitted,



Stephen Flott

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Appendix A – ITIN Acceptance Agent Program

Section 6109(a) of the Code mandates that persons required to make a return, statement or other document under the Code to include on the return, statement or document an identifying number as prescribed by the Secretary of the Treasury. Treas. Reg. §301.6109-1(a)(1)(ii)(B) requires an individual, who is required to furnish a taxpayer identifying number but is not eligible to obtain a social security number, to use an ITIN as defined in §301.6109-1(d)(3)(i).¹

Treas. Reg. §301.6109-1(d)(3)(ii) requires any individual who cannot obtain a social security number to apply for an ITIN using Form W-7, Application for IRS Individual Taxpayer Identification Number. A copy of Form W-7, which includes the instructions, is included in this Appendix. In addition to completing the Form W-7, the applicant is required to provide documentary evidence of his or her foreign status and identity. The documents provided have to be originals or notarized or certified copies.

Acknowledging that many persons who would require an ITIN would be resident abroad and would be dealing with the Service from a distance and in an unfamiliar language, the Service decided to create a role for intermediaries, called acceptance agents, to smooth the process. Treas. Reg. §301.6109-1(d)(3)(iv)(A) provides rules for acceptance agents and procedures by which these agents are required to operate. Treas. Reg. §301.6109-1(d)(3)(iv)(B) sets out who can be an acceptance agent. In this case, financial institutions, colleges or universities, any federal agency or any other person authorized by Internal Revenue Service procedures are listed as being eligible to serve as acceptance agents.²

Acceptance agents serve as agents of the Service in processing the documentation required of foreign persons who need to obtain an ITIN. Indeed, when the acceptance agent forwards the W-7 to the IRS without including the documentation that he has reviewed, he or she must sign the certification on Form W-7 under penalties of perjury. The advantages to the Service of this approach are obvious. The program enables the Service to extend service around the world by using persons who are familiar with local identification documentation and speak the language of the person applying for an ITIN.

The certification proposed in this Petition differs in several important respects from the ITIN acceptance agent program as befits the different role that a paid tax preparer plays in the preparation of filing of a tax return. In the ITIN acceptance agents program, the agreements allow the Service to utilize the services of a variety of persons from several service sectors and government agencies to complete the task of verifying individuals' identities without having to process and verify the documentation itself. Nonetheless, not surprisingly, many acceptance agents are financial services and tax professionals.³

¹T.D. 8671, [61 FR 26788, May 29, 1996].

²Acceptance agents have to enter into an agreement with the Service. According to the ITIN Program Office, the program is not currently accepting new applications because administration of the program is being revised. We have requested a copy of the former acceptance agent agreement form for evaluation. That request has been submitted to the ITIN Program Office, Wage and Investment Division, Atlanta.

³The list can be found on the IRS website at <http://www.irs.gov/individuals/article/0,,id=96304,00.html>.

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Appendix B – Filing Compliance is Essential to Sound Tax Administration

It has long been accepted that a voluntary tax system can function only when it is effectively enforced.¹ Professor James Alm, a leading authority on tax administration, uses the “economics of crime approach” to describe the connection between enforcement and tax compliance in a section of his article, “Tax Compliance and Administration”, entitled, “Theoretical Foundations of the Individual Tax Compliance Decision”.² Unsurprisingly, he asserts that pervasive non-compliance breeds more non-compliance.³

The research and literature about tax compliance divides tax compliance into three categories: filing, reporting and payment compliance. Filing compliance, that is, whether taxpayers file required returns in a timely manner or at all, is the primary concern of this Petition. Filing compliance is reporting compliance for those who qualify for exemption under Section 883.

The Service has engaged in extensive research and analysis of tax compliance for years, most of it concentrating on individual and employer compliance because those are the two principal sources of federal tax receipts. Indeed, Service researchers have compared measuring the compliance behavior of US taxpayers to measuring net profit for a private sector business, that is, it is a summary, bottom-line measure of the effectiveness of the organization.⁴

The Service understands that ensuring high compliance levels is a core part of its mission and demonstrates that it has invested substantial time, money and effort into studying causes for non-compliance and ways to counteract it.⁵ Two recent contributions by Service personnel to the tax compliance literature are worth highlighting because they underscore the importance of filing compliance and comment on trends that reinforce non-compliance. Commenting on the impact of filing compliance, which for individual US taxpayers was estimated to be 90.7% in 2000, Brown and Mazur (2003) points out that, of the three compliance measures (filing, reporting and payment), filing compliance has the greatest affect on the size of the “tax gap”, the amount by which the total tax collected is less than the amount which should be collected. According to the authors, research indicates that filing non-compliance accounts for 57% of the tax gap, confirming its importance in the proper administration of the tax code.⁶

¹“If taxpayers perceive that the tax system is failing to fairly enforce the law for all, then overall voluntary compliance levels will erode.” Department of the Treasury, Internal Revenue Service, *Report to Congress: IRS Tax Compliance Activities*, July 15, 2003 at page 3. This report will be referred to hereafter as the “Report”.

²James Alm (2000), “Tax Compliance and Administration”, in *Handbook on Taxation* edited by W. Bartley Hildreth and James A Richardson, (Marcel Dekker, New York 2000), pages 743-747. Virtually all of the research and literature on compliance focuses on personal tax returns and employment tax returns. However, the principles discussed in the research and the literature are relevant to the behavior of corporations.

³Alm (2000), p. 751

⁴Robert E. Brown and Mark J. Mazur, “IRS’s Comprehensive Approach to Compliance Measurement”, IRS (N:ADC:R, Washington, DC), June 2003, page 1. Referred to hereafter as Brown and Mazur (2003).

⁵Seventeen articles and reports on compliance research and measurement and on determinants of taxpayer compliance are available on the IRS website under the Taxpayer Compliance Research link on the Tax Statistics tab of the website.

⁶Brown and Mazur (2003), Table 2, Interaction of IRS Compliance Measures and Impact on the Tax Gap, p. 10.

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In a paper that explores the debate among experts about the reasons for growing tax noncompliance, Kim M. Bloomquist, Senior Economist at the Service's Office of Research, examined several studies by authorities from the OECD and the US.⁷ Bloomquist argues that the positive relationship between "transaction visibility" and "reporting compliance" best explains increased noncompliance. The author studied the correlation between income which is reported to the IRS by third parties (*e.g.* wages, interest, dividends, etc.) and income which is not subject to such reporting (*e.g.*, self-employed earnings and capital gains) and found that the empirical results "appear consistent with the consensus view of a positive correlation between transaction visibility and tax compliance."⁸

This research is relevant to this Petition. Brown and Mazur (2003) emphasizes the vital importance of filing compliance, particularly in the Section 883 context when filing compliance is reporting compliance. Bloomquist (2003) offers a persuasive explanation for why filing noncompliance is so high. The income earned by foreign corporations from the international operation of ships is "invisible" to the Service, which has no way of knowing which foreign corporations earn such income from transportation to or from the US. The "invisibility" of the income greatly increases the enforcement challenge for the Service in identifying those who should be filing "reciprocal exemption" returns.

As a practical matter, tax regulations achieve their purpose when those covered by them actually file tax returns and when a statistically important number of the filed returns are audited. At its most basic, Section 883 tax policy needs to take tax return filing compliance into account to assess the effectiveness of policy implementation. A low level of tax return filing compliance undermines sound administration of tax policy by shrinking the pool of tax returns available to be examined for adherence to the policy. Even more to the point, tolerating a high level of tax return filing non-compliance encourages even more filing non-compliance further reducing the effectiveness of the tax policy.

⁷Kim M. Bloomquist, "Trends as Changes in Variance: The Case of Tax Noncompliance", 2003 IRS Research Conference, June 2003. Referred to hereafter as Bloomquist (2003).

⁸Bloomquist (2003), p. 6/7.