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# GLOBAL TAX WEEKLY

## a closer look

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**SUBJECTS** TRANSFER PRICING INTELLECTUAL PROPERTY VAT, GST AND SALES TAX CORPORATE TAXATION INDIVIDUAL TAXATION REAL ESTATE AND PROPERTY TAXES INTERNATIONAL FISCAL GOVERNANCE BUDGETS COMPLIANCE OFFSHORE

**SECTORS** MANUFACTURING RETAIL/WHOLESALE INSURANCE BANKS/FINANCIAL INSTITUTIONS RESTAURANTS/FOOD SERVICE CONSTRUCTION AEROSPACE ENERGY AUTOMOTIVE MINING AND MINERALS ENTERTAINMENT AND MEDIA OIL AND GAS

**COUNTRIES AND REGIONS** EUROPE AUSTRIA BELGIUM BULGARIA CYPRUS CZECH REPUBLIC DENMARK ESTONIA FINLAND FRANCE GERMANY GREECE HUNGARY IRELAND ITALY LATVIA LITHUANIA LUXEMBOURG MALTA NETHERLANDS POLAND PORTUGAL ROMANIA SLOVAKIA SLOVENIA SPAIN SWEDEN SWITZERLAND UNITED KINGDOM EMERGING MARKETS ARGENTINA BRAZIL CHILE CHINA INDIA ISRAEL MEXICO RUSSIA SOUTH AFRICA SOUTH KOREA TAIWAN VIETNAM CENTRAL AND EASTERN EUROPE ARMENIA AZERBAIJAN BOSNIA CROATIA FAROE ISLANDS GEORGIA KAZAKHSTAN MONTENEGRO NORWAY SERBIA TURKEY UKRAINE UZBEKISTAN ASIA-PAC AUSTRALIA BANGLADESH BRUNEI HONG KONG INDONESIA JAPAN MALAYSIA NEW ZEALAND PAKISTAN PHILIPPINES SINGAPORE THAILAND AMERICAS BOLIVIA CANADA COLOMBIA COSTA RICA ECUADOR EL SALVADOR GUATEMALA PANAMA PERU PUERTO RICO URUGUAY UNITED STATES VENEZUELA MIDDLE EAST ALGERIA BAHRAIN BOTSWANA DUBAI EGYPT ETHIOPIA EQUATORIAL GUINEA IRAQ KUWAIT MOROCCO NIGERIA OMAN QATAR SAUDI ARABIA TUNISIA LOW-TAX JURISDICTIONS ANDORRA ARUBA BAHAMAS BARBADOS BELIZE BERMUDA BRITISH VIRGIN ISLANDS CAYMAN ISLANDS COOK ISLANDS CURACAO GIBRALTAR GUERNSEY ISLE OF MAN JERSEY LABUAN LIECHTENSTEIN MAURITIUS MONACO TURKS AND CAICOS ISLANDS VANUATU



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## GLOBAL TAX WEEKLY a closer look

### Global Tax Weekly – A Closer Look

Combining expert industry thought leadership and the unrivalled worldwide multi-lingual research capabilities of leading law and tax publisher Wolters Kluwer, CCH publishes Global Tax Weekly — A Closer Look (GTW) as an indispensable up-to-the minute guide to today's shifting tax landscape for all tax practitioners and international finance executives.

Unique contributions from the Big4 and other leading firms provide unparalleled insight into the issues that matter, from today's thought leaders.

Topicality, thoroughness and relevance are our watchwords: CCH's network of expert local researchers covers 130 countries and provides input to a US/UK

team of editors outputting 100 tax news stories a week. GTW highlights 20 of these stories each week under a series of useful headings, including industry sectors (e.g. manufacturing), subjects (e.g. transfer pricing) and regions (e.g. asia-pacific).

Alongside the news analyses are a wealth of feature articles each week covering key current topics in depth, written by a team of senior international tax and legal experts and supplemented by commentative topical news analyses. Supporting features include a round-up of tax treaty developments, a report on important new judgments, a calendar of upcoming tax conferences, and "The Jester's Column," a lighthearted but merciless commentary on the week's tax events.

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## United States Taxation Of Income From International Shipping – Transportation Income v. Qualified Income

by Stephen Flott and Joseph Siegmann, Flott & Co.

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*This is the third in a series of articles on US taxation of income from the transportation of cargo or passengers to or from the United States or from the provision of services on the US Outer Continental Shelf, and the compliance regimes that apply to companies that receive such income.*

As briefly discussed in the second article, US source gross transportation income ("USSGTI") is 50 percent of the gross income earned by a foreign corporation from the international transportation of cargo to or from the United States. Section 887(b) (1) defines USSGTI as gross income which is transportation income as defined in Section 863(c)(3). That subsection provides that the term "transportation income" means "any income derived from, or in connection with the use (or hiring or leasing for use) of a vessel<sup>1</sup> or the performance of services directly related to the use of a vessel." The subsection includes in the term vessel "any container used in connection with a vessel."

The statute itself only provides a broad definition of "transportation income." The task of filling in the details fell to the US Treasury and the Internal



Revenue Service ("IRS"). The IRS was first to publish guidance in the form of a Revenue Procedure.<sup>2</sup> Rev. Proc. 91-12 [1991-1 CB 473, February 11, 1991] provides "guidelines for computing, reporting, and paying the Section 887 tax" on USSGTI earned by foreign corporations. In addition, it also offered the first official instruction that those claiming exemption from the tax were also required to file a US tax return. The Treasury finalized the regulations governing exclusions from gross income of foreign corporations pursuant to Section 883 on August 26, 2003 [68 Fed. Reg. 51394] (the "Section 883 Regulations").<sup>3</sup>

Although the Section 883 Regulations and Rev. Proc 91-12 address the meaning of "transportation income" in Section 863(c), the Section 883 Regulations address the term from the perspective of what income qualifies for exclusion from gross income under Section 883 and thus is not subject to tax in the United States. Rev. Proc. 91-12 on the other hand instructs taxpayers on how to calculate USSGTI and how to pay the tax levied under Section 887.

Rev. Proc. 91-12 addresses the three categories of income mentioned in Section 863(c)(3), namely, income derived from hiring or leasing a vessel transporting cargo, services performed directly related to the use of the vessel, and the rental of cargo containers used on a vessel. It confirms that the first category – hire or lease of a vessel – includes bareboat, period and voyage hire. It divides the second category – income from the performance of services directly related to the use of a vessel – into subcategories: on-board and off-board services.

On-board services include rental of living accommodations, operating shops, excess baggage storage, and payment for other personal services. Although these kinds of on-board services are most often associated with cruise ships, some freight vessels provide passenger accommodation and regularly book passengers.<sup>4</sup> Oddly, on-board services also includes demurrage, dispatch and dead-freight which, of course, are not services at all, but additional charges/subtractions that often arise in a voyage charter arrangement.

Off-board services are only considered transportation income if conducted by the operator of the vessel, defined as both the actual operator as well as the time or voyage charterer of the vessel. Off-board services include, but are not limited to, storage, lights, water, refrigeration, refueling and similar services; stevedoring and other cargo handlings services; and maintenance and repairs. These are generally provided by third party providers and so are rarely, if ever, includable as transportation income.

The third category – rental of cargo containers used on a vessel – is transportation income only if the operator owns cargo containers and rents them out, independently of charging to transport them. If an independent third party rents out containers, the rental income is not transportation income of the operator.

USSGTI is 50 percent of the gross transportation income earned by the foreign corporation. With respect to bareboat, period or voyage hire, the most common income earned by foreign corporations from the operation of ships, Rev. Proc. 91-12 allows taxpayers to use any reasonable method to calculate USSGTI, and provides two safe harbor rules.<sup>5</sup> The first uses the ratio of the total number of days of uninterrupted travel where cargo is loaded on the way to the United States or where it is discharged on the way from the United States to the days of the taxable year or a particular charter period. The other safe harbor uses the ratio of hire earned by the lessee-operator from US related voyages compared to the total gross income earned by the lessee-operator during the taxable year or the charter term.

The most common basis for calculating USSGTI is to begin counting days from commencement of loading of the vessel at the load port and to continue counting until the completion of discharge at the discharge port. Remembering to include both the date loading began and the date discharge was completed in the number of days, USSGTI equals 50 percent of the gross daily time/bareboat hire multiplied by the number of days engaged in the

transportation. For voyage hire, it is 50 percent of the gross freight plus or minus, as applicable, demurrage, deadfreight and dispatch.

Ballast legs and ballast bonuses are not included in the calculation of USSGTI based on Rev. Proc. 91-12's safe harbor rules, which refer to "loading" and "discharging" of "cargo". Ballast legs do not involve the movement of cargo; accordingly period or bareboat hire and any bonuses paid in connection with ballast voyages do not constitute "transportation income" and are not includable in USSGTI.

Rev. Proc. 91-12 defines transportation income on which tax is to be paid. The Section 883 Regulations use the term "qualified income," that is, income that is qualified to benefit from the exclusion provided by Section 883. Qualified income under the Section 883 Regulations is broader in the categories of income covered as well as the inclusion of income within certain categories that are not included in the definition of transportation income by Rev. Proc. 91-12.

Section 883(a)(1) exempts "[g]ross income derived by a corporation organized in a foreign country from the international operation of a ship or ships" from the Section 887 tax. Treas. Reg. 1.883-1(a) provides that only "[q]ualified income derived by a qualified foreign corporation from the international operation of ships" is excluded from gross income. Qualified income is defined in Treas. Reg. 1.883-1(b) as income "derived from the international operation of ships that is

properly includible in any of the income categories" described in Treas. Reg. 1.883-1(h)(2).

Treas. Reg. 1.883-1(h)(2) lists eight categories of income and provides whether a foreign country grants an equivalent exemption shall be determined separately with respect to each category of income. If a foreign country does not grant an equivalent exemption for a specific category of income listed, it would be subject to tax under Section 887. Treas. Reg. 1.883-1(h)(2)(vii) specifically includes capital gains derived by "a qualified foreign corporation engaged in the international operation of ships from the sale, exchange or other disposition of a ship ...". Although capital gains from the sale of vessels are not included as transportation income under Rev. Proc. 91-12, they are included in the Section 883 Regulations as a category of qualified income. This difference between the Section 883 Regulations and Rev. Proc. 91-12 creates the anomaly that capital gains might not be covered within the scope of a qualified country's equivalent exemption and, therefore, not be excludable from US tax, but the non-excludable capital gain would not in fact be taxed because capital gains are not defined as "transportation income" in Rev. Proc. 91-12.

Treas. Reg. 1.883-1(h)(2)(vi) includes in the definition of "qualified income" incidental income that is broader than the on-board and off-board services defined in Rev. Proc. 91-12. Treas. Reg. 1.883-1(g) lists 11 categories of incidental income, including interest on the investment of working capital. It is important to note that

incidental income included in qualified income, but not included in the definition of transportation income in Rev. Proc. 91-12, is not subject to tax under Section 887.

Contrasted with Rev. Proc. 91-12, Treas. Reg. 883-1(f)(2)(iv) provides that ballast legs are included in qualified income. The fact is whether ballast legs and ballast bonuses are included in qualified income or not, all of the qualified income of a foreign corporation that is entitled to exclude it from the taxation is exempt from tax. Thus, the exact amount of the qualified income is not material.

The fact that Rev. Proc. 91-12 and the Section 883 Regulations include different items of income has been the source of some confusion. The reality is that Rev. Proc. 91-12 governs the payment of tax on what it categorizes as "transportation income" and the Section 883 Regulations govern the scope of qualified income that is excludable from US gross income and thus exempt from tax.

## ENDNOTES

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- <sup>1</sup> The statute includes "or aircraft" in the definition, but these articles discuss only the application of the statute to vessels.
- <sup>2</sup> A revenue procedure, referred to as a Rev. Proc., is an official statement published by the IRS in the Internal Revenue Bulletin to provide guidance to the public on tax return preparation and similar matters. For example, a revenue procedure allows the taxpayer to use specified mileage rates to claim automobile expenses rather than having to determine actual operating expenses.
- <sup>3</sup> The Section 883 Regulations were originally to come into force for tax years beginning on or after September 24, 2003, but that effective date was postponed by Section 423 of the American Jobs Creation Act of 2004 (Pub. L. 108-357) for one year to tax years beginning on or after September 24, 2004.
- <sup>4</sup> See, e.g., [www.freightercruises.com](http://www.freightercruises.com) for a company that caters travelers wanting to book cruises on freighters (last visited November 5, 2014).
- <sup>5</sup> The only method of calculating USSGTI that is expressly prohibited is the use of "net income."