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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

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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.

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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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The unacceptable face of tax journalism

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United States Taxation Of Income From International Shipping – Section 883

by Stephen Flott and Joseph Siegmann, Flott & Co.

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This is the fifth 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.

If a foreign corporation cannot use provisions of a bilateral tax treaty to avoid the 4 percent gross tax imposed by Section 887, as discussed in the last article, it may be able to use Section 883 to exclude US source gross transportation income ("USSGTI") from its US gross income. In effect, Section 883 allows USSGTI to be excluded from a foreign corporation's gross income, thus reducing its US source income to zero. Even though technically an "exclusion from gross income," it is most commonly referred to as the Section 883 "exemption," which is how we will refer to it in these articles.

Section 883 provides a two-step qualification process for the exemption. The first depends upon the country in which the foreign corporation is incorporated. The second depends upon the identity and residence of the individuals who are the ultimate beneficial shareholders of the corporation because more than 50 percent of the value of the shares of the corporation must ultimately be owned, for more than half the days of the corporation's tax year, by shareholders who reside in countries that provide an equivalent exemption to companies organized in the United States.

Determining residence is key to both steps. The first step focuses on the country of incorporation. A corporation that earns USSGTI must be incorporated in a country that extends an equivalent exemption to corporations organized in the United States. Such countries are referred to in the Section 883 Regulations[1] as "qualified countries." If the foreign corporation is not organized in a qualified country, that is the end of the story. It may not use the Section 883 exemption regardless of who owns it.

Countries are "qualified countries" if they extend an "equivalent exemption" within the meaning of Section 883. Essentially, if a country does not tax the international shipping income of companies organized in the United States sourced in that country, it is a qualified country. This can be established in one of two ways: an exchange of diplomatic notes with the United States explicitly exempting such income – generally called Transportation Agreements – or by its domestic law. Section 883 sets out an objective test in this regard which is not dependent upon approval from the IRS. A company that wants to claim exemption under Section 883 based on the domestic law of the jurisdiction in which it is incorporated need only prove that the domestic law of that country does not tax income from international shipping.

Table I, Part A of Revenue Ruling 2008-17 [2008-12 IRB 626, March 24, 2008] lists countries which have exchanged diplomatic notes with the United States. Table I, Part B lists countries which the IRS has determined extend an equivalent exemption under Section 883 based on their domestic laws. Even if a country is not listed in Part B of Table I, it may qualify based on proof that its domestic law qualifies.

Part A of Table I identifies the year in which each Transportation Agreement became effective and the types of income it covers. The footnotes are important as they contain limitations that may exist in the scope of an exemption. For example, the Belgium and Pakistan Transportation Agreements do not cover bareboat hire. The Chilean, Indian, Malaysian, Peruvian, Swedish and Venezuelan agreements exempt bareboat income only if it is incidental to operating income.

Part B of Table I lists those countries whose domestic law the IRS officially declared meets the "equivalent exemption" test, the date that the foreign law was reviewed, and the scope of the exemption provided by the relevant country's domestic law. Again, footnotes identify limitations. For example, bareboat hire is not within the scope of the British Virgin Islands', Qatar's and Spain's domestic law exemptions. Bareboat, time or voyage hire are not covered by Turkey's and Uruguay's domestic law exemptions.

If the foreign corporation that earns USSGTI is incorporated in a qualified country, it must be able to establish that its controlling ultimate beneficial owners ("UBOs") are also residents of a qualified country. The country of incorporation and the country of residence of the controlling UBOs can be different qualified countries and the basis on which the countries qualify can also be different. We use the term controlling because the UBOs must own more than 50 percent of the shares of the foreign corporation seeking to use the Section 883 exemption.

It is important to understand that, with some exceptions to be discussed in the next article, the controlling UBOs must be physical persons because Section 883 incorporates a "look through" rule to determine whether the foreign corporation qualifies for the exemption. This aptly named rule "looks through" legal persons (corporations, trusts, partnerships, foundations, limited liability companies, *etc.*) to identify the physical persons who ultimately control the legal person seeking to use the exemption. This requirement is often not well understood.

Many think that the Section 883 inquiry ends with a corporate shareholder; it does not. The Section 883 Regulations make it very clear that ownership must be traced to human beings, who, with few exceptions, are the only ones who can be what the regulations call "qualified shareholders."[2]

The Section 883 Regulations use attribution rules to establish "constructive ownership" of legal persons, that is, the regulations specify how ownership of an entity is apportioned among its owners. For example, in the case of a corporation, ownership is attributed *pro-rata* based on ownership of its shares. There are constructive ownership rules for partnerships, trusts and estates, taxable non-stock corporations, mutual insurance companies, non-government pension funds, and non-profit organizations.

The "look through" rule tracks ownership up to the UBOs. When a foreign corporation seeking exemption under Section 883 is wholly owned by a second corporation, the "look through" rule in effect ignores the second corporation, and looks to identify its controlling shareholder and so on up the corporate ownership chain until it reaches the UBOs. If the controlling UBOs at the top of the structure are not qualified shareholders, as defined by the Section 883 Regulations, the foreign corporation does not qualify for exemption under Section 883.

The Section 883 Regulations give particular attention to shares issued to bearer, commonly known as "bearer shares." Essentially, notwithstanding the constructive ownership rules that attribute ownership of a corporation proportionally to the holders of its shares, the Section 883 Regulations specifically prohibit attribution of bearer shares.[3] Without the attribution of its shares, a foreign corporation cannot be controlled by "qualified shareholders" and thus is subject to the tax under Section 887 on its USSGTI.[4]

When the controlling UBO is identified, he or she must be a qualified shareholder as defined in the Section 883 Regulations. To be a qualified shareholder, a UBO must reside in a qualified country, that is, the UBO must "reside" in a country which extends an equivalent exemption to US corporations. Revenue Ruling 2008-17 lists the qualified countries. A UBO qualifies if he or she resides, within the meaning of the Section 883 Regulations, in any of these countries. The basis on which the country qualifies (treaty, diplomatic note or domestic law) does not matter as long as the UBO resides in a qualified country.

The Section 883 Regulations set out two requirements to "reside" in a qualified country. First, the UBO must be "fully liable" to tax in the qualified country. Second, the qualified country must be the UBO's "tax home," defined as the country in which the UBO resides for at least 183 days in the tax year of the corporation seeking exemption under Section 883. The definition of "tax home" also includes a "regular or principal" place of business test. The 183 day minimum applies both to the place of business and the place of abode tests. The Section 883 Regulations specifically disqualify persons who reside in the United Kingdom as "non-doms" because they are not subject to tax in the United Kingdom on their worldwide income. There are other countries that allow people who reside in them to pay either on money brought into the country or under a special arrangement. In effect, any person who lives in a country and does not pay tax on the same basis as ordinary residents will not be a qualified shareholder.

This article has discussed the rules that apply to qualified shareholders who are individuals. The next article will address qualified shareholders who are not individuals.

Endnotes

1 Treas. Reg. §1.883-1 *et seq.*, 68 Fed. Reg. 51394 *et seq.* (August 26, 2003), as amended. The 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.

2 Qualified shareholders are ultimate beneficial owners ("UBOs") who meet the residency requirements set out in the Section 883 Regulations discussed later in this article.

3 On November 15, 2010, the Treasury finalized rules that allow attribution of bearer shares if they are held in an immobilized or dematerialized book entry system. T.D. 9502, IRB 2010-46. Most jurisdictions that permit bearer shares (*e.g.*, Antigua, Cayman Islands, Liberia, and Marshall Islands) do not have such systems in place. Panama now requires bearer shares be held by designated authorized custodians. *See* Don Winner, Law 47 Passed: Panama Corporation Bearer Shares to be Restricted, *Welcome to Panama Guide*, Aug, 28, 2013, available at http://www.panama-guide.com/article.php/20130828163830289 (last visited November 17, 2014). Thus, the changes to the Section 883 Regulations permitting attribution of bearer shares in such systems are of little, if any, practical use to most companies that issue such shares. Of course, countries that allow bearer shares also authorize companies to issue shares in the names of the shareholders. These are sometimes called "registered" shares.

4 A number of foreign corporations have taken the Section 883 exemption despite that fact that their shares are issued in bearer form. One such corporation is currently engaged in a US Tax Court case challenging the validity of the prohibition on bearer shares. The case has been briefed and argued, but no decision has yet been issued.