



Proposed Transportation Regulations – Suggestions for Final Course Correction

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BACKGROUND

In the case of income arising from the international operation of ships and aircraft, there has long been a concern that consistency of allocation may be difficult to achieve, and that international shipping and aircraft operations pose a particularly substantial threat of double taxation. In order to avoid double taxation, Section 883 prescribes a reciprocal exemption regime pursuant to which a foreign corporation's income from the international operation of ships or aircraft would be exempt from U.S. tax if, among other requirements, the foreign country in which the corporation is organized grants an equivalent exemption to U.S. corporations.¹ Note that this reciprocal exemption applies regardless of whether any such income is subject to the special source rules for space and ocean income set forth in Section 863(d).

Section 883(a) generally excludes the following from the gross income of a foreign corporation:

"(1) **Ships Operated By Certain Foreign Corporations.**--Gross income derived by a corporation organized in a foreign country from the international operation of a ship or ships if such foreign country grants an equivalent exemption to corporations organized in the United States.

(2) **Aircraft Operated By Certain Foreign Corporations.**--Gross income derived by a corporation organized in a foreign country from the international operation of aircraft if such foreign country grants an equivalent exemption to corporations organized in the United States."

Pursuant to Section 883(c), a foreign corporation may claim the reciprocal exemption only if it satisfies (1) a qualified shareholder test, (2) a publicly traded test, or (3) a controlled foreign corporation (CFC) test.

Pursuant to Section 883(c)(1), a foreign corporation satisfies the qualified shareholder test if less than 50 percent of the value of its stock is owned by individuals who are not residents of foreign countries that provide an equivalent exemption meeting the requirements of Section

¹ Except as otherwise expressly indicated, all "Section" or "§" references herein are to the Internal Revenue Code of 1986, as amended (the "Code"). §872(b)(1) & (2) provides a similar exemption for nonresident aliens. In the case of nonresident aliens, the reciprocity requirement is satisfied if the country in which the individual is resident grants an equivalent exemption to individual residents of the U.S.

883(a).² Pursuant to Section 883(c)(2), the publicly traded test is satisfied if stock of the foreign corporation "is primarily and regularly traded on an established securities market" in the country in which the corporation is organized, another foreign country that provides an equivalent exemption, or the United States.³ Pursuant to Section 883(c)(2), the CFC test is satisfied if the foreign corporation "is a controlled foreign corporation (as defined in section 957(a))."

On February 8, 2000, the IRS proposed regulations implementing the reciprocal exemption (the "2000 proposed regulations").⁴ The 2000 proposed regulations met with substantial criticism, and revised regulations were proposed on July 31, 2002 (the "2002 Proposed Regulations" or simply the "Proposed Regulations").⁵

This article describes the Proposed Regulations and highlights a number of provisions that seem burdensome, inappropriate or unsupported by the Code or legislative history.

THE PROPOSED REGULATIONS

Overview

The general rule prescribed by the Proposed Regulations is as follows:

"Qualified income derived by a qualified corporation from its international operation of ships or aircraft is excluded from gross income and exempt from United States Federal income tax."⁶

Thus, the Proposed Regulations would exclude from gross income certain income earned by a foreign corporation only if (1) the foreign corporation is a "qualified foreign corporation," and (2) the income is "qualified income."

The Proposed Regulations provide welcome guidance but, as discussed in greater detail below, are still overly restrictive in several ways. For example, the "qualified foreign corporation" requirement can only be satisfied if the foreign corporation complies with certain substantiation and reporting requirements, which are extensive. Furthermore, the Proposed Regulations impose requirements and limitations that have no discernable basis in either Section 883 or its legislative history.

Qualified Foreign Corporation

A "qualified foreign corporation" must: (1) be "engaged in the international operation of ships or aircraft;" (2) be organized in a "qualified foreign country;" (3) satisfy one of three stock ownership tests; and (4) satisfy certain substantiation and reporting requirements.⁷

² For this purpose, "stock owned (directly or indirectly) by or for a corporation, partnership, trust, or estate shall be treated as being owned proportionately by its shareholders, partners, or beneficiaries. Stock considered to be owned by a person by reason of the application of the preceding sentence shall, for purposes of applying such sentence, be treated as actually owned by such person."

³ Any stock owned by a corporation that satisfies the publicly traded test is treated as owned by individuals who are residents of the foreign country in which the corporation is organized for purposes of the qualified shareholder test.

⁴ REG-208280-86.

⁵ REG-136311-01. The Proposed Regulations generally would be effective only for taxable years of foreign corporations ending 30 days or more after the date that they are published as final regulations, subject to certain transition rules and the availability of an election to apply the Proposed Regulations to all post-1986 years. Prop. Regs., §1.883-5.

⁶ Prop. Regs., §1.883-1(a).

International Operation of Ships or Aircraft

As noted above, the Proposed Regulations require a foreign corporation to be engaged in the international operation of ships or aircraft. Furthermore, only income derived from such international operation of ships or aircraft (and certain incidental income) is excluded. The Proposed Regulations indicate which activities constitute the international operation of ships or aircraft, and provide rules for determining the amount of income derived from such activities.

Operation of Ships or Aircraft

Except as indicated below, a foreign corporation is considered to be engaged in the “operation of ships or aircraft” *only* if it is the owner or lessee of one or more entire ships or aircraft⁸ and uses such ships or aircraft in one or more of the following activities:⁹

- Carriage of passengers or cargo for hire;
- In the case of a ship, the leasing out of the ship under a time or voyage charter (full charter),¹⁰ space or slot charter,¹¹ or bareboat charter,¹² in each case, provided that the ship is used to carry passengers or cargo for hire;
- In the case of an aircraft, the leasing out of the aircraft under a wet lease (full charter),¹³ space, slot or block-seat charter,¹⁴ or dry lease,¹⁵ in each

⁷ Prop. Regs., §1.883-1(c)(1).

⁸ This entire-ship limitation neither appears on the face of §883 itself nor has any apparent basis in the legislative history.

⁹ Prop. Regs., §1.883-1(e)(1). The Proposed Regulations also set forth a list of nonqualifying activities, including the activities of an NVOCC (defined below); ship or aircraft management; obtaining crews for ships or aircraft operated by another party; acting as a ship’s agent; ship or aircraft brokering; freight forwarding; the activities of travel agents and tour operators; rental by a container leasing company of containers and related equipment; and concessionaire activities. Prop. Regs., §1.883-1(e)(3).

¹⁰ A time charter is a contract for the use of a ship or aircraft for a specific period of time during which the lessor of the ship or aircraft retains control of the navigation and management of the ship or aircraft (*i.e.*, the lessor continues to be responsible for the crew, supplies, repairs and maintenance, fees and insurance, charges, commissions and other expenses connected with the use of the ship or aircraft). Prop. Regs., §1.883-1(e)(5)(ix). A voyage charter is similar to a time charter, except that the ship or aircraft is chartered for a specific voyage or flight, rather than a specific period of time. Prop. Regs., §1.883-1(e)(5)(x). *See also* Rev. Rul. 74-170, 1974-1 C.B. 175.

¹¹ A space or slot charter is a contract for use of a certain amount of space (but less than all of the space) on a ship or aircraft, and may be on a time or voyage basis. Prop. Regs., §1.883-1(e)(5)(viii).

¹² A bareboat charter is a contract for the use of a ship or aircraft whereby the lessee is in complete possession, control, and command of the ship or aircraft. For example, the lessee is responsible for the navigation and management of the ship or aircraft, the crew, supplies, repairs and maintenance, fees, insurance, charges, commissions and other expenses connected with the use of the ship or aircraft. The lessor bears none of the expense and responsibility of the ship or aircraft. Prop. Regs., §1.883-1(e)(5)(i). *See also* Rev. Rul. 74-170, 1974-1 C.B. 175.

¹³ The time or voyage charter of an aircraft is referred to as a wet lease. Prop. Regs., §1.883-1(e)(5)(xi).

¹⁴ As noted above, a space or slot charter is a contract for use of a certain amount of space (but less than all of the space) on a ship or aircraft, and may be on a time or voyage basis. When used in connection with passenger aircraft, this sort of charter may be referred to as the sale of block seats or a block-seat charter. Prop. Regs., §1.883-1(e)(5)(viii).

¹⁵ The bareboat charter of an aircraft is referred to as a dry lease. Prop. Regs., §1.883-1(e)(5)(iii).

case, provided that the aircraft is used to carry passengers or cargo for hire.

The 2000 proposed regulations had not included space or slot chartering as activities that constitute the operation of a ship or aircraft, and this change was suggested by commentators. Commentators also suggested that non-vessel operating common carriers ("NVOCCs")¹⁶ be treated as engaged in the operation of ships or aircraft, but this suggestion was not adopted. Under the Proposed Regulations, the rental of containers and various other related activities do not qualify as the operation of ships or aircraft. As indicated below, however, income from such activities may in some cases qualify for the exclusion in certain circumstances as incidental income.

The 2000 proposed regulations had provided that the term "operation of ships or aircraft" includes "[a]ctive participation by a foreign corporation that is otherwise engaged in the operation of ships or aircraft in a pool, partnership, strategic alliance, joint operating agreement, code sharing or other joint venture, that is itself engaged in the operation of ships or aircraft."¹⁷ Thus, under the 2000 proposed regulations, a corporate partner not directly engaged in the operation of ships or aircraft could not be treated as so engaged solely due to its status as a partner in a partnership that was so engaged. Moreover, even if such corporate partner were otherwise engaged in the operation of ships or aircraft, its distributive share of the partnership's income would have been treated as income derived from such activities only if the corporation were also an active participant in the partnership.¹⁸

The limitations of the 2000 proposed regulations seemed unnecessary, and appeared inconsistent with the terms of certain diplomatic notes exchanged with other countries. Consequently, the 2002 Proposed Regulations generally treat a corporate partner in a partnership that is engaged in the operation of ships or aircraft as being so engaged, regardless of whether the partner is otherwise so engaged and regardless of whether its participation in the partnership is active.

Under the Proposed Regulations, a foreign corporation is considered engaged in the operation of ships or aircraft with respect to its participation in a pool, partnership, strategic alliance, joint operating agreement, code-sharing arrangement or other joint venture that is (1) an "entity" and (2) "fiscally transparent" under the income tax laws of the U.S. with respect to the type of income derived through the entity, provided that (3) the entity would be considered

¹⁶ An NVOCC is an entity that does not exercise control over any part of a vessel, but holds itself out to the public as providing transportation for hire, issues bills of lading, assumes responsibility or is liable by law as a common carrier for safe transportation of shipments, and arranges in its own name with other common carriers, including those engaged in the operation of ships, for the performance of such transportation. Prop. Regs., §1.883-1(e)(5)(vii).

¹⁷ 2000 Prop. Regs., §1.883-1(e)(1)(iv). Code sharing is an arrangement whereby one air carrier puts its identification code on the flight of another carrier. This allows the first carrier to hold itself out as providing service in markets where it operates infrequently. Code sharing can range from a very limited agreement between two carriers involving only one market to agreements involving multiple markets and alliances between international carriers that include joint marketing, baggage handling, one-stop check-in service and sharing of frequent flyer awards. Prop. Regs., §1.883-1(e)(5)(ii).

¹⁸ See 2000 Prop. Regs., §1.883-1(e)(2)(x) (operation of ships or aircraft does not include passive investment in an enterprise engaged in the international operation of ships or aircraft).

engaged in the operation of ships or aircraft if it were a foreign corporation.¹⁹ For this purpose, an entity is "any person that is treated by the United States as other than an individual for U.S. Federal income tax purposes." The term includes disregarded entities.²⁰ Whether an entity is fiscally transparent under the income tax laws of the U.S. is determined separately for each category of income.²¹

As suggested above, a foreign corporate partner may qualify for the reciprocal exemption with respect to its distributive share of the partnership's income *only* if, among other things, the partnership conducts *all* of the activities necessary to be considered engaged in the operation of ships or aircraft. Thus, if the combined activities of the foreign corporation and the partnership would constitute the operation of ships or aircraft, but the activities of the partnership *qua* partnership do not, the reciprocal exemption apparently would not be available. Thus, for example, a foreign corporation that makes ships or aircraft available to its partnership (without actually contributing or leasing them), apparently would be ineligible for the reciprocal exemption in connection with its distributive share of partnership income unless the partnership owned or leased other ships or aircraft.

This distinction between the activities of the partnership and the activities of the partner appears to be unnecessary, and may present a trap for the unwary. One might therefore wonder whether the distinction was unintentional. The Proposed Regulations' focus on the activities of the partnership, to the exclusion of the activities of the foreign partner, is not unique. Notably, the so-called "Brown Group" regulations provide that various exceptions to the Subpart F rules must be applied to CFC partners of partnerships solely by reference to the activities of the partnership.²²

It is difficult to perceive a compelling need for this restrictive entity-level approach, but if the Proposed Regulations are finalized, it is unlikely that the rules for income earned through partnerships will be further liberalized. In any event, the Proposed Regulations reflect a marked improvement from the far more stingy approach taken in the 2000 proposed regulations.

Under the Proposed Regulations, a foreign corporation will also be considered engaged in the operation of ships or aircraft with respect to its participation in a pool, partnership, strategic alliance, joint operating agreement, code-sharing arrangement or other joint venture that is *not* an

¹⁹ Prop. Regs., §1.883-1(e)(2). Whether the entity is "fiscally transparent" for foreign tax purposes does not appear to be relevant.

²⁰ Prop. Regs., §1.883-1(e)(5)(iv).

²¹ This determination is made under the rules of §894(c). Prop. Regs., §1.883-1(e)(5)(v).

²² For example, these regulations provide that a CFC partner in a partnership may satisfy the "manufacturing exception" for goods sold by the partnership "by taking into account only the activities of, and property owned by, the partnership and not the separate activities or property of the controlled foreign corporation or any other person." Treas. Reg. § 1.954-3(a)(6)(i). In *Brown Group, Inc. v. Commissioner*, 77 F.3d 217 (8th Cir. 1996), *rev'g* 104 T.C. 105 (1995), the Tax Court and the Court of Appeals for the Eighth Circuit considered whether a CFC's distributive share of certain commission income earned through a partnership constituted Subpart F income. Among the issues raised was whether the applicable related-party test (which, if satisfied, would have resulted in Subpart F income) should be applied by reference to the CFC or to the partnership. The Eighth Circuit ultimately held that the related-party test should be applied by reference to the partnership, with the result that the test was not satisfied and the CFC did not have Subpart F income. In response, the IRS issued regulations in 2000 governing the application of aggregate and entity principles to income earned by CFCs through partnerships. *See* Treas. Reg. §§1.954-1(g), 1.954-2(a)(5)(ii) & 1.954-3(a)(6).

"entity,"²³ but *only* if the foreign corporation is otherwise engaged in the operation of ships or aircraft.²⁴ The reason for this rule also is not obvious.

The Proposed Regulations do not address issues likely to arise as a result of multiple classes of partnership interests or special allocations of partnership income.

International Operation

In general, the "international" operation of ships or aircraft means the operation of ships or aircraft (as defined above) with respect to the carriage of passengers or cargo on voyages or flights that begin *or* end in the U.S., but not both.²⁵ The term does not include the carriage of passengers or cargo on a voyage or flight that begins and ends in the U.S., even if the voyage or flight contains a segment extending beyond the territorial limits of the U.S., unless the passenger disembarks or the cargo is unloaded outside the U.S.²⁶ Thus, a "cruise to nowhere" would not qualify as the international operation of ships or aircraft under the Proposed Regulations.²⁷

According to the Proposed Regulations, whether income is derived from the international operation of ships or aircraft must be determined separately for *each* passenger or item of cargo.²⁸ Furthermore, in the case of income from the bareboat charter of a ship or the dry lease of an aircraft, whether the charter income is derived from the international operation of ships or aircraft is determined by reference to the lowest-tier operator in the chain of lessees.²⁹ Looking through to the lowest-tier operator may be burdensome in some cases, but seems necessary to avoid abuse.

Except in the case of certain round trip travel (discussed below), income from the carriage of a passenger qualifies as income from the international operation of ships or aircraft as long as the passenger is carried between a beginning point in the U.S. and an ending point outside the U.S., or vice versa.³⁰ For this purpose, carriage of a passenger will be treated as ending at the passenger's final destination even if a stop is made at an intermediate point for refueling, maintenance, or other business reasons, provided that the passenger does not change ships or aircraft.³¹ Similarly, carriage of a passenger will be treated as beginning at the

²³ The preamble to the 2002 Proposed Regulations (the "2002 Preamble") observes that a contractual arrangement that only involves the carriage of cargo or passengers for hire may not rise to the level of a partnership or other entity under the income tax laws of the U.S.

²⁴ Prop. Regs., §1.883-1(e)(2)(ii).

²⁵ Prop. Regs., §1.883-1(f)(1).

²⁶ Prop. Regs., §1.883-1(f)(1).

²⁷ See the preamble to the 2000 proposed regulations (the "2000 Preamble"), which provided the same result.

²⁸ Prop. Regs., §1.883-1(f)(2). This item-by-item approach seems appropriate from a policy perspective, but may be extremely difficult to apply in practice. Query how many foreign shipping or air transport companies possess (or, solely for U.S. tax purposes, would be willing to acquire) the software that would permit such detailed allocations to be made.

²⁹ Prop. Regs., §§1.883-1(f)(2) & 1.883-1(f)(2)(iii). In the case of back-to-back bareboat charters, presumably this rule applies to each lessor in the chain.

³⁰ Prop. Regs., §1.883-1(f)(2)(i)(A).

³¹ Prop. Regs., §1.883-1(f)(2)(i)(A). This rule addresses the situation in which a passenger travels from a point of origin outside the U.S., stops at an intermediate point within the U.S. and then continues on to its destination within the U.S. If the intermediate U.S. point is disregarded under this rule, then the passenger is considered to have traveled from the point of origin outside the U.S. directly to the final U.S. destination; the U.S.-to-U.S. leg is disregarded.

passenger's point of origin even if a stop is made at an intermediate point, if the passenger does not change ships or aircraft.³² Carriage of a passenger will be treated as beginning or ending at a U.S. or foreign intermediate point, however, if the passenger changes ships or aircraft at that point.

A special rule applies in the case of a round trip cruise. The carriage of a passenger on a round trip cruise that begins and ends in the U.S. will be treated as the international operation of a ship as long as the ship stops at one or more foreign intermediate ports.³³

The rules for cargo income are similar, but not identical, to those for passenger income. Thus, in general, income from the carriage of cargo will constitute income from the international operation of ships or aircraft if the cargo is carried between a beginning point in the U.S. and an ending point outside the U.S., or vice versa.³⁴ For this purpose, carriage of cargo will be treated as beginning at the cargo's point of origin, and as ending at the cargo's final destination, even if a stop is made at a U.S. intermediate point, if either (1) the cargo is transported to its final destination on the same ship or aircraft, or (2) the same taxpayer transports the cargo to and from the U.S. intermediate point, and the cargo does not pass through customs at that point.³⁵ Repackaging, recontainerization, or any other activity involving the unloading of cargo at a U.S. intermediate point will not change the foregoing results if the same taxpayer transports the cargo to and from the U.S. intermediate point and the cargo does not pass through customs at that point.³⁶

The Proposed Regulations generally do not include international operation the inland leg of transportation of passengers or cargo before or after an intermediate stop in the U.S. This was also the position of the 2000 proposed regulations. Commentators objected to this approach, on the grounds that the term "international operation" should be defined coextensively with the term "international transport" as used in the OECD Committee on Fiscal Affairs, Model Tax Convention on Income and Capital (2000) (the "OECD Model") and the United States Model Income Tax Convention of September 26, 1996 (the "U.S. Model"). While this suggestion was not adopted, as discussed below, the Proposed Regulations treat certain income from inland transportation as incidental income that may be eligible for the reciprocal exemption.

The 2000 proposed regulations effectively precluded lightering³⁷ income from qualifying as income from the international operation of ships, by providing that income from the carriage

³² Prop. Regs., §1.883-1(f)(2)(i)(A). This rule addresses the situation in which a passenger travels from a U.S. point of origin, stops at an intermediate point in the U.S. and then continues on to its destination outside the U.S. If the intermediate U.S. point is disregarded under this rule, then the passenger is considered to have traveled from the U.S. point of origin directly to the final destination outside the U.S.; the U.S.-to-U.S. leg is disregarded. Note that, unlike the former rule, this rule applies only if the stop has a business purpose. It is not clear whether such inconsistency was intended.

³³ Prop. Regs., §1.883-1(f)(2)(i)(B). This rule applies even if the cruise includes one or more intermediate stops at U.S. ports and even if the passenger does not disembark at any foreign intermediate port. The Proposed Regulations do not appear to require a business purpose for stopping at one or more intermediate foreign ports.

³⁴ Prop. Regs., §1.883-1(f)(2)(ii).

³⁵ Prop. Regs., §1.883-1(f)(2)(ii). This rule apparently applies regardless of whether the carriage of the cargo is inbound or outbound.

³⁶ Prop. Regs., §1.883-1(f)(2)(ii). It is not entirely clear how these "same taxpayer" rules would apply in the case of activities performed by different participants in a joint venture.

³⁷ Lighterage, or lightering, is the business of transferring, loading and unloading merchandise to and from vessels by means of lighters. Blacks Law Dictionary (6th ed. 1990).

of cargo so qualifies only if the cargo is carried between a point in the U.S. and a point *in a foreign country*. The Proposed Regulations change this rule by requiring only that the cargo be carried between a point in the U.S. and a point *outside the U.S.*³⁸ Whether the lightering income will qualify thus depends on whether the vessel to which it carries, or from which it picks up, the cargo is located outside the territorial limits of the U.S.

Under a special rule, the Proposed Regulations provide that income from the carriage of military cargo on a voyage that begins in the U.S., stops at a foreign intermediate port or a military prepositioning location, and returns to the same or another U.S. port without unloading its cargo at the foreign intermediate point, will nevertheless be treated as derived from the international operation of ships or aircraft.

As noted above, whether income from a bareboat charter or dry lease is derived from the international operation of ships or aircraft is determined by reference to the lowest-tier operator(s) in the chain of lessees. Where the operator or operators use the ship or aircraft only partially for such qualifying activities, an allocation of the charter income must be made. The Proposed Regulations permit the allocation to be based on (1) the portion of the relevant period that consists of days on which the ship or aircraft was used for certain international operations, (2) the portion of the operator-lessee's total gross income from operation of the ship or aircraft that consists of United States source gross transportation income ("USGTI") or (3) any other reasonable method.³⁹

Whatever method is used, foreign lessors under bareboat charters and dry leases should be aware of the need to obtain detailed information (which may need to be verified in the event of audit) from their lessees in order to determine their U.S. federal income tax liabilities. In some circumstances, an uncooperative lessee (such as a military lessee unwilling to disclose the location of its operations) may render such compliance impossible. If the Proposed Regulations are finalized in their current form, foreign lessors under bareboat charters and dry leases should consider revising their lease agreements to require their lessees to provide (and, if necessary, obtain from their lessees) the necessary information.

Qualified Foreign Country

A qualified foreign country is a foreign country that grants an "equivalent exemption" for the category of qualified income ("Exempt Income Category") that is earned by the foreign corporation seeking qualified foreign corporation status.⁴⁰ A foreign corporation's status as a qualified foreign corporation must be made separately with respect to each Exempt Income Category.⁴¹

Under the Proposed Regulations, a foreign country may provide an equivalent exemption if it:

³⁸ Prop. Regs., §1.883-1(f)(2)(ii).

³⁹ Prop. Regs., §1.883-1(f)(2)(iii). §887(b)(1) generally defines USGTI as "any gross income which is transportation income (as defined in section 863(c)(3)) to the extent such income is treated as from sources in the United States under section 863(c)(2)." Certain exceptions are set forth in §887(b)(2) & (3).

⁴⁰ Prop. Regs., §1.883-1(d). As discussed below, all income to which the reciprocal exemption applies must fall within one of the Exempt Income Categories set forth in Prop. Regs., §1.883-1(h)(2).

⁴¹ Prop. Regs., §1.883-1(c)(1). Note, §§872(b)(6) and 883(a)(4) permit the IRS to apply the reciprocal exemption separately with respect to income from different types of transportation, and therefore appear to authorize this approach.

- "(i) Generally imposes no tax on income, including income from the international operation of ships or aircraft;
- "(ii) Specifically provides a domestic law tax exemption for income derived from the international operation of ships or aircraft, either by statute, decree, or otherwise; or
- "(iii) Exchanges diplomatic notes with the United States, or enters into an agreement with the United States, that provides for a reciprocal exemption under section 883."⁴²

While it would appear that an equivalent exemption should be available via an income tax treaty,⁴³ the Proposed Regulations generally preclude it.⁴⁴ According to the Proposed Regulations, a foreign corporation that qualifies for an equivalent exemption only under an income tax treaty "must satisfy the terms of that convention to receive a benefit under the convention, and the foreign corporation may not claim an exemption under section 883."⁴⁵ The authority and rationale for this prohibition, which also appeared in the 2000 proposed regulations and other IRS guidance, are unclear.

The 2000 Preamble cites Conf. Rep't No. 99-841, 2d Sess. 599 (Sept. 18, 1986) (the "1986 Conference Report") and Staff of the Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Tax Reform Act of 1986, 931 (1987) (the "1986 Bluebook"), but it is difficult to discern how this legislative history supports the proposition for which it is cited. The 1986 Bluebook provides in part as follows:

"The Act's reciprocal exemption extends to alien individuals who are residents of a foreign country which grants U.S. citizens and domestic corporations an equivalent exemption. For a foreign corporation to qualify for the reciprocal exemption, the corporation must be organized in a foreign country which grants U.S. citizens and domestic corporations an equivalent exemption. *Congress intended that a country which, as a result of a treaty with the United States, exempts U.S. residents and domestic corporations from tax on income derived from the international operation of ships or aircraft, qualify under the Act, even though the treaty technically contains certain additional requirements other than residence such as registration or documentation of the ship or aircraft.*"⁴⁶

Far from supporting the position of the 2000 proposed regulations (and the Proposed Regulations), the language quoted above quite clearly appears to refute it. Indeed, the quoted passage above goes further, expressly permitting a foreign corporation to use a treaty to access the reciprocal exemption even if certain treaty requirements are *not* satisfied.⁴⁷ The 1986

⁴² Prop. Regs., §1.883-1(h)(1).

⁴³ See Prop. Regs., §1.883-4(b)(3).

⁴⁴ Nevertheless, the ability to provide an exemption via an income tax treaty remains important, since this affects the application of the "qualified shareholder test," discussed below.

⁴⁵ Prop. Regs., §1.883-1(h)(3) (subject to a limited exception).

⁴⁶ 1986 Bluebook at 930-931 (emphasis added).

⁴⁷ The IRS might conceivably argue that this language pertains only to the ability of a shareholder of the foreign corporation to qualify as entitled to an equivalent exemption for purposes of §883(c), but such an interpretation would be highly implausible. Read in context, this passage solely addresses the threshold requirement of

(continued)

Conference Report, which the 2000 Preamble also cites, does not appear to address this issue in any way.

Indeed, the legislative history to certain U.S. tax treaties confirms that, at least prior to 1986, a treaty exemption could be used to access the reciprocal exemption. For example, the Treasury Department Explanations to the 1984 U.S.-Italy treaty and the 1975 U.S.-U.K. treaty (as amended by a 1976 protocol) expressly provide that the exemptions provided in those treaties were intended to allow Italian and U.K. residents to access the reciprocal exemption.⁴⁸

Under the 2000 proposed regulations, if a corporation is organized in a foreign country that provides an equivalent exemption both under an income tax treaty and also by some other means, the foreign corporation would have been required to choose annually whether it wished to claim benefits under the income tax treaty (*i.e.*, under Section 894) or under Section 883.⁴⁹ Both the authority and the rationale for requiring foreign corporations to choose between treaty benefits and the reciprocal exemption were doubtful. In response to the objections of commentators, the Proposed Regulations would permit a foreign corporation to choose annually whether to claim the benefits of: (i) Section 883, (ii) a tax treaty, or (iii) both.⁵⁰ The Proposed Regulations provide that any such choice applies with respect to *all* qualified income of the corporation and cannot be made separately with respect to different Exempt Income Categories.⁵¹ This rule does not appear to apply to all members of a commonly controlled or affiliated group.

The IRS took a similar approach in Revenue Ruling 84-17.⁵² In that ruling, a Polish corporation realized effectively connected net gains from the sale of "product a" through a permanent establishment. The corporation also realized effectively connected net gains from the sale of "product b" and effectively connected net losses from the sale of "product c" in the U.S.; these gains and losses were *not* attributable to a permanent establishment. The corporation clearly was subject to U.S. tax on its profits from product a in all events. The corporation attempted to use the business profits article of the U.S.-Poland treaty to avoid tax on the profits from product b, while also applying the rules of the Code to its losses from product c, so that the product c losses would offset the product a profits. The IRS held such "mixing and matching" to be inappropriate. The IRS's rationale is not clearly articulated, but may be justified on the ground that the business profits provision of the treaty implicitly requires some consistency in subjecting

residence in a country that provides an equivalent exemption; it does not address the additional ownership requirements imposed under §883(c).

⁴⁸ The question of whether a treaty may be used to access the reciprocal exemption will in many cases be purely theoretical, since reciprocal exemption hardly seems necessary if treaty benefits are available. As indicated in the passage from the 1986 Bluebook quoted above, however, Congress contemplated that a treaty could constitute an equivalent exemption in some circumstances in which certain requirements for treaty access (*e.g.*, a registration requirement) are not satisfied. In such a situation, the question of whether a treaty provides an equivalent exemption that may be used to access the reciprocal exemption is critical. Moreover, as foreign corporation may be subject to State tax if §883 does not apply, since income tax treaties do not apply for State tax purposes. In contrast, an exclusion pursuant to the reciprocal exemption typically would result in zero income for State tax purposes. In most cases, income for State tax purposes "piggybacks" off of federal income.

⁴⁹ 2000 Prop. Regs., §1.883-1(h)(3).

⁵⁰ Prop. Regs., §1.883-1(h)(3)(i).

⁵¹ Prop. Regs., §1.883-1(h)(3)(i). The 2000 proposed regulations imposed a similar consistency requirement. *See* §1.883-1(h)(3).

⁵² 1984-1 C.B. 308.

to tax *all* business profits under the same set of rules prescribed therein.⁵³ The rule of the Proposed Regulations appears consistent with this approach.⁵⁴

Under the Proposed Regulations, whether a foreign country provides an equivalent exemption is determined separately with respect to each Exempt Income Category and, within each such category, is determined separately for ships and aircraft.⁵⁵ An equivalent exemption is available for an Exempt Income Category (for either shipping income or aircraft income) only if *all* income in that category is exempt from tax.⁵⁶ Thus, for example, a foreign country that exempts dry lease income for passenger aircraft but not for cargo aircraft would *not* be viewed as providing an equivalent exemption for dry lease income.

Despite its superficial simplicity, the category Proposed Regulations' category-by-category approach may be difficult to apply in practice. Thus, under this approach, it is necessary to inquire into a foreign country's hypothetical tax treatment of *all* conceivable transactions that could produce income included within the applicable Exempt Income Category in which the income item at issue falls. Such an approach seems unduly burdensome, both to foreign corporations and the IRS. Moreover, the policy ground for denying the reciprocal exemption to income of a type for which an equivalent exemption clearly is available under foreign law because no equivalent exemption is available for some *other* item within the same category is less than clear. For example, if the otherwise-equivalent exemption under foreign law does not extend to income from temporary investment of working capital, query what policy ground exists for denying the reciprocal exemption to other incidental items? Or what would the result be if the otherwise-equivalent exemption extends only to, say, four days of incidental container rental income, rather than the five days permitted under the Proposed Regulations.⁵⁷

Stock Ownership Tests

In order to constitute a qualified foreign corporation, a foreign corporation must also satisfy one of three stock ownership tests: (a) a qualified shareholder test, (b) a publicly traded test or (c) a controlled foreign corporation (CFC) test.⁵⁸

Qualified Shareholder Test

⁵³ Cf. Treasury Department Technical Explanation of the U.S.-Canada treaty, as amended by protocols signed on June 14, 1983 and March 28, 1984, Art. XXIX(1) ("Paragraph 1 does not, however, authorize a taxpayer to make inconsistent choices between rules of the Code and rules of the Convention. For example, if a resident of Canada desires to claim the benefits of the 'attributable rule' of [the business profits provision], such person must use the 'attributable to' concept consistently for all items of income and deductions and may not rely upon the 'effectively connected' rules of the Code to avoid U.S. tax on other items of attributable income."). The Treasury Department Technical Explanation to many other U.S. tax treaties is to the same effect.

⁵⁴ If a foreign corporation chooses to forego the benefits of §883, but attempts to apply a U.S. income tax treaty only to certain categories of shipping or aircraft income (*e.g.*, if a loss is incurred in another category), the IRS presumably will invoke the Proposed Regulations (if finalized) to prevent such mixing and matching. In such a case, the Proposed Regulations may present a trap for the unwary, since tax advisors of foreign corporations that attempt to rely solely on a U.S. income tax treaty may not realize the potential significance of a regulation issued under §883.

⁵⁵ See Prop. Regs., §1.883-1(h)(2).

⁵⁶ Further, a mere reduction in the level of tax imposed, or an exemption that applies only for a limited period of time, is not considered an equivalent exemption. Prop. Regs., §1.883-1(h)(4).

⁵⁷ See the discussion below of incidental income qualifying for the reciprocal exemption.

⁵⁸ Prop. Regs., §1.883-1(c)(2). These are essentially the three alternative tests set forth in §883(c), which is quoted in full above.

A foreign corporation generally satisfies the qualified shareholder test if more than 50% of its stock (by value) is owned (directly or through attribution) by one or more "qualified shareholders" for at least half of the year.⁵⁹

Qualified shareholders generally include (i) individual residents of a qualified foreign country, (ii) the governments of qualified foreign countries, (iii) foreign corporations that are organized in a foreign country and satisfy the "publicly traded" test described below, (iv) certain nonprofit organizations that are organized in a qualified foreign country, (v) certain individual beneficiaries of pension funds administered in or by a qualified foreign country, and (vi) certain shareholders of corporate airlines covered by a bilateral Air Services Agreement.⁶⁰

Commentators suggested that the list of qualified shareholders include regulated investment companies, investment partnerships and certain other investment vehicles that are available to the public and subject to regulation by the Securities and Exchange Commission. The Treasury Department acknowledged in the 2002 Preamble that such entities will have considerable difficulty in demonstrating that more than 50 percent of the value of their shares is owned (or treated as owned) by qualified shareholders, but did not adopt these suggestions, since many of the owners of such entities may in fact be U.S. residents or other non-qualified shareholders.⁶¹ Query why U.S. residents should not be qualified.

For purposes of the qualified shareholder requirement, an individual generally is considered a resident of a qualified foreign country only if (i) the individual is fully liable to tax as a resident in that country and (ii) *either* (a) the individual's "tax home" is in that country for at least 183 days during the taxable year, *or* (b) the individual is treated as a resident of a foreign country that provides an equivalent exemption pursuant to an income tax treaty, under the rules described immediately below.⁶²

As previously noted, although a foreign corporation cannot use an income tax treaty directly in order to access Section 883, an income tax treaty may nevertheless be used to support a shareholder's status as a qualified shareholder for purposes of qualifying for the Section 883 exemption. Under the Proposed Regulations, a shareholder's country of residence will be considered to provide an equivalent exemption for an Exempt Income Category via an income tax treaty with the U.S. if the shareholder demonstrates that: (1) it is treated as a resident of that country under the treaty; (2) it qualifies for benefits under the limitation on benefits article, if any; and (3) the treaty provides an exemption for that Exempt Income Category.⁶³ For this purpose, if the treaty has a requirement in the shipping and air transport article other than residence, such as place of registration or documentation of the ship or aircraft, the shareholder is not required to demonstrate that the corporation seeking qualified foreign corporation status could satisfy any such additional requirement.⁶⁴ This is actually a more lenient standard than was provided under the 2000 proposed regulations. Under the earlier proposed regulations, a shareholder resident in a treaty country could not have been a qualified shareholder by virtue of

⁵⁹ Prop. Regs., §1.883-4(a). As discussed below, constructive ownership rules apply for this purpose.

⁶⁰ Prop. Regs., §1.883-4(b)(1)(i).

⁶¹ The 2002 Preamble does note, however, that under Proposed Regulations §1.883-4(d)(3)(viii), a publicly traded corporation may rely on its SEC Form 13G (Statement of Beneficial Ownership) to identify 5-percent shareholders for purposes of the documentation requirements of Proposed Regulations §1.883-2(e).

⁶² Prop. Regs., §1.883-4(b)(2)(i).

⁶³ Prop. Regs., §1.883-4(b)(3).

⁶⁴ Prop. Regs., §1.883-4(b)(3).

the treaty unless the corporation seeking qualified foreign corporation status would, if it were organized in the treaty country, also satisfy any further requirements in the shipping and air transport article (*e.g.*, registration) and the limitation on benefits article.⁶⁵

In addition to the requirements described above, a qualified shareholder must also: (1) not hold its interest in the foreign corporation through bearer shares, either directly or indirectly through attribution rules,⁶⁶ and (2) provide certain documentation so that the foreign corporation satisfies its reporting requirements with respect to that shareholder.⁶⁷

Measuring Qualified Shareholder Ownership: Constructive Ownership Rules. For purposes of the qualified shareholder test and the publicly traded test described below stock owned by or for a corporation, partnership, trust, estate, or mutual insurance company or similar entity is treated as owned proportionately by its shareholders, partners, beneficiaries, grantors, or other interest holders; stock that is treated as owned by a person under the attribution rules is treated as actually owned by that person for purposes of further applying the attribution rules.⁶⁸ While, in many respects, the attribution rules resemble those set forth in Section 318, there are a few noteworthy exceptions.

Under the Proposed Regulations, a partner is treated as having an interest in stock of a foreign corporation owned by a partnership in proportion to the *least* of the partner's percentage distributive share of: (i) the partnership's dividend income from the stock; (ii) the partnership's gain from the disposition of the stock; and (iii) the stock (or proceeds from the disposition thereof) upon liquidation of the partnership.⁶⁹ This attribution rule seems unusually restrictive.⁷⁰ In order to avoid some of the more absurd results that could otherwise arise under this "least of" rule, the Proposed Regulations permit aggregation of all qualified shareholders that are partners in a partnership *and* that are residents of, or organized in, the *same* qualified foreign country *before* applying the "least of" rule.⁷¹ Yet, if the partners are resident in two or more countries, adverse consequences could arise solely as a result of owning stock through a partnership with non-pro rata allocations. The reason for permitting aggregation only among partners who are resident in the *same* qualified foreign country is unclear. Therefore, the authors suggest that this "same country" requirement be eliminated in the final regulations.

The Proposed Regulations generally treat an individual as having an interest in stock of a foreign corporation owned by a trust or estate in proportion to that individual's actuarial interest

⁶⁵ 2000 Prop. Regs., §1.883-4(b)(3).

⁶⁶ The prohibition on ownership through bearer shares also appeared in the 2000 proposed regulations. Some commentators objected, but due to the difficulty of establishing ownership of bearer shares, the prohibition was retained in the Proposed Regulations. In this regard, note that the OECD's anti-tax-haven initiative generally has been successful in eliminating bearer shares, although a number of jurisdictions were not yet in compliance as of the date of this writing.

⁶⁷ Prop. Regs., §1.883-4(b)(1). The documentation requirements are extensive.

⁶⁸ Prop. Regs., §1.883-4(c)(1).

⁶⁹ Prop. Regs., §1.883-4(c)(2)(i). The test for distributive share of gain may be difficult to apply, and may produce inappropriate results, in certain situations. For example, the rule may be difficult to apply if stock in the foreign corporation is contributed to a partnership by a partner at a time when its value exceeds the contributing partner's tax basis therein. Under §704(c), all of the built-in gain could be allocated to the contributing partner for U.S. federal income tax purposes when the stock is sold or distributed to the partners.

⁷⁰ *Compare, e.g.*, §§318(a)(2)(A), 267(c)(1), 554(a)(1) and 958(b).

⁷¹ Prop. Regs., §1.883-4(c)(2)(ii).

in the trust or estate, as determined under Section 318(a)(2)(B)(i).⁷² The aggregate percentage interest of the remainder beneficiaries is equal to 100%, reduced by the sum of the percentage interests of the income beneficiaries.⁷³ Ownership of an interest in stock owned by a trust generally cannot be attributed to any beneficiary whose interest cannot be ascertained under the rules above.⁷⁴ Under one favorable rule in the Proposed Regulations, however, if *all* potential beneficiaries with respect to such interest are qualified shareholders, however, such interest is treated as owned by a qualified shareholder.⁷⁵

Stock held through a fully discretionary trust would appear generally not to be attributed to any qualified shareholder. One commentator suggested that the limited attribution rules for discretionary trusts (which are essentially unchanged from the 2000 proposed regulations) be modified to permit attribution based on the facts and circumstances, but this suggestion was not adopted. The Proposed Regulations' prohibition on attribution through discretionary trusts, except where all potential beneficiaries are qualified shareholders, seems harsh, but might be justified by the need for clear rules and the abuse potential that discretionary trusts provide.⁷⁶

Under the Proposed Regulations, a shareholder of an upper-tier corporation that owns stock of a lower-tier foreign corporation generally is treated as owning stock of that lower-tier foreign corporation on any day in the same proportion as the value of the stock of the upper-tier corporation owned by the shareholder to the value of all stock of such upper-tier corporation.⁷⁷ The shareholder need not own any minimum percentage of the shares of the upper-tier corporation under these attribution rules.

Special rules apply in the case of mutual insurance companies (and similar entities) and non-government pension funds.⁷⁸

Substantiation Requirements. As discussed below, a foreign corporation that seeks to satisfy the qualified shareholder test must establish all the facts necessary to satisfy the IRS that a majority of the value of its shares is owned, directly or constructively, by qualified shareholders.⁷⁹ As will be seen below, these substantiation requirements are extensive and, in some cases, truly burdensome.

Reporting Requirements. Any foreign corporation claiming to be a qualified foreign corporation must include certain information on its Form 1120F (U.S. Income Tax Return of a Foreign Corporation), including the foreign country in which the corporation is organized, the applicable authority for the equivalent exemption, the Exempt Income Categories for which the exemption is claimed, and a reasonable estimate of the amount of exempt income in each category.⁸⁰ The IRS may also request *further* documentation, substantiating various

⁷² Prop. Regs., §1.883-4(c)(3)(i). For purposes of this rule, an income beneficiary's actuarial interest in a trust is determined as if the trust's only asset were the stock of the foreign corporation.

⁷³ Prop. Regs., §1.883-4(c)(3)(i).

⁷⁴ Prop. Regs., §1.883-4(c)(3)(i).

⁷⁵ Prop. Regs., §1.883-4(c)(3)(i).

⁷⁶ Query whether, under a typical discretionary trust instrument, the trustee of a discretionary trust, either alone or in conjunction with a protector, could exclude nonqualified shareholders as necessary to access the exemption.

⁷⁷ Prop. Regs., §1.883-4(c)(4). Special rules apply, however, in the case of an upper-tier corporation that does not issue stock.

⁷⁸ Prop. Regs., §1.883-4(c)(6) & (7).

⁷⁹ Prop. Regs., §1.883-4(d)(1).

⁸⁰ Prop. Regs., §1.883-1(c)(3)(i).

representations made with respect to a foreign corporation's claim that it is a qualified foreign corporation.⁸¹ Such information must be provided within 60 days following a written request, unless the IRS grants an extension for reasonable cause.⁸² The IRS has the authority to cure any defects in documentation where it is satisfied that the foreign corporation otherwise fulfills the requirements for qualified foreign corporation status.⁸³

The purpose for reporting amounts of exempt income by category is not clear. Nor is it clear whether the "income" is to be estimated based on gross or net income. If the latter, this would require the foreign corporation to adopt some methodology for allocating its expenses. In the case of a foreign corporation all of the income of which otherwise qualifies for exemption, such bookkeeping obligations would seem both unnecessary and unduly burdensome. If this requirement is retained, the final regulations should clarify that estimates of exempt income may be made on a gross basis.

A corporation relying on the qualified shareholder test must also provide additional information on Form 1120F, including a representation that more than 50 percent of the value of the outstanding shares of the corporation is owned by qualified shareholders for each Exempt Income Category and identifying information for each individual shareholder owning 5 percent or more of the foreign corporation.⁸⁴ It is not clear why such detailed (and potentially sensitive) information must be disclosed on the return. It should be sufficient to provide such information to the IRS upon audit.

The IRS may believe that the representation as to qualified-shareholder ownership described above would be unreliable if the foreign corporation were not required to provide specific identifying information for the individual qualified shareholders with significant (*e.g.*, 5% or greater) interests. This concern is understandable, but it nevertheless should be possible to implement an alternative procedure that provides sufficient indicia of reliability without requiring disclosure of sensitive, shareholder-specific identifying information on the corporate income tax return. For example, the foreign corporation could designate a U.S. agent, and provide such U.S. agent with the documentation relied upon to satisfy the qualified shareholder test. In lieu of identifying any qualified shareholders, the foreign corporation might be permitted to provide a statement from the U.S. agent certifying, under penalties of perjury, that it has been provided with documentation that reflects aggregate ownership by certain types of qualified shareholder of a specified percentage of the value of all outstanding shares of stock of the foreign corporation. Presumably, the U.S. agent would agree to make such documentation available to the IRS upon request for a specified period, *e.g.*, 3 years.

Publicly Traded Test. Under the Proposed Regulations, a foreign corporation satisfies the publicly traded test if: (1) it is considered a publicly traded corporation; (2) certain substantiation requirements are satisfied; and (3) certain reporting requirements are satisfied.⁸⁵

Publicly Traded Corporation. In general, a foreign corporation is considered a publicly traded corporation for this purpose if its stock is primarily and regularly traded on one or more established securities markets in the U.S. or in any qualified foreign country. Note that stock that

⁸¹ Prop. Regs., § 1.883-1(c)(3)(ii).

⁸² Prop. Regs., § 1.883-1(c)(3)(ii).

⁸³ Prop. Regs., § 1.883-1(c)(4).

⁸⁴ Prop. Regs., § 1.883-4(e).

⁸⁵ Prop. Regs., § 1.883-2(a).

otherwise satisfies this test may fail to qualify if the closely held exception (described below) applies.⁸⁶

As noted in the 2000 Preamble, the rules set forth in the Proposed Regulations for the publicly traded test are drawn in large part from Treasury Regulations Section 1.884-5(d), which provides guidance for determining whether stock of a foreign corporation is considered to be primarily and regularly traded for purposes of the branch tax.⁸⁷

A class of stock of a foreign corporation generally will not satisfy the publicly traded test if, at any time during the taxable year, one or more persons who own at least five percent of the vote and value of the outstanding shares of the class of stock (each a “5%-shareholder”) own, in the aggregate, fifty percent or more of the vote and value of the shares of that class (the “closely held exception”).⁸⁸ For purposes of determining 5%-shareholder status, certain related persons are treated as a single person.⁸⁹

The closely held exception will not apply to a class of shares if the corporation can demonstrate that qualified shareholders own sufficient shares in the closely held block of stock to prevent non-qualified shareholders of shares in the closely held block of stock from owning fifty percent or more of the value of the outstanding shares of the class of which the closely held block is a part,⁹⁰ provided that qualified shareholders do not own their interests through bearer shares and the corporation obtains certain ownership statements (described below) from such qualified shareholders and each intermediary in the chain of ownership.⁹¹

The closely held exception may reflect legitimate tax policy concerns,⁹² but it has no apparent basis in Section 883 or its legislative history. Commentators raised this issue following release of the 2000 proposed regulations. The 2002 Preamble notes this objection, and points out certain changes that make the closely held exception in the Proposed Regulations more palatable than under the 2000 proposed regulations,⁹³ but does not attempt to explain why the IRS considers the closely held exception to be authorized by Section 883. Notably, Treasury

⁸⁶ See Prop. Regs., §1.883-2(d)(3).

⁸⁷ §884(e)(3)(B).

⁸⁸ Prop. Regs., §1.883-2(d)(3)(i). The closely held exception is drawn from the branch profits tax regulations. See Treas. Reg. §1.884-5(d)(4)(iii)(A). Note that the closely held exception was even broader under the temporary branch profits tax regulations originally issued in 1988. Under those temporary regulations, a class of stock was not treated as regularly traded for any year in which 100 or fewer persons owned (or were considered to own under certain attribution rules) 50 percent or more of the outstanding shares of such class. Treas. Reg. §1.884-5T(d)(4)(ii) (1988).

⁸⁹ Prop. Regs., §1.883-2(d)(3)(iii). A special rule also applies to certain investment companies.

⁹⁰ For purposes of this test, any shares that, after application of the applicable attribution rules, are treated as owned by a qualified shareholder are not also treated as owned by a non-qualified shareholder. Prop. Regs., §1.883-2(d)(3)(ii).

⁹¹ Prop. Regs., §1.883-2(d)(3)(ii). The same attribution rules that apply for purposes of the qualified shareholder test, and the same definition of qualified shareholder, apply for this purpose.

⁹² See PLR 9639010 (June 13, 1996) (examining agents expressed the view that “as a matter of sound tax policy, a closely-held corporation never should be treated as ‘publicly traded’ -- that the two concepts are antithetical.”). Note, the ruling declined to imply a closely held exception, but only because no applicable regulations so provided.

⁹³ For example, as noted in the 2002 Preamble, under the 2002 Proposed Regulations, an otherwise publicly traded foreign corporation seeking qualified foreign corporation status or a publicly traded shareholder corporation that is traded on an established securities market in the U.S. may rely on its latest SEC Form 13G to determine whether a class of stock has any 5%-shareholders.

Regulations have also imposed a similar closely held exception under other provisions of the Code providing a favored status to publicly traded corporations or their shareholders.⁹⁴ In contrast, the limitation on benefits article of the U.S. Model, which accords treaty benefits to a corporate resident of the other country if shares possessing a majority of the vote and value of the corporation are "regularly traded on a recognized stock exchange," does not include a closely held exception.⁹⁵

Substantiation Requirements. A foreign corporation that relies on the publicly traded test must substantiate that its stock is primarily and regularly traded on one or more established securities markets.⁹⁶ These substantiation requirements are described briefly below.

Reporting Requirements. As discussed above, a corporation claiming qualified foreign corporation status must provide certain information on its Form 1120F. A corporation relying on the publicly traded test must also provide, among other things, the name of the country in which the stock is primarily traded; the name of the established securities market or markets on which the stock is listed; a description of each class of stock relied upon to satisfy the regularly traded test; and certain information as to whether the closely held exception applies.

CFC Test

A foreign corporation will satisfy the CFC test if it: (1) is a CFC within the meaning of Section 957(a); (2) satisfies an income inclusion test; (3) satisfies certain substantiation requirements; and (4) satisfies certain reporting requirements.⁹⁷

Definition of CFC. A CFC is a foreign corporation a majority of the shares of which (measured by vote or value) are owned (directly, indirectly, or pursuant to certain constructive ownership rules) by U.S. shareholders.⁹⁸ For this purpose, a U.S. shareholder generally is a United States person that owns (directly, indirectly, or pursuant to certain constructive ownership rules), stock possessing at least 10 percent of the voting power of the foreign corporation.⁹⁹

Note that a U.S. partnership is a U.S. person for this purpose.¹⁰⁰ Thus, for example, a foreign corporation will be a CFC if a majority of the voting power of such corporation is owned by a U.S. partnership.

Income Inclusion Test. A CFC satisfies the income inclusion test if more than 50% of the CFC's "adjusted net foreign base company income" derived from the international operation of ships or aircraft is includible in the gross income of U.S. citizens, U.S. individual residents or U.S. corporations for the taxable years of such persons in which the taxable year of the CFC ends.¹⁰¹ The motivation for adding the income inclusion test by the IRS is understandable, since

⁹⁴ See Treas. Reg. §§ 1.897-9T(d)(1)(ii)(B) & 1.884-5(d)(4)(iii).

⁹⁵ Art. 22(2)(c)(i). See also the Treasury Department Explanation to the United States Model Income Tax Convention of September 26, 1996, ¶1.22(2) ("Sections 1.884-5(d)(4)(i)(A), (ii) and (iii) will not be taken into account for purposes of defining the term 'regularly traded' under the Convention.").

⁹⁶ Prop. Regs., § 1.883-2(e)(1).

⁹⁷ Prop. Regs., § 1.883-3(a).

⁹⁸ § 957(a).

⁹⁹ § 951(b).

¹⁰⁰ § 7701(a)(30)(B).

¹⁰¹ Prop. Regs., § 1.883-3(b)(1). Note that, pursuant to § 954(f), income derived in connection with the use, or the hiring or leasing for use, of any aircraft or vessel in foreign commerce is treated as Subpart F income. Amounts included in the income of a domestic non-grantor trust do not appear to be taken into account for purposes of this more-than-50% test. Presumably, this is an oversight.

a foreign corporation can be structured to qualify as a CFC without the need to include Subpart F income in the gross income of any U.S. shareholder.¹⁰² Nevertheless, Section 883(c) merely requires that the foreign corporation be a CFC, and a statutory amendment is probably required to ensure that it is enforceable.

In defense of the income inclusion test, the 2002 Preamble provides (citation omitted) as follows:

"The Conference report accompanying the legislation that added the CFC exception provides with respect to the exception that 'corporations are not considered residents of countries that exempt U.S. persons unless 50 percent or more of the ultimate individual owners are U.S. shareholders of controlled foreign corporations'."

Section 883(c) on its face plainly does not contain an income inclusion test, however, and it is doubtful that the above-quoted legislative history is sufficient to reform the statute. Moreover, the portion of the 1986 Conference Report quoted above describes the Senate amendment to the House bill, which was further modified in conference, and describes a unified qualified shareholder test and CFC test that ultimately was *not* adopted. The more complete quotation is as follows:

"corporations are not considered residents of countries that exempt U.S. persons unless 50 percent or more of the ultimate individual owners are U.S. shareholders of controlled foreign corporations or are residents of countries that exempt U.S. carriers from tax."¹⁰³

The legislative history quoted in the 2002 Preamble does not appear to anticipate any such separate income inclusion test.

Similarly, a number of diplomatic notes exchanged by the U.S. and other countries parallel Section 883(c)(2) in providing that the ownership test will not apply (or will be considered satisfied) in the case of a CFC.¹⁰⁴ Those countries may well regard this aspect of the Proposed Regulations as a violation of their agreements with the U.S.¹⁰⁵ If the income inclusion test is retained in the final regulations, a challenge should be expected. In the event of such a

¹⁰² For example, a group of foreign shareholders could choose to hold their foreign corporation through a U.S. partnership. *See* Prop. Regs., § 1.883-3(b)(2), Ex. 1. This would not appear to violate the partnership anti-abuse rule, which contains an example that expressly contemplates "opting in" to CFC status. *See* Treas. Reg. § 1.701-2(f), Ex. 3.

¹⁰³ 1986 Conference Report at 598. *Accord* 1986 Senate Report at 343 ("For purposes of applying the 50-percent test to a foreign corporation (or other type of entity), if the foreign corporation is a U.S. controlled foreign corporation, the U.S. shareholders of the foreign corporation are treated as residents of the foreign country in which the corporation is organized.").

¹⁰⁴ *See, e.g.*, the diplomatic notes exchanged with Colombia, Denmark, El Salvador, Fiji, India, Isle of Man, Japan, Jordan, Liberia, Luxembourg, Panama, Singapore, St. Vincent and the Grenadines, Sweden, and Taiwan. Other notes provide instead that, for purposes of the ownership test, U.S. shareholders of a CFC will be treated as residents of the other country. *See, e.g.*, the diplomatic notes exchanged with Cyprus, Finland, Hong Kong, and Peru.

¹⁰⁵ Diplomatic notes do not have the force of an income tax treaty, but a violation would nevertheless not be conducive to international relations.

contest, a taxpayer victory should be expected, particularly if the foreign corporation was not structured as a CFC solely to access Section 883.¹⁰⁶

Under the 2000 proposed regulations, the income inclusion test could have been satisfied only if, in addition to satisfying the more-than-50%-inclusion requirement, the foreign corporation would qualify as a CFC even if Section 957 were applied without regard to the option attribution rules of Section 318(a)(4).¹⁰⁷ This aspect of the initially proposed income inclusion test was deleted without explanation in the Proposed Regulations.

Substantiation Requirements. As discussed below, a foreign corporation must establish all facts necessary to satisfy the IRS that it qualifies under the CFC test.¹⁰⁸

Reporting Requirements. As discussed above, any corporation claiming qualified foreign corporation status must provide certain information on its Form 1120F. A corporation relying on the CFC test must also identify, and specify the percentage of the corporation's vote and value owned by, each U.S. shareholder.¹⁰⁹

Qualified Income

As noted above, the reciprocal exemption applies only in the case of "qualified income." The Proposed Regulations generally define qualified income as follows:¹¹⁰

"Qualified income is income from the international operation of ships or aircraft that--

- (1) Is properly includible in any of the income categories described in paragraph (h)(2) of this section [the Exempt Income Categories]; and
- (2) Is the subject of an equivalent exemption . . . granted by the qualified foreign country . . . in which the foreign corporation seeking qualified foreign corporation status is organized."

Thus, in order for income to qualify as qualified income: (1) the income must arise from the international operation of ships or aircraft (including incidental income deemed to so arise); (2) the income must fall within an Exempt Income Category; (3) such Exempt Income Category must be the subject of an equivalent exemption granted by the foreign country in which the foreign corporation is organized; and (4) such foreign country must be a qualified foreign country. See the discussion above for a definitions of "the international operation of ships or aircraft," the "Exempt Income Categories," "equivalent exemption," and "qualified foreign country."

The Proposed Regulations provide that certain activities of an operator of ships or aircraft are so closely related to the primary activity of operation of ships or aircraft that they are considered incidental to such operations. Income from such incidental activities is *deemed* to

¹⁰⁶ Notwithstanding that the partnership anti-abuse rule appears to expressly sanction such structuring, and the clear absence of any income inclusion test in §883, a court may be troubled by a deliberate attempt to take advantage of this loophole in the statute. In that event, the flawed legislative history cited in the 2002 Preamble may provide the court with sufficient excuse to reach the desired result.

¹⁰⁷ 2000 Prop. Regs., §1.883-3(b)(1)(i).

¹⁰⁸ Prop. Regs., §1.883-3(c)(1).

¹⁰⁹ Prop. Regs., §1.883-3(d).

¹¹⁰ Prop. Regs., § 1.883-1(b).

arise from the international operation of ships or aircraft.¹¹¹ Examples in the Proposed Regulations of such incidental activities include the temporary investment of working capital funds to be used in the international operation of ships or aircraft; certain ticket sales by a foreign corporation engaged in the international operation of aircraft on behalf of other operators; providing for the carriage of cargo preceding or following the international carriage of cargo under a through bill of lading, airway bill or similar document; and the bareboat charter of a ship or dry lease of an aircraft normally used in international operation, if the ship or aircraft is used by the lessee for international carriage of cargo or passengers.¹¹²

One activity treated as incidental under the Proposed Regulations is "[r]ental of containers ... for a period not exceeding five days beyond the original delivery date by the foreign corporation to the consignee as stated on the bill of lading," provided that certain additional requirements are satisfied.¹¹³ There is typically a threshold question of whether income earned by a vessel owner or operator from the provision of containers in connection with a contract for the international transportation of cargo should be characterized as rent for U.S. tax purposes. Even if that characterization is appropriate, however, it is not clear why such activity ceases to be incidental if the "rental" period exceeds five days. So long as the provision of the containers is provided in connection with a contract for the international transportation of cargo - -and not in connection with a separate rental business-- the authors believe that all container rental income should be considered incidental income eligible for the reciprocal exemption. It is not clear why any limitation on the permissible rental period should be imposed,¹¹⁴ but if such a limit is deemed absolutely necessary, five days may not be adequate. Based on comments submitted in connection with the 2002 Proposed Regulations, an emerging consensus seems to be developing that 45 days would be reasonable.¹¹⁵

The Proposed Regulations also specify certain activities that do not qualify as incidental to the international operation of ships or aircraft. These include, among others, the sale or rental of real property and treasury activities involving the investment of excess funds (as opposed to working capital) or funds awaiting repatriation even if derived from the international operation of ships or aircraft.

The Proposed Regulations provide that none of the definitions provided therein are to be used in interpreting U.S. tax treaties.¹¹⁶ Therefore, it would appear to be the position of the IRS that the activities treated as incidental activities under the Proposed Regulations should not be presumed to qualify as incidental for purposes of an applicable U.S. tax treaty. Most U.S. tax treaties expressly *do* look to domestic law to define otherwise undefined terms, however, so the IRS's stance on this issue is at the very least likely to be confusing to a court looking for

¹¹¹ Prop. Regs., § 1.883-1(g)(1).

¹¹² Prop. Regs., § 1.883-1(g)(1).

¹¹³ Prop. Regs., § 1.883-1(g)(1)(x).

¹¹⁴ Apparently, no such limitation applies for purposes of the OECD Model. The Commentary to Art. 8, ¶10, provides as follows: "Profits derived by an enterprise engaged in international transport from the lease of containers which is supplementary or incidental to its international operation of ships or aircraft fall within the scope of this Article."

¹¹⁵ The 2002 Preamble indicates that the IRS was concerned about "temporary warehousing," but fails to explain why an arbitrary five-day limit is needed.

¹¹⁶ Prop. Regs., § 1.883-1(h)(3)(iii).

guidance as to the internal law of the United States.¹¹⁷ The final regulations should not include this limitation.

It is conceivable that the drafters' intention was merely to preserve the ability to negotiate a treaty with exclusions (*e.g.*, for incidental income) that differ from those provided for under Section 883, or to avoid upsetting existing treaty partners, which may have anticipated more generous rules. If these are the concerns, the final regulations might properly state that the definitions provided therein are not *determinative* as to the meaning of any given treaty provision. It is difficult to see why this should be necessary, but such a clarification should not be objectionable to the United States or its treaty partners.

The Proposed Regulations also provide rules for treating a foreign corporation's distributive share of certain partnership income as incidental income. In general, the partnership activity generating the income generally must be incidental to the international operation of ships or aircraft *by the partnership*. Alternatively, however, the income may qualify as incidental if the foreign corporation itself is engaged in the international operation of ships or aircraft and activity would be incidental to such international operation.

Documentation Requirements

Qualified Shareholder Test

As noted above, a foreign corporation that seeks to satisfy the qualified shareholder test must establish all the facts necessary to satisfy the IRS that a majority of the value of its shares is owned, directly or constructively, by qualified shareholders.¹¹⁸

Ownership Statements From Qualified Shareholders

In general, a person is treated as a qualified shareholder only if that person provides the foreign corporation with an ownership statement that provides the information set forth in the Proposed Regulations.¹¹⁹ Where that person owns stock in the foreign corporation through an intermediary, the intermediary must *also* provide an ownership statement.¹²⁰ An ownership statement generally remains valid until the earlier of any change in circumstance that renders any information provided incorrect or the last day of the third calendar year following the year in which it is signed.¹²¹

The requirements for the ownership statement vary somewhat, depending upon the type of qualified shareholder, *e.g.*, individual, corporation satisfying the publicly traded test, etc. In the case of an individual, the ownership statement must be signed under penalties of perjury and must state, among other things, the individuals' name, permanent address, country of residence (where the individual is fully liable to tax), and information regarding the individual's ownership

¹¹⁷ See, *e.g.*, Art. 4(2) of the OECD Model ("As regards the application of the Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that State for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State.").

¹¹⁸ Prop. Regs., §1.883-4(d)(1).

¹¹⁹ Prop. Regs., §1.883-4(d)(2)(i)(A) & (C).

¹²⁰ Prop. Regs., §1.883-4(d)(2)(i)(B).

¹²¹ Prop. Regs., §1.883-4(d)(2)(ii).

interest in the qualified foreign corporation (or the intermediate entity through which the individual owns an interest in the qualified foreign corporation).¹²²

As noted above, a publicly traded corporation that is organized in a qualified foreign country may itself constitute a qualified shareholder if it provides the required ownership statement (and other applicable requirements are satisfied).¹²³ Therefore, there is no need to look through to the actual residence of, or obtain ownership statements from, the publicly traded corporation's public shareholders.

The ownership statement for a publicly traded corporation that is a direct or indirect owner of shares of a qualified foreign corporation status must be signed under penalties of perjury by a person authorized to sign a tax return on behalf of the publicly traded corporation and must include, among other things, the name of the country in which the stock is primarily traded; the name of the established securities market or markets on which that the stock is listed; a description of each class of stock relied upon to qualify as regularly traded; and certain information as to whether the closely held exception applies.¹²⁴ If the corporation satisfies the closely held test, but qualifies for an exception, the corporation must identify each qualified shareholder on whom it relies to satisfy the exception and must provide copies of the ownership statements from such shareholders.¹²⁵

A foreign corporation with at least 250 registered holders that is not a publicly traded corporation, as described above (a “widely held” corporation) generally is not required to obtain an ownership statement from an individual who was a less-than-1% shareholder at all times during the taxable year.¹²⁶ Instead, the widely held foreign corporation generally may treat the address of record in its ownership records as the residence of any such less-than-1% individual shareholder.¹²⁷ This rule does not apply, however, if the individual’s address of record is a non-residential address (e.g., a post office box or in care of a financial intermediary of stock transfer agent), or if the officers or directors of the widely held corporation know or have reason to know that the individual does not reside at that address.¹²⁸

The Proposed Regulations also provide requirements for ownership statements provided by foreign governments, not-for-profit corporations, beneficiaries of pension funds, shareholders of airlines covered by a Bilateral Air Services Agreement and taxable nonstock corporations.¹²⁹

Statements from Intermediaries

The Proposed Regulations require the foreign corporation seeking qualified foreign corporation status to obtain ownership statements not only from the ultimate qualified shareholders, but also from each intermediary in the chain of ownership.¹³⁰

¹²² Prop. Regs., §1.883-4(d)(4)(i).

¹²³ See Prop. Regs., §1.883-4(b)(1)(i)(D).

¹²⁴ Prop. Regs., §1.883-4(d)(4)(iii).

¹²⁵ Prop. Regs., §1.883-4(d)(3)(iv).

¹²⁶ Prop. Regs., §1.883-4(d)(3)(ii). If the widely held corporation is an intermediary, it must provide the required intermediary ownership statement, described below, in order for this rule to apply.

¹²⁷ Prop. Regs., §1.883-4(d)(3)(ii).

¹²⁸ Prop. Regs., §1.883-4(d)(3)(ii).

¹²⁹ See Prop. Regs., §§1.883-3(d)(3) & (d)(4).

¹³⁰ Prop. Regs., §1.883-4(d)(4)(v)(A).

An intermediary ownership statement is a written statement signed under penalties of perjury by the intermediary (if the intermediary is an individual) or a person who would be authorized to sign a tax return on behalf of the intermediary (if the intermediary is not an individual) containing detailed information identifying the intermediary and regarding the intermediary's direct or indirect ownership in the qualified foreign corporation. If the intermediary is a nominee, the intermediary ownership statement must disclose the identity of the principal.

If the intermediary is not a nominee, the intermediary ownership statement generally must disclose the name and country of residence and the proportionate interest in the intermediary of each direct shareholder, partner, beneficiary, grantor, or other interest holder on which the foreign corporation seeking qualified foreign corporation status intends to rely to satisfy the requirement of 50 percent ownership by qualified shareholders.¹³¹ If the intermediary is a widely-held corporation with registered shareholders owning less than one percent of the stock thereof, however, the "widely held intermediary supplemental statement" described below may be provided instead of such detailed information regarding owners of interests in the intermediary.¹³²

Widely Held Intermediary Supplemental Statement

A widely held corporation that relies on the special rule described above, regarding individual shareholders that own less than 1 percent interests therein, must provide a "widely held corporation supplemental statement." This statement must set forth (i) the aggregate proportionate interest by country of residence in the widely held corporation of such registered shareholders or other interest holders whose address of record is a specific street address, and (ii) a representation that the officers and directors of the widely held intermediary neither know nor have reason to know that the individual shareholder does not reside at his or her address of record in the corporate records.

Document Retention

The documentation described above must be retained by the corporation seeking qualified foreign corporation status until expiration of the statute of limitations period for the taxable year to which such documentation relates.¹³³ Such documentation must be made available for inspection by the IRS at such time and place as the IRS may request in writing.

Publicly Traded Test

A foreign corporation that relies on the publicly traded test must substantiate that its stock is primarily and regularly traded on one or more established securities markets.¹³⁴ If one of the classes of stock on which the corporation relies to satisfy this test is closely held, the corporation generally must obtain an ownership statement form each qualified shareholder and intermediary

¹³¹ The intermediary must obtain ownership statements from such qualified shareholders.

¹³² Other alternative statements may be provided in the case of certain pension funds and taxable non-stock corporations.

¹³³ The requirement that the foreign corporation retain such documentation until expiration of the statute of limitations period for the year to which it relates does not seem unreasonable. *Compare* Treas. Reg. §1.1441-1(e)(4) ("A withholding agent must retain each withholding certificate and other documentation for as long as it may be relevant to the determination of the withholding agent's tax liability under section 1461 and §1.1461-1.").

¹³⁴ Prop. Regs., §1.883-2(e)(1).

that it relies on to satisfy the exception to the closely held rule.¹³⁵ The foreign corporation must also maintain, and provide to the IRS upon request, a list of its shareholders of record and any other relevant information.¹³⁶

This documentation must be retained until the expiration of the statute of limitations period for the taxable year to which the documentation relates and must be made available to the IRS upon request.¹³⁷

CFC Test

As noted above, a foreign corporation must establish all facts necessary to satisfy the IRS that it qualifies under the CFC test.¹³⁸ If the CFC has one or more United States shareholders that are U.S. partnerships, estates or trusts, a United States shareholder's proportionate share of the CFC's Subpart F income will not be treated as includible in the gross income of any partner, beneficiary or other interest owner that is a U.S. citizen, U.S. individual resident or U.S. corporation unless the CFC obtains certain documentation from the United States shareholder.¹³⁹

The required documentation includes a copy of Form 5471 (Information Return of U.S. Persons With Respect to Certain Foreign Corporations) and a written statement, signed under penalties of perjury by a person authorized to sign the U.S. Federal tax return of the United States shareholder, providing certain information for each U.S. citizen, U.S. individual resident or U.S. corporation on whom the CFC intends to rely to satisfy the income inclusion test.¹⁴⁰ Such documentation must be retained until expiration of the statute of limitations period for the year to which the documentation relates and must be made available to the IRS upon request.¹⁴¹

Notably, Form 5471 is submitted by each U.S. shareholder of a CFC, and seldom if ever is provided to the CFC itself. Moreover, it should go without saying that the IRS would already be in possession of any Forms 5471 filed by the CFC's United States shareholders. Therefore, the Proposed Regulations would require the CFC to gather documents that it does not have in order to provide the IRS with additional copies of documents that it does have. Compliance generally should not be difficult, but this requirement nevertheless seems unnecessary. A certification by the CFC (or, alternatively, a U.S. agent) should be sufficient.

Provision of Equivalent Exemption Through Diplomatic Notes

Statutory Authority

As discussed above, Section 883(a) provides a reciprocal exemption pursuant to which the U.S. generally exempts foreign corporations from U.S. tax on their international shipping and aircraft income if, among other requirements, the foreign country in which the foreign

¹³⁵ Prop. Regs., §1.883-2(e)(1).

¹³⁶ Prop. Regs., §1.883-2(e)(1). Query whether such disclosure might violate applicable secrecy laws in the jurisdiction in which the corporation is organized.

¹³⁷ Prop. Regs., §1.883-2(e)(2).

¹³⁸ Prop. Regs., §1.883-3(c)(1).

¹³⁹ Prop. Regs., § 1.883-3(c)(1).

¹⁴⁰ Prop. Regs., § 1.883-3(c)(2)(i). As discussed above, the income inclusion test does not appear to take into account amounts included in the income of a domestic non-grantor trust. Presumably, this was an oversight.

¹⁴¹ Prop. Regs., § 1.883-3(c)(2)(ii).

corporation is organized grants an "equivalent" exemption. Among other methods, a foreign country may provide an equivalent exemption through an exchange of diplomatic notes.¹⁴²

No Independent Force

Diplomatic notes are sometimes referred to as shipping agreements, but their force derives from the reciprocal exemption in the Code, rather than the treaty-making power of the executive branch.¹⁴³ Writers referring to such diplomatic notes as shipping agreements typically treat this as a third category of exemption, and the reader should be prepared for such misleading terminology.

Distinguishing the Treaty Exemption

The reciprocal exemption provided under the Code is conceptually distinct from any exemption that may be available under a U.S. income tax treaty. Thus, for example, a foreign person that is unable to qualify for the benefits of an applicable income tax treaty (*e.g.*, due to a failure to satisfy the limitation on benefits provision) may still access the reciprocal exemption under the Code. As discussed above, the Proposed Regulations generally would *not* permit a resident of a country that provides an equivalent exemption under a treaty to use that treaty to access the reciprocal exemption under the Code; but the authority for this limitation is at best questionable.

Scope of the Reciprocal Exemption

The requirements of the Proposed Regulations set forth above do not depend on whether an equivalent exemption is provided pursuant to internal law or an exchange of diplomatic notes. Thus, as discussed above, only profits from the "international operation of a ship or ships" or "international operation of aircraft" (including certain related profits or gains) may qualify for the reciprocal exemption.

It should be emphasized that the reciprocal exemption is available under the Proposed Regulations only with respect to the Exempt Income Categories to which the equivalent exemption applies. Thus, for example, if an equivalent exemption is provided solely pursuant to an exchange of diplomatic notes, the terms of those notes must be carefully examined. Most of the diplomatic notes in effect expressly provide that the exemption applies to (1) full charter income, (2) bareboat charter income and (3) incidental income from rental of containers and related equipment. More often than not, the diplomatic notes do not address gain from the disposition of ships or aircraft.

The diplomatic notes exchanged with Cyprus, for example, provide as follows:

"Gross income [to which the exemption applies] includes all income derived from the international operation of ships or aircraft, including income from the rental of ships or aircraft on a full (time or voyage) basis and income from the rental of containers and related equipment which is incidental to the international operation of ships or aircraft. It also includes income from the rental on a bareboat basis of ships and aircraft used for international transport."

¹⁴² Prop. Regs., §1.883-1(h)(1).

¹⁴³ Pursuant to Art. II, §2 of the United States Constitution, such treaty-making power is subject to the Senate's advice and consent.

This formulation is most typical of the post-1986 Act diplomatic notes. There are, however, significant variations.¹⁴⁴ For a summary of the income categories that the IRS considers to be exempt under the terms of outstanding diplomatic notes, *see* Revenue Ruling 2001-48.¹⁴⁵

CONCLUSION

The Proposed Regulations provide welcome guidance and, in many ways, are considerably more liberal than the 2000 proposed regulations. For example, the Proposed Regulations broaden the class of activities that would qualify as the "operation of ships or aircraft" as well as those that produce incidental income potentially eligible for exemption. In addition, the Proposed Regulations generally would treat a corporate partner in partnership that is engaged in the international operation of ships or aircraft as being so engaged, even if the corporation is a passive investor in the partnership and is not otherwise so engaged. As noted above, however, the Proposed Regulations still present a seemingly unnecessary trap for the unwary: the exemption apparently would *not* be available if the combined activities of the foreign corporation and the partnership constitute the operation of ships or aircraft, but the activities of neither the foreign corporation nor the partnership themselves rise to this level.

Further, the Proposed Regulations appear to be overly restrictive in several respects. For example, there is no clear basis in Section 883 for several aspects of the Proposed Regulations, including: the inability of using a treaty to access the reciprocal exemption; the income inclusion test that must be satisfied in order to satisfy the CFC test; and the closely held exception to the publicly traded test. These rules may be motivated by understandable policy considerations, but the IRS does not--or at least should not--have boundless license to reform perceived deficiencies in the Code. A challenge to these restrictions should be expected.

The attribution rules are also overly restrictive in some respects. As noted above, a partner is treated as having an interest in stock of a foreign corporation owned by a partnership in proportion to the *least* of the partner's percentage distributive share of: (i) the partnership's dividend income from the stock; (ii) the partnership's gain from the disposition of the stock; and (iii) the stock (or proceeds from the disposition thereof) upon liquidation of the partnership. The harshness of this "least of" rule is mitigated somewhat by the ability to aggregate all qualified-shareholder partners that are residents of, or organized in, the *same* qualified foreign country, but the "same country" requirement greatly diminishes the relief provided under this aggregation rule and serves no apparent purpose. The inability generally to attribute shares held through a discretionary trust also appears harsh, although, as noted above, this may be justifiable in light of the need for clear, easily administrable rules for measuring ownership by qualified shareholders.

The Proposed Regulations' provision that none of the definitions provided therein are to be used in interpreting U.S. tax treaties is also curious, to say the least. As noted above, this may have been intended to preclude any presumption that the activities treated as incidental under the Proposed Regulations qualify as incidental for treaty purposes. This limitation should be deleted from the final regulations. In any event, it is unclear whether it would be respected by a court.

In addition, certain provisions of the Proposed Regulations, though arguably necessary, may be difficult to apply in practice. For example, whether income is derived from the international operation of ships or aircraft would need to be determined separately for *each*

¹⁴⁴ For a more detailed discussion, *see* [the Portfolio at _____].

¹⁴⁵ 2001-42 IRB 324.

passenger or item of cargo; and, in the case of income from a bareboat charter or dry lease, this determination would need to be made by reference to the lowest-tier operator in the chain of lessees. Many companies may be unable to gather the information necessary to determine the portion of their transportation income that qualifies as derived from the international operation of ships or aircraft. Lessors under a bareboat charter or dry lease, in particular, may be unable to extract the necessary information from their lessees.

Finally, the Proposed Regulations' reporting and substantiation requirements, described in detail above, will be burdensome for many foreign corporations. Indeed, query how many foreign corporations will be able to gather the requisite information from their direct and indirect shareholders. Moreover, even where a foreign corporation is able to access such information, there undoubtedly will be numerous occasions when some of the necessary documentation is incorrect or inadvertently omitted. The absence of such documentation could preclude a foreign corporation from accessing the reciprocal exemption, even where all other requirements are satisfied, and even if the necessary documentation is later acquired and produced on audit. If there is no way to avoid complex and burdensome substantiation requirements, the final regulations should include an exception for reasonable or good faith efforts, or at least "substantial compliance."¹⁴⁶

¹⁴⁶ The Proposed Regulations do provide the IRS with discretion to "cure any defects in the documentation" but this may be of little comfort if the IRS declines to do so.