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NOTES

Under Foreign Flags: The Inequitable Avoidance of U.S. Taxation by American-Owned Ships

TAX AVOIDANCE IS the primary purpose for an American corporate or individually owned vessel to fly a foreign flag rather than an American flag. Vessels indirectly owned by Americans but incorporated in a foreign country do not pay a tax on income earned from the operation of the vessel while vessels similarly owned but incorporated in this country and which fly the American flag do pay a tax.[1] Thus, the earnings derived from these foreign incorporated vessels remain tax-free in this country and usually in the country of incorporation as well. Why doesn't every American ship register in a tax-haven country to avoid taxation? In addressing this question, it is significant to note that a substantial part of the American foreign flag fleet is owned directly or indirectly by major oil companies or other multinational corporations.[2]

This note will examine the present United States approach and rationale to taxing foreign shipping, the obstacles that limit foreign flag shipping to the largest companies and wealthiest individuals, and two alternative legislative proposals designed to maintain equity in the shipping industry by requiring foreign flag vessels owned by Americans to pay tax to the United States Treasury on United States source income.

The scope of the problem is evident from the number of American-owned vessels flying foreign flags. At the end of 1968, there were 436 United States-owned foreign flag vessels amounting to 18.5 million dry weight (hereinafter, dwt.),[3] the largest number being owned by American oil companies.[4] In 1972, the Merchant Marine fleet, which ranked fifth, consisted of 1,579 vessels with an equival-

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[1] Baker and Fritzhand, *United States Federal Income Taxation of Foreign Flag Shipping*, 26 NAT'L TAX J. 537 (1973).

[2] *Id.* at 539.

[3] E. CLARK, H. HADDOCK AND S. VOLENS, THE UNITED STATES MERCHANT MARINE TODAY 20 (1970) [hereinafter cited as MERCHANT MARINE].

[4] *Id.*

ent to 21.4 million dwt. and had a mere 49 vessels on order or under construction. Liberia, the nation with the largest Merchant Marine fleet had 1,840 vessels with an equivalent of 60.9 dwt. and 313 vessels on order or under construction adding another 27.7 million dwt. to its fleet. Liberia and her citizens do not own or control all of the vessels that fly her flag, however. On January 1, 1971, 180 vessels of 12.2 million dwt. registered in Liberia were owned beneficially by United States parent corporations or United States citizens. Second to Liberia in the number of United States-owned foreign flag vessels was England, with 93 vessels of 5.8 million dwt., and third was Panama with 91 vessels of 3.6 million dwt.[5] If these vessels beneficially owned by Americans or American companies were registered in the United States rather than the three nations listed above, the United States would have had 1,943 vessels registered in 1972 compared to Liberia's 1,660 vessels. The United States would have had the largest fleet in the world, in terms of vessels, although Liberia would still have a 5.7 million dwt. advantage in terms of capacity.[6]

If the 364 American-owned and controlled vessels of 21.6 million dwt., which were registered in Liberia, England, and Panama in 1972, were registered in the United States, then the income of those vessels would have been taxable in part by the United States Treasury. As a result of the foreign registration of these vessels, no tax was paid to any nation.[7]

United States Taxation of Foreign Ship Earnings

A foreign ship which does not receive reciprocal exemption benefits, but which does business in American ports, is taxed by the United States as any other foreign corporation doing business in the United States.[8] These corporations are taxed only on income arising in the United States or effectively connected with a trade or business carried on in the United States. The *Internal Revenue Code* of 1954, sections 861 and 864, provides rules for determining the source of various types of income. For example, a United States taxpayer that controls a foreign shipping company would be taxed in essentially the same manner as other American-

[5] U.S. Dep't of Commerce, A Statistical Analysis of the World's Merchant Fleet (1972).

[6] *Id.*

[7] *Id.*

[8] Or non-resident alien if the owner of the ships does not use the corporate form.

owned foreign corporations under Sub Part F of the tax code.[9] If a United States taxpayer owns 50 percent or more of a foreign corporation then specific income of the corporation will be deemed distributed to United States shareholders who hold 10 percent or more of the stock.[10] The statute, however, is replete with exceptions and relief measures reflecting policies regarded as overriding the policy of the elimination of deferral under Sub Part F.[11] The obvious difficulty is determining what portion of a vessel's earnings are determined taxable by the United States. Section 863(b) of the tax code specifically makes a portion of the "Gains, profits, and income — 1) from transportation or other services rendered partly within and partly without the United States," taxable in the United States.[12] Regulations describe the portion of international shipping income that is subject to United States tax.[13] In general, applying the Regulations formula about 10 percent to 12 percent of the income on a trans-Atlantic voyage is taxable.[14] It has been

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[9] Baker and Fritzhand, *supra* note 1, at 539.

[10] CHOMMIE, FEDERAL INCOME TAXATION 800 (2d ed. 1973).

[11] *Id.* at 801. Also the Tax Reduction Act of 1975 eliminates the exclusion from Sub Part F income, income of U.S. shareholders of a foreign corporation for reinvestment in less developed countries and less developed corporations. As a consequence, the "shipping company" form of less developed country corporations has also been eliminated. In addition, the exclusion from Sub Part F income for rental income from aircraft and vessels used in foreign commerce has been eliminated. In place of the two types of shipping exclusions, the concept of foreign base company shipping income has been created. Section 954 (a), defining foreign base company income, has been amended to add foreign base company shipping income as a fourth category to the present categories of foreign personal holding company income, foreign base company sales income and foreign base company service income. Foreign base company shipping income is then defined in the Code language as "income derived from, or in connection with, the use (or hiring or leasing for use) of any aircraft or vessel in foreign commerce, or from, or in connection with, the performance of services directly related to the use of any such aircraft, or vessel or from the sale, exchange, or other disposition of any such aircraft or vessel." Section 954 (f). (*See* Heyde, *A New Concept in Sub Part F — Foreign Base Company Shipping Income*, (Taxes October 1975)). Therefore, the deferral of taxation of shipping income received by a foreign subsidiary is also ended except to the extent that the subsidiary's shipping profits are reinvested in shipping operations. Note that these changes in the 1975 Tax Reduction Act eliminate only the deferral on shipping income reinvested in other than the shipping subsidiary or retained without reinvestment. Also note that Sub Part F deals with the taxation of U.S. shareholders of foreign-controlled corporations, outside the scope of this paper. The present concern is with the corporation itself, not the shareholders.

[12] INT. REV. CODE OF 1954, §863(b)(1).

[13] Treas. Reg. §1.863-4 (1957).

[14] Fridlund, *Tax Problems of the Shipping Industry*, TUL. TAX INST. 744, 747 (1957) [hereinafter cited as Fridlund].

argued[15] that if the United States could tax 10 percent of trans-oceanic shipping income and if the benefits of sections 872 and 883 could be removed from the Code, the importance of the exemption as a lost revenue source (discussed below) would have been over-emphasized. The argument, unfortunately, sidesteps the issue that makes section 883 a revenue-loser in light of its original purpose. United States taxpayers were not intended to benefit from the exemption as a result of foreign incorporation in a tax-haven country. If the 364 vessels registered in Liberia, England, and Panama in 1972, yet owned by United States taxpayers, were not exempt under 883, and were registered in the United States, then the world-wide income of those 364 vessels would be potentially taxable by the United States.[16]

Foreign Shipping may be Exempt from United States Tax — Sections 872 (b) and 883 (a) Internal Revenue Code

If the income of foreign vessels which entered any particular nation's ports were taxed, not only would the expense be great but there would also be a risk of international tax retaliation. To eliminate this problem of double taxation, the United States has entered into tax conventions of a bilateral nature with more than 21 nations, providing for reciprocal exemptions of foreign ship income. Additionally, the U.S. tax code provides a broad unilateral exemption.[17] Also, the United States, in 1963, was a signatory of an international treaty that provided for a reciprocal exemption of income from foreign vessels.[18] Sections 872 (b)(1) and 883 (a)(1) provide for exclusions from United States gross income of a foreign corporation's[19] earnings derived from the operation of a ship, documented under the laws of a foreign country, which grants equivalent exemptions to citizens of the United States and to corporations organized in the United States.[20] If a Cuban ship entered a United States port and Cuba did not grant United States ships an exemption, then the United States could tax that vessel's United States earnings.

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[15] Baker and Fritzhand, *supra* note 1, at 540.

[16] S. Surrey, *Current Issues in the Taxation of Corporate Foreign Investment*, 56 COLUM. L. REV. 815 (1956).

[17] Baker and Fritzhand, *supra* note 1, at 540.

[18] Draft Convention of the Organization for Economic Cooperation and Development (O.E.C.D. 1968).

[19] INT. REV. CODE OF 1954, §872(b)(1).

[20] *Id.*, §§883(a)(1), 872(b)(1).

Sections 872 (b)(1) and 883 (a)(1) were enacted in 1921.[21] The Senate committee report on those sections indicates that the purpose was to promote international stability in shipping and to prevent retaliatory taxation of shipping by different nations.[22] It has been suggested, however, that a major reason was actually that collection of the tax would have been practically impossible. If a foreign ship failed to pay the tax, the United States would have been forced into attaching a foreign ship for delinquent taxes when it arrived in port, and the fear of possible retaliation on United States vessels far outweighed the marginal revenues that could be gained.[23] Also, during World War I, the United States spent over $3 billion for ship construction[24] ranking its merchant fleet second only to England. At the time of the enactment of sections 872 (b)(1) and 883 (a)(1), the United States had the most to gain from such exemptions. The thought of American vessels registering under foreign flags, and foreign countries inducing registration of American vessels through tax incentives had not entered into the committee's deliberations.

Requirements of a Vessel in Order to Qualify Under the Exemption

After a foreign corporation is formed, regardless of the citizenship of its shareholders, that corporation's vessels must be registered under the maritime laws of that country.[25] Revenue Ruling 73-350 requires that in order to qualify, the foreign corporation must be organized in a country that grants an equivalent exemption to United States corporations engaged in shipping.[26] If the incorporator of the foreign corporation is an American taxpayer, then there are requirements outside of the tax code which may affect the transfer of American vessels to foreign corporations.

The Shipping Act of 1916, section 808, forbids the selling, mortgaging, leasing, chartering, or transferring in any manner, of an American vessel to a non-American or to a foreign flag or registry. The law applies when any vessel or any interest therein is owned, in whole or in part, by a citizen of the United States, or when the last documentation was under the laws of the United

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[21] Act of Nov. 23, 1921, ch. 136, 42 Stat. 227.

[22] S. Rep. No. 275, 67th Cong., 1st Sess. (1921).

[23] J. SIDMAN, SIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS, 1938-1961, at 413 (1954).

[24] MCDOWELL AND GIBBS, OCEAN TRANSPORTATION 413 (1954).

[25] R. MADIGAN, TAXATION OF THE SHIPPING INDUSTRY (1971).

[26] Rev. Rul. 73-350, 1973 Int. Rev. Bull. No. 35, at 8.

States,[27] or when the permission of the Secretary of Commerce was not obtained. The Act only requires ships already registered under the United States flag to acquire permission before transfer to a foreign flag. The requirement is easily circumvented by a citizen who has the ship documented initially abroad in a foreign corporation. Failure to comply with the Act may force the American owner, individual or corporate, to forfeit his ship, be guilty of a misdemeanor, and be subject to a fine of up to $5,000, or 5 years in prison, or both.[28]

One requirement of the Maritime Administration[29] for approving the transfer of an already registered American vessel to foreign registry, is that the owner promise to make the vessel available in times of declared national emergency.[30] Shippers would like to avoid such agreements if possible because it is during such times that supply and demand make shipping most lucrative. The shipper does not want his vessels laden with government cargo and subject to national police powers.[31] The Maritime Administration also restricts transport of cargo or passengers from or to Communist-bloc nations.[32]

The requirements of the 1916 Shipping Act were not intended to cover the type of situation that existed after the section 872 and 883 exemptions were enacted 5 years later in 1921. Thus, it was not surprising that the requirements of the 1916 Act were easily circumvented in order for a United States taxpayer to benefit from the section 872 and 883 exemptions through foreign incorporation. Neither the House nor Senate committee reports or floor debates on sections 872 and 883 discussed the possibility of American corporations or citizens setting up foreign corporations in a tax-haven country with favorable admiralty laws in order to avoid United States taxation and utilize lower labor rates. Subsequent tax laws, which will be discussed below, did create obstacles to smaller shipping operations and made foreign incorporation prohibitively expensive except for the largest of operations.

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[27] Shipping Act of 1916, 46 U.S.C. §808.

[28] *Id.*

[29] Referred to as the Secretary of Commerce under §808 of the Shipping Act of 1916.

[30] MERCHANT MARINE, *supra* note 3, at 6.

[31] An example of such a situation existed during the 1967 Arab-Israeli War when oil tankers made immense profits, although this was not a state of emergency in the United States.

[32] MERCHANT MARINE, *supra* note 3, at 6.

THE LOCATION OF PORTS OF CALL FOR A VESSEL MAY MAKE SOME TAX-HAVEN COUNTRIES UNDESIRABLE FOR INCORPORATION

The primary reason for incorporating in a foreign country is the benefit derived from the tax law in that country. As a result of foreign incorporation, the earnings of those vessels will not be taxed in the United States nor, in some instances, in the country of incorporation. This is the result of the reciprocal exemption provided by the unilateral nature of sections 872 and 883,[33] which permits any nation that meets the two requirements of those sections to qualify for the exemption. There are two further treaties which the United States has on a bilateral basis with most other trading nations[34] that place more restrictive requirements on qualifying under the United States exemption and the exemption of the other nation. These treaties or tax conventions have an additional double-test requirement, that is, both the residence of the owner and the documentation of the ship must be from the same country.[35] This requirement obviously tightens the abuse which is permitted under the general provisions of sections 872(b) and 883(a).

These additional treaties make it more beneficial for vessels trading exclusively between the nation which is party to the treaty and the United States. For example, registry in Liberia may provide for low tax in the incorporating country, but if the other nations do not grant an exemption to Liberia because of Liberia's loose residency requirements for the owner, the vessel may be taxed in all or some of her ports of business. In other words, lack of a full reciprocal agreement, because the residence of the owner is not of the country of incorporation, may permit taxation of one

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[33] The two requirements which must be met are:

(a) The earnings must be derived from the operation of a foreign ship, and

(b) The law of the ship's flag must grant an equivalent exemption to United States citizens and corporations.

[34] Examples of bilateral reciprocal tax exemption treaties that were negotiated up to 1956: (This list is not meant to be complete, but indicative of the large number of trading countries that govern their tax relationship with the U.S. by treaty.)

Belgium, 1 I.T.A. 295 (1926) and 1 I.T.A. 81 (1948); Canada, 1 I.T.A. 104 (1942); France, 1 I.T.A. 118 (1939); Union of South Africa, 1 I.T.A. 160 (1946) and 1 I.T.A. 211 (1950); Netherlands, 1 I.T.A. 239 (1948); Denmark, 1 I.T.A. 248 (1948); Ireland, 2 I.T.A. 59 (1949); Greece, 2 I.T.A. 80 (1950); Switzerland, 4 I.T.A. 60 (1951); Finland, 4 I.T.A. 101 (1952); Australia, 4 I.T.A. 179 (1953).

[35] *See* Fridlund, note 14 *supra*.

country's vessels in another country's ports solely because the vessel is of a particular foreign registry.

Due to the above considerations some shipping operations do not find it advantageous to register their ships in tax-haven countries. American oil companies doing most of their business between the Middle East and the United States do not face the restrictions of the bilateral tax conventions, therefore, are in a more advantageous position to utilize the full benefits of sections 872(b) and 883(a) than the foreign vessels that were originally intended to benefit under the sections.

TAX OBSTACLES TO FOREIGN INCORPORATION

The tax obstacles to foreign incorporation place a severe limitation on who can efficiently and effectively take advantage of sections 872(b) and 883(a). The purpose of a foreign corporation, substantially owned by United States citizens or corporations, registering ships under a foreign flag, is to locate in a country that has either no or low income tax rates at both the individual and corporate level. Revenue Ruling 73-350 now requires that in order to receive the exemption, the corporation must be organized in the foreign country or, if individually owned, the owner of the vessel must be a citizen of the foreign country that grants the exemption. Since the citizenship requirement severely curtails ownership by individual Americans, our discussion will concentrate on foreign incorporation.

When a businessman transfers his property to a corporation within the United States he can do it without any tax consequences[36] if he meets certain requirements.[37] The policy behind this provision is to encourage businessmen to use the best operating form that meets his business needs without penalty. Although the transfer of assets to a corporation in exchange for stock is technically a sale or exchange which is normally taxable to the individual transferor,[38] the corporation will not recognize any gain or loss on the receipt of money or property in exchange for the stock.[39] Section 351 waives tax liability on the transfer, except to the extent of receipt of "boot," and utilizes a deferral by allowing a carryover of basis. Section 367 prevents such a tax-

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[36] INT. REV. CODE OF 1954, § 351.

[37] C. MCCARTHY, THE FEDERAL INCOME TAX, ITS SOURCES AND APPLICATIONS (2d ed. 1971).

[38] INT. REV. CODE OF 1954, § 1002.

[39] INT. REV. CODE OF 1954, § 1032.

free incorporation when a foreign corporation is formed unless approved by the Commissioner. Approval is only granted if the foreign incorporation is not for purposes of tax avoidance; therefore, the benefits of the section 351 deferral for foreign flag shipping is excluded. The policy behind section 367 is to prevent inducing the exporting of American capital abroad. In effect, if an American ship owner wishes to set up a corporation in Liberia, the transfer of his ship to such corporation becomes a taxable event to the transferor.

EXAMPLE: (A) Ship's Fair Market Value = $1 million
(B) Depreciated basis = $650,000
Transfer to Liberian Corporation for $1 million stock
result: the taxable gain to the transferor = $350,000
Transferor's basis in stock now = $1 million

The corporation now owns the vessel in Liberia. If foreign incorporation is primarily used for tax avoidance, then section 367 prevents the benefits of the following sections:

(a) The liquidation of a subsidiary by its parent without recognition of gain or loss to the parent under section 332;
(b) Corporate acquisitions which are reorganizations under section 354;
(c) Corporate separations under section 355;
(d) Transactions previously described, treated by reason of the receipt of additional consideration under section 356; and
(e) Transactions which are treated as reorganizations at the corporate level under section 361.[40]

As a transaction becomes taxable, section 1245 recapture will turn the gain realized into ordinary income to the extent that the vessel's fair market value exceeds its adjusted basis. The ordinary income recognized from the sale of the ship cannot exceed the depreciation allowed after 1961. The longer the owner holds the vessel before foreign incorporation, the greater the possibility of ordinary income on the transfer to the corporation because of the cumulating effect of depreciation and its effective reduction in the tax basis of the ship.[41] Section 1245 recapture would not apply if section 367 did not govern the transaction, and in such circumstances the ordinary income recaptured would be collected upon the transferee's sale or disposition of the property in which

[40] J. MERTENS, CODE AND COMMENTARY, LAW OF FEDERAL INCOME TAXATION, § 367:1 (1971).

[41] INT. REV. CODE OF 1954, § 1245.

the section 1245 recapture rules apply.[42] To the foreign corporation to which a ship is being transferred, the subsequent disposition will not be governed by United States tax law but by the tax law of that country, though this point is only academic in light of section 367.

In order to avoid the hazards of a taxable transfer of assets to a foreign corporation, there are alternatives that may effect the purpose without taxation. A frequently used alternative is the utilization of accumulated foreign earnings of a United States based multinational corporation to purchase a vessel for a foreign corporation.[43] The income of a foreign subsidiary would be taxed abroad at a lower rate than in the United States and would only be taxed by the United States if repatriated.[44] The vessel could be purchased with dollars taxed at a lower rate than they would be taxed in the United States and then utilized to purchase a vessel that would generate tax-free income to the foreign corporation as a result of section 883 and the tax structure of that foreign country. The result is that American citizens or corporations may substantially own a ship that does business in American ports yet neither pays tax to the United States government nor the government of the country of incorporation.

A second alternative would be to transfer cash to a foreign corporation in the form of a contribution to capital, then utilize that cash for the purchase of a vessel. The taxpayer must be prepared to prove that this was not a step-transaction,[45] requiring the application of section 367 as previously discussed. This alternative, however, is no longer useful in most situations even if the Commissioner doesn't apply the step-transaction doctrine. Contributions to capital have traditionally been a tax-free transfer, but in 1971[46] an amendment to section 367 made contributions to capital subject to section 367.[47] As amended, section 367[48] applies

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[42] Treas. Reg. § 1.1245-2(a)(4), T.D. 6832, 7-6-65. Amended by T.D. 7084, 1-7-71 and T.D. 7141, 9-21-71. CUM. BULL.

[43] *See* R. MADIGAN, *supra* note 25, at 32.

[44] INT. REV. CODE OF 1954, § 901.

[45] Aliegg v. Commissioner, 429 F2d. 1209 (2d Cir. 1970), aff'g 50 T.C. 145 (1968).

[46] Jan. 12, 1971, Pub. L. No. 91-681, § 367, 84 Stat. 2065, *amending* 26 U.S.C. § 367 (1954) (codified at 26 U.S.C. § 367 (I.R.C., 1971)).

[47] This reversed the holding of the Tax Court and the Second Circuit which had rejected a position held by I.R.S. that section 367 as originally enacted applied to capital contribution. Aliegg v. Commissioner, 429 F2d. 1209 (2d. Cir. 1970), aff'g 50 T.C. 145 (1968).

[48] INT. REV. CODE OF 1954, § 367(d).

to contributions to capital of an 80 percent or more controlled foreign corporation even though no stock or securities are received in exchange. This alternative may be used if less than 80 percent of the corporation is within a taxpayer's control or controlled group. But the source of the capital contributed may be treated as a step-transaction. For example, if a liquidation of a United States subsidiary was utilized, section 367 would apply.

Another alternative which is no longer useful, occurs when a citizen attempts to transfer stock and securities rather than a depreciable vessel or cash to a foreign corporation.[49] Section 1491 imposes a flat excise tax on such a transfer of stock or securities by a citizen of the United States or a domestic corporation to a foreign corporation as paid in surplus or a contribution to capital, equal to 27-1/2 percent of the excess of —

(1) the value of the stock or securities so transferred, over
(2) its adjusted basis (for determining gain) in the hands of the transferor.[50]

If section 367 (D) applies to the same transaction to which section 1491 applies, then section 367 will take precedence to the detriment of the taxpayer.[51] If the taxpayer can prove that the principal purpose of the plan was not the avoidance of federal income tax then section 1491 will not apply. Sections 367 and 1491 can be avoided if the taxpayer can get a ruling that the primary purpose was not tax avoidance.

Another obstacle discouraging Americans from purchasing securities in a foreign corporation, is the Interest Equalization Tax, section 4911. Section 4911 imposes an excise tax on the acquisition of investments by United States citizens[52] of foreign securities and debt obligations.[53] The tax escalates as the value of the investment increases; thus, if there is a debt obligation the tax is equal to a percentage of the actual value of the debt obligation measured by the period remaining to maturity, with a maximum

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[49] CHOMMIE, *supra* note 10, at 811.

[50] INT. REV. CODE OF 1954, § 1491.

[51] *Id.*, § 1492 (3).

[52] *Id.*, § 4920 (a)(4). "U.S. person" includes:
(a) A citizen or resident of the United States
(b) A domestic Partnership
(c) Domestic corporation
(d) Agency or wholly owned instrument of the United States
(e) State or political subdivision
(f) Any estate or trust

[53] CHOMMIE, *supra* note 10, at 756.

rate of 22-1/2 percent.[54] The tax on stock is equal to 15 percent of the actual value of the stock.[55] However, the tax may be avoided if certain qualifications and precautions are taken.[56]

The conclusion drawn from the above alternatives to foreign incorporation of a vessel substantially owned by a domestic taxpayer in order to benefit from the exemption, is that United States corporations with substantial accumulated foreign surplus earnings are in the most advantageous position[57] to utilize the benefit of sections 872(b) and 883(a).[58]

The obstacles to foreign incorporation make it difficult or impossible in an indirect manner for some United States shipping concerns to obtain the benefits of the exemption, yet some shipping operations, especially large oil companies, incorporate in a foreign land and reap the benefits.[59]

WHAT SOURCES OF INCOME ARE EXEMPT?

Section 883 of the Internal Revenue Code and tax convention treaties describe earnings only as being "derived from the operation of ships." There has been no dispute as to whether income derived from the transfer of passengers or cargo within the world market would be entitled to the exemption. But what of the types of income to the foreign corporation that are not directly related to the operation of the ship, but only indirectly related? Areas that could be considered indirectly related to the ship's income may involve dock fees, demurrage fees, or even fuel fees if the corporation fuels other vessels as well as its own. Also, interest earned on temporary surplus funds and corporate repair facilities that charge fees to ships which are not their own could be considered.

The Internal Revenue Service has not challenged many of these potential areas of dispute, yet when they have, they have not been too hard on the industry. In 1928,[60] interest received by a

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[54] INT. REV. CODE OF 1954, § 4911 (b)(B).

[55] *Id.*, § 4911 (b)(A).

[56] *Id.*, § 4916.

[57] Baker and Fritzhand, *supra* note 1, at 539.

[58] An exemption is also granted to non-resident aliens for income from ships registered to a foreign nation that grants an equivalent exemption to United States vessels. INT. REV. CODE OF 1954, § 872 (b). This provision could be used by few Americans to benefit from the exemption, in that non-resident aliens are by definition not United States citizens, although agreements have been made that permit a United States citizen to benefit from § 872 (b) indirectly.

[59] MERCHANT MARINE, *supra* note 3, at 20.

[60] G.C.M. 4859, C.B. VII-2, 73 (1928).

British corporation on money held temporarily in United States banks represented surplus working cash arising and collected in the United States from the business of shipping and was regarded by the Internal Revenue Service as being included in the term "earnings derived from the operation of a ship" and, thus, within the meaning of the exemption. The above opinion of the General Council of the Internal Revenue Service was reinforced by a 1970 Revenue Ruling, 70-263,[61] thereby solidifying the position of the Internal Revenue Service exempting interest income under sections 872(b) and 883(a). The Internal Revenue Service for the first time began to limit the area of income that was not exempt because of the remoteness to the operation of the vessel. In a 1953 Revenue Ruling, 53-274,[62] the Internal Revenue Service drew the line between interest on temporary working capital in the form of "draw on notice bank accounts" and interest earned by foreign shipping corporations on temporary short-term investments such as short-term Treasury notes and certificates purchased with surplus working cash. The Service stated that Treasury notes and certificates purchased with surplus working cash are not considered interest received from current assets used in the operation of a shipping business and therefore such interest does not represent earnings derived from taxation under section 883.[63]

As a result of these rulings, an American corporation which substantially owns a foreign flag vessel qualifying for the exemption can invest the short-term earnings of its vessels in a United States bank, earning interest yet paying no tax. No limit has been placed on the amount of earnings that may be placed in such a bank account, the only limitation is that the income must be derived from the operation of the shipping business. The Service gives no indication as to what may be the limitations placed on the term "income from the shipping business." Those in the shipping industry have interpreted both the term "income" and the short term "investment" very broadly[64] with no objection from the Service.[65] The questionable areas of income as discussed earlier in this section have gone unchallenged by the Service.

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[61] Rev. Rul. 70-263, 1970-1 CUM. BULL. 170.

[62] Rev. Rul. 274, 1953-2 CUM. BULL. 81.

[63] *Id.*

[64] R. MADIGAN, *supra* note 25, at 37.

[65] *Id.*

Income of Charterer and Owner Both Benefit from the Exemption

A charterer takes over the entire use of the ship.[66] The charter usually calls for a vessel replete with crew and officers and usually includes fuel costs, wharf fees, overtime and other such expenses in addition to the fee to the owner.[67] The income he receives from the operation of the ship is income from a ship as defined in sections 872 and 883.

The owner of the vessel rents out his ship with crew and insurance prepaid but is reimbursed by the charterer. The owner usually receives a fixed fee for the charter.[68] The income derived from the charterer is also income from a ship as defined in sections 872 and 883. Thus, both parties receive the exemption from the operation of the same vessel.[69] The Internal Revenue Service has made no public pronouncement[70] eliminating this double exemption.[71]

An American owner of a foreign flag vessel may not be the only beneficiary of a section 883 exemption. A ripple effect occurs and benefits the charterer as well as the foreign corporation. Therefore, the exemption is not limited to the owner of the ship, but extends also to the charterer who hires the ship from the owner and operates it in American ports. Further, if the law of the vessel's flag grants an equivalent exemption, the ship's earnings in this country are exempt, regardless of whether a similar exemption is granted by the law of the country in which the ship's owner or charterer is domiciled.[72] For example, Cuba does not grant an equivalent

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[66] Note that these rulings benefit actual foreign owned corporations as well as American owners of foreign flag corporations. This note does not challenge the benefits to actual foreign corporations, which is beyond the scope of the present theme.

[67] GILMORE AND BLACK, THE LAW OF ADMIRALTY 193 (2d ed. 1975).

[68] R. MADIGAN, *supra* note 25, at 37.

[69] *Id.*

[70] BAKER, FLAGS OF REFUGE 140 (1970).

[71] R. MADIGAN, *supra* note 25, at 38.

[72] Aside from the unofficial holding by a number of the Services Conference section, the concept of a strikingly similar double exemption has been permitted in the Treasury's regulations. The regulations held that the income earned from the carriage of freight and passengers by a chartered vessel and the charter payments for the use of such vessel are both eligible for the shipping exclusion from the jurisdiction of Sub-Part F. Although this exemption has no effect upon the characterization of charter payments, since the exception of sec. 954(b)(3) is much broader than that of sec. 883, it does at least point to the Treasury's acceptance of the "double exemption." *See* MADIGAN, TAXATION OF THE SHIPPING INDUSTRY, 38 (1971); The purpose of this footnote is only to point out examples of

exemption[73] but Panama does; nevertheless, a Cuban corporation may obtain a United States exemption on the earnings of a Panamanian flag vessel which the Cuban corporation owns or charters.[74] Also, an American corporation may charter oil tankers under the Liberian flag and sell its cargo anywhere in the United States and not pay a tax on its earnings from the transport of such cargo because of the reciprocal exemption with Liberia. Or, if an American corporation owns an oil tanker flying a Liberian flag, then again, no tax will be paid to the United States on the ship's earnings in United States ports.

Need for Legislative Reform

The attraction of these foreign flags of refuge are only too apparent. In addition to the discussed tax benefits, the operating costs are much lower, including the cost of labor.[75] In examining possible reform of the present law, there are four directions in which Congress may proceed. First, the law can remain in its present form. Such a position, however, is difficult to support by any reasonable arguments.[76] Second, Congress could totally repeal sections 872(b)(1) and 883(a)(1) relating to ships under foreign flag.[77] Such a repeal, however, would violate United States treaty agreements around the world and would induce international tax retribution by shipping and trading nations.[78]

Third, Congress should leave intact the original intent of sec-

the double exemption with regard to owners and charterers, but for substantive changes to Sub Part F made in 1975, *see* note 11 *supra*.

[73] Fridlund, *supra* note 14, at 752.

[74] The example of Cuba and Panama was very important during the heavy trade of sugar and tobacco during the 1950's prior to Castro's revolution. Although at present, the United States does not trade with Cuba, both countries are taking steps to resume commerce allowing this example to become relevant once again.

[75] Fridlund, *supra* note 73.

[76] *Id.* at 758.

[77] Baker and Fritzhand in their article, *United States Federal Income Taxation of Foreign Flag Shipping*, address themselves to the defense of sections 872 (b) and 883 (a), because to eliminate them would cause chaos and retribution in the taxation of international shipping and violate United States treaty obligations around the world. But such arguments fail to address the totally unplanned tax windfalls of foreign flag registration in order to avoid U.S. taxes. Sections 883 and 872, in seeking to avoid double taxation for all American vessels, permit some Americans to register in tax-haven countries and avoid paying any tax at all. 26 National Tax Journal 537 (1973).

[78] H. R. 1040, 94th Cong., 1st Sess. (1975), introduced by Congressman Corman of California on January 14th, 1975, and is now before the Ways and Means Committee. The bill is so large, however, that it is difficult to say what Congress might do on any of its provisions if put to vote.

tions 872(b)(1) and 883(a)(1) but eliminate the ability of an American citizen or corporation from utilizing the benefits of these provisions by incorporating or investing in foreign shipping companies for the purpose of United States tax avoidance. The proposal could provide that income of foreign shipping which is United States source income, would not be exempt under sections 872(b)(1) and 883(a)(1) if the foreign flag vessel or corporation was owned directly or indirectly by a United States citizen, resident alien, or corporation. The proposal could become effective 2 years after enactment and, thus, allow foreign corporations with smaller percentages of American stockholders to decide whether to lose the exemption or require American interests to be divested.

Fourth, Congress could amend sections 872(b)(1) and 883(a)(1) to make more stringent the requirements for qualification, yet retain the bilateral tax conventions that already exist with many nations.[79] Sections 872(b)(1) and 883(a)(1) should require a double-residence test in order to qualify. The exemption should be granted only if both the owner is a resident of a foreign country and documentation of the ship is in that country. This would repeal the present single qualification that only the ship need be registered in a foreign country which grants the exemption.

An objection to this proposal may be that many vessels are currently registered in tax-haven countries with the owner a foreign citizen living in another nation. The proposal would deny the United States exemption to those vessels, as well as American foreign flag vessels. To a certain degree this would be inevitable, but the United States would not be violating its treaty obligations with trading nations around the globe, which are mainly governed by bilateral agreements already using this approach.

Additionally, 872(b)(1) and 883(a)(1) should define earnings from a ship only as that income earned by the owner of the vessel. The income exempted should only be the direct earnings of the ship. The exemption should exclude from the definition of "income," interest from temporary surplus funds, repair facilities, fuel receipts, demurrage fees, and dock fees, to name a few.

Such reforms would comply with treaty obligations of the United States yet prevent abuse of sections 872 and 883 by American citizens and multinational corporations and provide revenue for the Treasury.

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[79] *See* note 1 *supra*.

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