Equity Investments in Shipping Vessels

Don't Set Sail on the S.S. Minnow: Structuring Private Equity Investments in Shipping Vessels

*Private equity funds should consider structuring shipping investments to maximize their investors' after-tax returns by taking advantage of the beneficial tax treatment under many U.S. income tax treaties and the generous domestic tax rules in **Sections 883** and **887** .*

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After the 2008 financial crises, many asset classes experienced significant devaluation, and shipping vessels were not immune. Some private equity funds may attempt to achieve outsized returns by acquiring vessels at below-market prices, leasing them for several years, and disposing of them at a significant profit. While the U.S. federal income tax rules are extremely favorable with respect to income earned from the international operation of shipping vessels, and in some instances gain from the disposition of these vessels, private equity funds should still take caution to structure investments in a way that takes advantage of these rules.

The most appropriate investment structure often depends on the private equity fund's investor base, which frequently includes pension funds. According to a 2014 report by State Street, approximately 77% of pension fund managers expected their institutions' investment risk appetite to increase over the next three years, and 60% anticipated increasing their allocations to private equity funds. [1] With the growing importance of pension fund investors in mind, this article discusses U.S. federal income tax rules applicable to private equity investments in shipping vessels and identifies certain points that private equity funds should consider when structuring these investments.

As noted, the U.S. federal income tax rules are quite favorable with respect to income from the operation and disposition of shipping vessels. For example, under many U.S. income tax treaties, income from the international operation of shipping vessels, as well as gain from the disposition of these vessels, may qualify for a complete exemption from U.S. tax. **2** Similarly, **Section 883** provides a domestic exemption for certain international transportation income derived by a foreign corporation, but only if the foreign country grants an equivalent exemption to the United States. Further, if the shipping income fails to qualify for the exemptions under an applicable income tax treaty or **Section 883** , the U.S.-source portion of the income may still qualify for the 4% excise tax under **Section 887** . Gain from the disposition of shipping vessels, however, is not covered by **Section 887** and is subject to the ordinary U.S. federal income tax rules for dispositions of property.

Hypothetical Investment Structure

This article reviews the U.S. federal income tax rules using a hypothetical structure in which a domestic fund manager formed a Delaware limited partnership (U.S. PE fund) that included a U.K. pension fund investor. The U.K. pension fund is a nongovernmental, tax-exempt pension fund established exclusively to administer employee benefits to residents in the United Kingdom, and does not maintain an office or fixed place of business in the United States. Under the limited partnership agreement, the fund manager has the flexibility to structure investments through an alternative investment vehicle (AIV).

Using an AIV structure, the U.S. PE fund acquired two shipping vessels. Specifically, the fund manager formed a Marshall Islands limited partnership (MI AIV) and called capital from its limited partners directly into MI AIV. The fund manager structured the U.K. pension fund's investment into MI AIV through a Marshall Islands limited partnership (MI Blocker), which elected to be treated as a corporation for U.S. federal income tax purposes.

The acquisition of the shipping vessels was sourced by an individual who is a tax resident of the Marshall Islands. In lieu of the typical fee associated with sourcing the deal, MI AIV and the Marshall Islands individual entered into a joint venture whereby MI AIV contributed sufficient cash to acquire the vessels in exchange for a 98% interest in the joint venture, and the Marshall Islands individual received a 2% interest in the joint venture in exchange for sourcing the deal. **3** The joint venture was formed as a Marshall Islands limited partnership (MI JV). The MI JV does not maintain an office or fixed place of business in the United States. For liability purposes, MI JV acquired each shipping vessel through a separate Marshall Islands limited partnership (Operating LPs). The fund manager formed a Marshall Islands limited liability company (MI LLC) to hold a nominal interest in and act as the general partner for each of MI Blocker, MI AIV, MI JV, and Operating LPs. **4** The MI LLC is board managed and has no officers or employees.

The Operating LPs entered into an administrative services and commercial management agreement with an asset manager that is a tax resident in, and whose sole office is located in, the Marshall Islands. Under the agreements, the shipping vessels will be leased as part of a pool of vessels managed by the asset manager. The asset manager will lease all of the vessels on time or voyage charters for the purpose of carrying passengers or cargo on voyages that (1) are wholly outside of the United States or (2) begin or end in the United States. In no case will the vessels operate on voyages that both begin and end in the United States. Further, the shipping vessels will not operate on published schedules with repeated sailings at regular intervals between the same points that begin or end in the United States.

U.S. Federal Income Tax Construct of the Hypothetical Structure

As an initial matter, it is important to understand how the hypothetical structure is viewed from a U.S. federal income tax perspective. The Operating LPs will earn income from the operation and disposition of the vessels but they are partnerships for U.S. federal income tax purposes. Thus, the Operating LPs are not subject to U.S. federal income tax and their partners are required to take into account their respective distributive shares of the Operating LPs' income. **5** As noted above, the general partner holds only a nominal interest in the Operating LPs so for all intents and purposes, MI JV should take into account all of the income that the Operating LPs earn.

This construct continues up the chain. Since MI JV is also a partnership for U.S. federal income tax purposes, the partners in MI JV, including MI AIV, are required to take into account their respective distributive shares of MI JV's income. Similarly, since MI AIV is a partnership for U.S. federal income tax purposes, the partners in MI AIV, including MI Blocker, are required to take into account their respective distributive shares of MI AIV's income. However, the flow-through treatment stops there. Since MI Blocker is treated as a corporation for U.S. federal income tax purposes, MI Blocker is required to take into account its distributive share of MI AIV's income.

Exemption Under an Income Tax Treaty

As a policy matter, income tax treaties are intended to promote international trade and investment by minimizing double taxation of income. **6** This is generally accomplished by allocating sole taxing authority on certain types of income to one of the two parties to the treaty (each a contracting state) or by providing reduced withholding tax rates on certain types of income earned from sources within a contracting state. **7** To qualify for benefits under an income tax treaty, the following requirements must be satisfied:

(1) The treaty must govern the specific type of income for which treaty benefits are sought.

(2) The person claiming treaty benefits must be a resident of a contracting state.

(3) The income must be derived by that resident.

(4) The person must satisfy the limitation-on-benefits provision of the treaty (if any).

(5) The person must not otherwise be denied treaty benefits under domestic law.

As noted above, MI Blocker must take into account its distributive share of income from the operation and disposition of the shipping vessels. As an initial matter, it must be determined whether that income is subject to a reduced withholding rate or complete exemption under an income tax treaty in effect with the United States. The Marshall Islands does not have such a treaty but all is not lost. Since the U.K. views MI Blocker as a partnership, the U.K. pension fund may be entitled to benefits with respect to the income under the 2001 U.S.-U.K. treaty ("U.K. Treaty").

As a starting point, the U.K. pension fund will be entitled to treaty benefits only if the type of income for which treaty benefits are sought is covered by the U.K. Treaty. Fortunately, the U.K. Treaty governs both income from the international operation of shipping vessels and gain from the disposition of these vessels. Shipping income is governed by U.K. Treaty Article 8 (Shipping and Air Transport), which says that profits of an enterprise of a contracting state from the operation of ships in international traffic are taxable only in that state. For purposes of Article 8, "operation of ships" specifically includes "the rental of vessels on a full (time or voyage) basis," **8** and "international traffic" means any transport by a ship, except when the ship is "operated solely between places in the other Contracting State." **9** These rules apply even if the income is derived through participation in a pool, a joint business, or an international operating agency. **10**

In the hypothetical structure above, income from operation of the shipping vessels should be considered income from the operation of ships in international traffic and covered by Article 8 of the U.K. Treaty since (1) the shipping vessels are leased under time or voyage charters, which, as stated above, the U.K. Treaty specifically identifies as "operation of ships," and (2) the shipping vessels do not operate on voyages that both begin and end in the United States, which is, by definition, international traffic. Further, Article 8 applies notwithstanding that the vessels are leased as part of a pooling arrangement.

While Article 8 of the U.K. Treaty governs income from the international operation of shipping vessels, Article 13 covers gain from the disposition of these vessels. The U.K. Treaty says specifically that "gain derived by an enterprise of a Contracting State from the alienation of vessels operated in international traffic by the enterprise is taxable only in that State." **11** In the hypothetical above, gain from the disposition of the shipping vessels should be governed by Article 13 since, for the reasons discussed above, the shipping vessels are operated in international traffic.

Since "international traffic" does not include voyages that both begin and end within the United States, whenever possible the asset manager should avoid leasing vessels on such voyages. If practical, the asset management agreement could be drafted to prohibit these voyages.

The U.K. pension fund will be entitled to benefits under the U.K. Treaty only if the fund is a resident of a contracting state. **12** For purposes of the Treaty, "resident of a contracting state" specifically includes pension schemes, as well as any plan, scheme, fund, trust, company, or other arrangement established in a contracting state that is operated exclusively to administer or provide employee benefits and that, by reason of such status, is generally exempt from income tax in that state. **13** Here, the U.K. pension fund should be considered a resident of a contracting state since the fund is a tax-exempt entity, established in the U.K. exclusively to administer employee benefits.

The U.K. pension fund will be entitled to treaty benefits only if income from the operation and disposition of the shipping vessels is derived by the fund for purposes of the U.K. Treaty. **14** The Treaty contains a specific provision concerning items of income derived through fiscally transparent entities, such as partnerships. An item of income derived through a person that is fiscally transparent under the laws of either contracting state is considered derived by a resident of a contracting state to the extent that the item of income is treated for purposes of the tax law of that contracting state as income of such resident. **15** The Treasury Technical Explanation to the U.K. Treaty provides the following examples:

> [First,] if a U.K. company pays interest to an entity that is treated as fiscally transparent for U.S. tax purposes, the interest will be considered *derived by* a resident of the U.S. only to the extent that the taxation laws of the United States treats [sic] one or more U.S. residents...as deriving the interest for U.S. tax purposes....The same result obtains even if the entity were viewed differently under the tax laws of the United Kingdom....
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> [Second,] income from U.S. sources received by an entity organized under the laws of the United States, which is treated for U.K. tax purposes as a corporation and is owned by a U.K. shareholder who is a U.K. resident for U.K. tax purposes, is not considered derived by the shareholder of that corporation even if, under the tax laws of the United States, the entity is treated as fiscally transparent. Rather, for purposes of the treaty, the income is treated as derived by the U.S. entity. **16** (Emphasis added.)

It is clear from the examples that if a U.K. resident owns an interest in an entity that is fiscally transparent under the laws of either the United States or the United Kingdom, income of that entity will be considered derived by the U.K. resident only if, under the U.K. tax laws, the item is treated as income of the U.K. resident.

In the hypothetical, income from the operation and disposition of the shipping vessels should be considered derived by the U.K. pension fund for purposes of the U.K. Treaty since, for purposes of this article, it is assumed Marshall Islands limited partnerships are treated as fiscally transparent entities for U.K. tax purposes. Thus, the U.K. pension fund's share of income from the operation and disposition of the shipping vessels should be treated as income of the U.K. pension fund. This construct is not changed, even though the United States views MI Blocker as fiscally opaque, i.e., a corporation. **17**

Prior to structuring an investment that brings a limited partner of the private equity fund directly into an investment that may give rise to a tax filing obligation, private equity funds should confirm that fund documents allow for such investments and consult with their investors as to whether this is an appropriate investment structure.

Private equity funds may choose to structure investments through LLCs that elect to be treated as flow-through entities for U.S. federal income tax purposes. However, the use of LLCs often presents problems under the hybrid entity provisions in many income tax treaties, as well as domestic law, since the income may be viewed as derived by the LLC.

On July 1, 2015, the U.K. Supreme Court issued a decision in *Anson* (2015) UKSC 44, which allowed U.K. investors to avoid double taxation when investing in the United States through a Delaware LLC. Private equity funds should consider the impact (if any) of that ruling when structuring investments through LLCs.

The U.K. pension fund will be entitled to benefits under the U.K. Treaty only if the U.K. pension fund qualifies for benefits under the limitation-on-benefits Article. Article 23(1) of the U.K. Treaty specifically says that "a resident of a Contracting State that derives income, profits or gains from the other Contracting State shall be entitled to all the benefits of this Convention otherwise accorded to residents of a Contracting State only if such resident is a qualified person." "Qualified person" includes a pension plan, scheme, fund, trust, company, or other arrangement established in a contracting state that is operated exclusively to administer or provide employee benefits and that, by reason of such status, is generally exempt from income taxation in that state, provided that more than 50% of the pension fund's beneficiaries, members, or participants are individuals who are residents of either the United Kingdom or United States. **18**

The U.K. pension fund should be considered a qualified person for purposes of the U.K. Treaty since it is a non-governmental, tax-exempt pension fund established exclusively to administer employee benefits to residents in the United Kingdom, and more than 50% of its beneficiaries are U.K. residents. The fund will be entitled to benefits under the U.K. Treaty only if it is not otherwise denied benefits under U.S. domestic law (e.g., **Reg. 1.881-3** , **Section 894(c)** , and case law on beneficial ownership). To avoid a comprehensive analysis of U.S. domestic law, it is assumed that the U.K. pension fund would not be denied benefits under the U.K. Treaty as a result of the application of U.S. domestic law and, therefore, should be exempt from U.S. tax with respect to income from the operation and disposition of the shipping vessels.

While this article is limited to a discussion of income from the operation and disposition of shipping vessels, pension funds may be entitled to benefits under other provisions of the U.K. Treaty.

Exemption Under Section 883

Even if income from the operation and disposition of the shipping vessels does not qualify for benefits under the U.K. Treaty, it may still qualify for the domestic exemption under **Section 883** . Specifically, **Section 883(a)(1)** says that gross income that a corporation organized in a foreign country derives from the international operation of ships is not included in gross income of a foreign corporation and is exempt from taxation if the foreign country grants an equivalent exemption to corporations organized in the United States. The Regulations clarify that qualified income that a qualified foreign corporation derives from its international operation of ships is excluded from gross income and exempt from U.S. federal income tax. **19**

As an initial matter, qualified income is exempt from U.S. taxation under **Section 883** only if the income is received by a qualified foreign corporation. The MI Blocker will be considered a qualified foreign corporation only if MI Blocker: **20**

(1) Is a corporation.

(2) Is engaged in the international operation of ships.

(3) Is organized in a qualified foreign country.

(4) Satisfies the stock ownership test.

(5) Satisfies the substantiation and reporting requirements under **Reg. 1.883-1(c)(3)** .

First, MI Blocker will be considered a qualified foreign corporation only if MI Blocker is a corporation for purposes of **Section 883** . Under **Section 7701(a)(3)** , "corporation" includes associations, joint-stock companies, and insurance companies, but does not include partnerships. However, under **Reg. 301.7701-3(a)** , an entity with at least two members may elect to be classified as a corporation. Here, MI Blocker has two members and elected to be treated as a corporation. Therefore, MI Blocker should be treated as a corporation for U.S. federal income tax purposes.

Second, MI Blocker will be considered a qualified foreign corporation only if MI Blocker is engaged in the international operation of ships. For purposes of **Section 883** , "operation of ships" includes leasing ships under time or voyage charters, provided that the ships are used to carry passengers or cargo for hire. **21** Further, "international operation of ships" means the operation of ships with respect to carrying passengers or cargo on voyages that begin *or* end in the United States, but does not include carrying passengers or cargo on voyages that begin *and* end in the United States. **22**

A foreign corporation will be considered engaged in the operation of ships through its participation in a partnership, if the partnership would be considered engaged in the operation of ships if the partnership were a foreign corporation. **23** This rule applies even if the vessels are owned indirectly through tiers of partnerships. **24** Further, a foreign corporation, or flow-through entity, may be considered engaged in the operation of ships notwithstanding its participation in a pool, strategic alliance, or other joint venture that is not an entity. **25**

In the hypothetical, MI Blocker should be considered engaged in the international operation of ships through its ownership in the tiered partnerships. Here, MI Blocker owns an interest in MI AIV, which is treated as a partnership for U.S. federal income tax purposes. Therefore, MI Blocker will be considered engaged in the international operation of ships if MI AIV would be considered engaged in the international operation of ships if MI AIV were a foreign corporation. This construct continues down the chain. Specifically, MI AIV owns an interest in MI JV, which is a partnership for U.S. federal income tax purposes, and MI JV, in turn, owns an interest in the Operating LPs, which are also partnerships for U.S. federal income tax purposes. Therefore, under the tiered partnership construct, MI Blocker will be considered engaged in the international operation of ships if the Operating LPs would be considered engaged in the international operation of ships if the Operating LPs were foreign corporations.

Here, if the Operating LPs were foreign corporations, they should be considered engaged in the international operation of ships. First, the vessels are leased under time or voyage charters for the purpose of carrying passengers or cargo, which is clearly "operation of ships." Second, the vessels operate on voyages that either begin or end in the United States, but not both, which should be considered "international operation of ships." The result does not change even though the vessels are leased through a pooling arrangement with the asset manager. Therefore, MI Blocker should be considered engaged in the international operation of ships.

Third, MI Blocker must be organized in a qualified foreign country. A "qualified foreign country" is a foreign country that grants to corporations organized in the United States an equivalent exemption for the category of qualified income derived by the foreign corporation seeking qualified foreign corporation status. **26** An equivalent exemption may exist where the foreign country (1) generally imposes no tax on income, including income from the international operation of ships; (2) provides a tax exemption for income derived from the international operation of ships, either by statute, decree, income tax convention, or otherwise; or (3) exchanges diplomatic notes with the United States, or enters into an agreement with the United States, that provides for a reciprocal exemption for purposes of **Section 883** . **27** Here, the Marshall Islands provides equivalent exemptions with the United States through an exchange of diplomatic notes, with respect to both income from the time or voyage charter of ships used in international transport and capital gain from the disposition of the vessels. **28**

Fourth, MI Blocker will be considered a qualified foreign corporation only if it meets one of three alternative stock ownership tests: (1) the publicly traded test, (2) the controlled foreign corporation (CFC) stock ownership test, or (3) the qualified shareholder stock ownership test. **29** The publicly traded and CFC stock ownership tests do not apply to the hypothetical structure, and are not discussed herein.

A foreign corporation satisfies the qualified shareholder stock ownership test if (1) one or more qualified shareholders own more than 50% of the total value of all the outstanding stock of the foreign corporation; (2) the foreign corporation meets the substantiation of stock ownership requirements under **Reg. 1.883-4(d)** ; and (3) the foreign corporation meets the reporting requirements under **Reg. 1.883-4(e)** . **30**

As an initial matter, it must be determined whether more than 50% of the total value of all of the outstanding stock of MI Blocker is owned by qualified shareholders. A shareholder is a "qualified shareholder" only if, with respect to the category of income for which the foreign corporation is seeking an exemption, the shareholder is:

(1) An individual who is a resident of a qualified foreign country.

(2) The government of a qualified foreign country (or a political subdivision or local authority of that country).

(3) A foreign corporation that is organized in a qualified foreign country and meets the "publicly traded" test.

(4) A not-for-profit organization that is not a pension fund and is organized in a qualified foreign country.

(5) An individual beneficiary of a pension fund that is administered in or by a qualified foreign country, who is treated as a resident under **Reg. 1.883-4(d)(3)(iii)** of a qualified foreign country.

(6) A shareholder of a foreign corporation that is an airline covered by a bilateral air services agreement in force between the United States and the qualified foreign country in which the airline is organized. **31**

While pension funds are noticeably excluded from the definition of "qualified shareholders," the U.K. pension fund is in luck. The **Section 883** Regulations provide that stock held by a pension fund is considered owned by the beneficiaries of the fund equally on a pro rata basis if the requirements of **Reg. 1.883-4(c)(7)** are satisfied. To avoid a lengthy discussion of the constructive ownership rules as they relate to pension funds and their beneficiaries, it is assumed that the U.K. pension fund would satisfy these requirements. Since the U.K. pension fund owns all of the stock of MI Blocker, other than the general partner's nominal interest, and the beneficiaries of the U.K. pension fund are treated as owning their pro rata share of MI Blocker stock, MI Blocker will satisfy the qualified shareholder prong of the stock ownership test if more than 50% of the U.K. pension fund investors are individual beneficiaries of a pension fund that is administered in a qualified foreign country, and these beneficiaries are treated as residents, under **Reg. 1.883-4(d)(3)(iii)** , of a qualified foreign country.

First, the beneficiaries of the U.K. pension fund will be considered qualified shareholders only if the fund is administered in a qualified foreign country. As noted above, a "qualified foreign country" is a foreign country that grants to corporations organized in the United States an equivalent exemption for the category of qualified income derived by the foreign corporation seeking qualified foreign corporation status. **32** An equivalent exemption may exist when the foreign country provides an exemption from tax for income derived from the international operation of ships by income tax treaty. **33** Here, the United Kingdom should be considered a qualified foreign country since it provides equivalent exemptions, through an income tax treaty, with respect to income from the rental on a full (time or voyage) basis of vessels used in international transport, as well as on capital gain from the disposition of these vessels. **34** Therefore, the beneficiaries of the U.K. pension fund should be considered beneficiaries of a pension fund that is administered in a qualified foreign country, i.e., the United Kingdom.

Second, the beneficiaries of the U.K. pension fund must be considered "residents," under **Reg. 1.883-4(d)(3)(iii)** , of a qualified foreign country. That Regulation says that the beneficiary of a pension fund is deemed to be a resident of the country of the beneficiary's address, as it appears on the pension funds records, provided that the funds files the requisite ownership statement. **35** Here, it is assumed that the addresses of all of the beneficiaries of the U.K. pension would be within the United Kingdom, a qualified country. Therefore, the beneficiaries of the fund should be considered residents, under **Reg. 1.883-4(d)(3)(iii)** , of a qualified foreign country.

Accordingly, MI Blocker should satisfy the qualified shareholder prong of the qualified shareholder stock ownership test since (1) the U.K. pension fund owns essentially all of the value of the outstanding stock of MI Blocker; (2) the beneficiaries of the U.K. pension fund are treated as owning their pro rata share of MI Blocker stock that the fund holds; and (3) the beneficiaries are individual beneficiaries of a pension fund that is administered in, and the beneficiaries are treated as residents of, the United Kingdom, a qualified foreign country.

Since MI Blocker satisfied the first prong of the qualified shareholder stock ownership test, it must next be determined whether it satisfies the shareholder substantiation requirement. As a general matter, a qualified shareholder is required to demonstrate its status as a resident by providing an ownership statement. **36** However, if the qualified shareholder is a beneficiary of a pension fund, the beneficiary is not required to complete an ownership statement, and is deemed to be a resident of the country of the beneficiary's address, as it appears on the pension funds records, provided the pension fund files the requisite ownership statement. **37** Here, it is assumed that the U.K. pension fund would provide MI Blocker with the appropriate ownership statement, so the substantiation requirement should be satisfied.

Under the third prong of the qualified shareholder stock ownership test, MI Blocker must satisfy the reporting rules under **Reg. 1.883-4(e)** , which requires MI Blocker to file Form 1120-F (U.S. Income Tax Return of a Foreign Corporation) and include the statements required thereunder. **38** In the hypothetical, MI Blocker should satisfy the qualified shareholder stock ownership test since more than 50% of the total value of its stock is owned by qualified shareholders, and it is assumed that MI Blocker would meet the substantiation requirements under **Reg. 1.883-4(d)** and the reporting requirements under **Reg. 1.883-4(e)** .

Finally, MI Blocker will be considered a qualified foreign corporation only if it files Form 1120-F and includes the information required by **Reg. 1.883-1(c)(3)** . **39** For purposes of this article, it is assumed that MI Blocker would meet the filing requirements under **Reg. 1.883-1(c)(3)** and thus be considered a qualified foreign corporation for purposes of **Section 883** .

As noted above, a qualified corporation is entitled to an exemption under **Section 883** only to the extent that it receives qualified income. Under the Regulations, income derived from the international operation of ships is considered qualified income only if:

(1) The income falls within one of the eight categories of income specified in **Reg. 1.883-1(h)(2)** . **40**

(2) The exempt category of income is subject to an equivalent exemption granted by the foreign country in which the foreign corporation is organized. **41**

First, **Reg. 1.883-1(h)(2)** says that the following categories of income derived from the international operation of ships or aircraft may be exempt from U.S. income tax:

(1) Income from the carriage of passengers and cargo.

(2) Time or voyage (full) charter income of a ship.

(3) Bareboat charter income of a ship.

(4) Incidental bareboat charter income.

(5) Incidental container-related income.

(6) Income incidental to the international operation of ships other than incidental income specifically excluded in **Regs. 1.883-1(h)(2)(iv)** and (v).

(7) Capital gains derived by a qualified foreign corporation engaged in the international operation of ships from the sale, exchange, or other disposition of a ship, container, or related equipment or other moveable property used by that qualified foreign corporation in the international operation of ships.

(8) Income from participation in a pool, partnership, strategic alliance, joint operating agreement, code-sharing arrangement, international operating agency, or other joint venture described in **Reg. 1.883-1(e)(2)** .

In the hypothetical, MI Blocker does not directly earn income from the operation and disposition of the shipping vessels, but instead takes into account its distributive share of the income earned through three tiers of partnerships. As a general matter, income that a partnership earns is not subject to tax at the partnership level, and is taken into account at the partner level. **42** Further, the items of income that a partnership earns generally retain their character when taken into account by the partner. **43** The Regulations provide a useful example of this principle in the **Section 883** context:

> X, Y, and Z, each a foreign corporation, enter into a partnership, P. P is a fiscally transparent entity under the income tax laws of the United States....Under the terms of the partnership agreement, each partner contributes all of the ships in its fleet to P in exchange for interests in the partnership and shares in the P profits from the international carriage of cargo. The partners share in the overall management of P, but each partner, acting in its capacity as partner, continues to crew and manage all ships previously in its fleet.
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> P owns the ships contributed by the partners and uses these ships to carry cargo for hire. Therefore, if P were a foreign corporation, it would be considered engaged in the operation of ships within the meaning of paragraph (e)(1) of this section. Accordingly, because P is a fiscally transparent entity under the income tax laws of the United States ... X, Y, and Z are each considered engaged in the operation of ships through P ... *with respect to their distributive share of income from P's international carriage of cargo.* **44**

Based on the general U.S. federal income tax principles with respect to the flow-through treatment of partnerships, as well as the example in the **Section 883** Regulations, the determination of whether MI Blocker's distributive share of income from MI AIV falls within one of the eight categories of income specified in **Reg. 1.883-1(h)(2)** is made at the Operating LP level. **45**

Here, the Operating LPs will earn (1) income from the time or voyage charters of vessels that operate on voyages that either begin or end in the United States, but not both; and (2) capital gain from the disposition of such vessels. Each of these types of income is specifically enumerated in **Reg. 1.883-1(h)(2)** , notwithstanding that the rental income is earned through a pooling arrangement with the asset manager. Since the Operating LPs are partnerships for U.S. federal income tax purposes, the income (and its character) should flow up to its partners. This construct continues up the chain of partnerships to MI Blocker. Accordingly, MI Blocker's distributive share of MI AIV's income should meet the first prong of the qualified income test.

Second, the exempt category of income must be subject to an equivalent exemption granted by the foreign country in which the foreign corporation is organized. **46** Whether income is subject to an equivalent exemption is determined separately for each category of income. **47** As noted above, an equivalent exemption may exist when the foreign country exchanges diplomatic notes or enters into an agreement with the United States that provides for a reciprocal exemption for purposes of **Section 883** . **48** Here, the Marshall Islands should be considered a qualified foreign country since it provides equivalent exemptions to the United States, through an exchange of diplomatic notes, with respect to income from the rental on a full (time or voyage) bases of vessels used in international transport, as well as on capital gain from the disposition of such vessels. **49** Therefore, the second prong of the qualified income test should be satisfied, and income from the operation and disposition of the shipping vessels should be considered qualified income.

Based on the above, MI Blocker's distributive share of income from the operation and disposition of the shipping vessels should qualify for the exemption under **Section 883** since MI Blocker should be considered a qualified corporation and MI Blocker's distributive share of MI AIV's income should be considered qualified income.

Section 887 4% Excise Tax

If income from the operation of shipping vessels is not exempt from U.S. federal income tax under **Section 883** , Congress made one last effort to mitigate U.S. federal income tax via a 4% excise tax on U.S.-source gross transportation income under **Section 887** . Any income taxable under **Section 887** is not taxable under **Section 871** , 881, or 882, i.e., the ordinary U.S. federal income tax rules applicable to foreign persons. Gain from the disposition of shipping vessels, however, does not fall under **Section 887** . **50**

Section 887(a) provides that, for a foreign corporation, there is imposed for each tax year a tax equal to 4% of the corporation's U.S.-source gross transportation income for that year. Under **Section 887** , "United States source gross transportation income" means any gross income that is transportation income to the extent that income is treated as derived from sources in the United States. **51**

"Transportation income" is defined broadly to include any income derived from, or in connection with the use (or hiring or leasing for use) of, a vessel (including any container used in connection with a vessel) or the performance of services directly related to the use of a vessel. **52** In addition, transportation income includes income derived through a partnership to the extent that the income is treated as transportation income in the hands of the partnership. **53**

Whether income is derived from sources in the United States is determined by where the transportation begins and ends. All transportation income attributable to transportation that begins and ends in the United States is treated as derived from sources within the United States, while 50% of all transportation income attributable to transportation that beings or ends in the United States, but not both, is treated as derived from sources within the United States. **54** Income attributable to transportation that neither begins nor ends in the United States is treated as derived from sources outside the United States. **55**

Section 887 provides one significant carve-out with respect to the general rule. The 4% excise tax does not apply with respect to income that is effectively connected with the conduct of a trade or business within the United States (ECI). **56** However, **Section 887** also provides a heightened U.S. trade or business standard. **57** For time or voyage charters, transportation income is considered ECI only if the taxpayer has a fixed place of business in the United States through which it conducts the U.S. transportation business, **58** and at least 90% of the transportation income is earned by voyages that follow a published schedule with repeated sailings at regular intervals between the same points that begin or end in the United States. **59**

To the extent that MI Blocker's distributive share of income from the operation of the shipping vessels relates to voyages that either begin or end within the United States, but not both, the income should be considered U.S.-source gross transportation income and so qualify for the 4% excise tax under **Section 887** . First, the rental income is derived from the leasing of vessels, which is clearly transportation income as defined in **Section 887** , notwithstanding that the income is derived through a partnership. Second, 50% of MI Blocker's income from the operation of the shipping vessels should be considered U.S.-source income to the extent that it is derived from voyages that either begin or end within the United States, but not both. Finally, the rental income should not be kicked out of **Section 887** as ECI since neither the Operating LPs, MI JV, MI AIV, nor MI Blocker has a fixed place of business in the United States and the shipping vessels do not operate on published schedules with repeated sailings at regular intervals between the same points that begin or end in the United States. Accordingly, MI Blocker should qualify for the 4% excise tax on 50% of the transportation income derived from voyages that begin or end in the United States, but not both.

Ordinary U.S. Federal Income Tax Rules

At the very end of the road, income from the operation and disposition of shipping vessels that does not qualify for an exemption under an income tax treaty, an exemption under **Section 883** , or the 4% excise tax under **Section 887** , is subject to tax under the ordinary U.S. federal income tax rules applicable to foreign persons. In general, a foreign person is subject to gross basis taxation in the United States on certain types of U.S.-source income that is not ECI, **60** and net basis taxation in the United States on income that is ECI. **61**

Specifically, the United States imposes a 30% tax on the amount that a foreign person receives from sources within the United States with respect to the following types of income:

> (1) Interest (other than original issue discount as defined in **Section 1273**), dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gain, profits, and income (FDAP income). **62**
>
> (2) Certain gain from the disposal of timber, coal, or domestic iron ore. **63**
>
> (3) Certain payments with respect to original issue discount obligations. **64**
>
> (4) Gain from the sale or exchange after October 4, 1966, of patents, copyrights, secret processes and formulas, goodwill, trademarks, trade brands, franchises, and other like property, or of any interest in any such property, to the extent that the gain is from payments that are contingent on the productivity, use, or disposition of the property or interest sold or exchanged. **65**

First, it must be determined whether income from leasing vessels on time or voyage charters that do not begin or end in the United States is subject to the 30% gross basis tax. While rental income is a type of income generally subject to the tax, since income attributable to transportation that neither begins nor ends in the United States is not U.S.-source income, **66** the income should not be subject to the 30% gross basis tax in the United States.

Similarly, gain from the disposition of shipping vessels should not be subject to the 30% gross basis tax. The only type of income potentially relevant to gain from the disposition of shipping vessels is FDAP income, which is defined broadly to include all gross income under **Section 61** except for items that are specifically excluded. **67** Gain derived from the sale of property, subject to limited exceptions, is excluded. **68** Therefore, gain from the disposition of shipping vessels should not be subject to gross basis taxation.

Next, it must be determined whether income from leasing vessels on time or voyage charters that do not begin or end in the United States is ECI. As an initial matter, foreign-source income is generally not treated as ECI. **69** While the Code and Regulations provide certain re-sourcing rules to recharacterize foreign-source income as U.S.-source income, they do not apply in the hypothetical. **70** Therefore, income from the operation of vessels on voyages that do not begin or end in the United States should not be considered ECI or subject to net basis taxation in the United States.

Finally, it must be determined whether gain from the disposition of shipping vessels is ECI. As discussed above, foreign-source income is generally not treated as ECI. **71** As a general rule, gain from the disposition of personal property is sourced based on the residency of the seller. **72** For a partnership, residency is determined at the partner level. **73** However, the general sourcing rule is subject to two primary exceptions. First, **Section 865(e)(2)** says that if a nonresident maintains an office or other fixed place of business in the United States, income from the sale of personal property attributable to that office or other fixed place of business is sourced in the United States. For this purpose, a partner in a partnership is deemed to have an office or fixed place of business in the United States if the partnership has an office or fixed place of business in the United States. **74** Second, gain from the disposition of personal property is generally treated as U.S.-source income to the extent that any depreciation adjustments were allocated to U.S.-source income. **75**

In the hypothetical, gain from the disposition of the shipping vessels should not be considered ECI or subject to net basis tax in the United States. First, any gain from the disposition of the shipping vessels, as it relates to MI Blocker, should be foreign-source income. Here, the Operating LPs are partnerships for U.S. federal income tax purposes. Thus, the source of gain from the disposition should be determined at the partner level. However, since MI JV is also a partnership for U.S. federal income tax purposes, the determination of the source of the gain must be made at MI JV partner level. This construct continues up the chain. Since MI AIV is a partnership, the source of gain from the disposition of the shipping vessels must be determined based on the residency of MI AIV partners, including MI Blocker. Here, MI Blocker is organized in the Marshall Islands so MI Blocker's distributive share of gain from the disposition of the shipping vessels should be considered foreign-source income.

Second, the re-sourcing rules under **Section 865(e)** should not apply to treat gain from the disposition of the shipping vessels as U.S.-source income since (1) all sales activities with respect to the vessels will take place outside of the United States; (2) neither the Operating LPs, MI JV, MI AIV, nor MI Blocker maintain an office or fixed place of business within the United States (by attribution or otherwise); and (3) MI Blocker has not taken any depreciation deductions with respect to the vessels that were allocated to U.S.-source income.

Accordingly, MI Blocker's distributive share of any gain from the disposition of the shipping vessels should not be ECI or subject to net basis taxation in the United States.

Conclusion

Private equity funds should structure investments in shipping vessels to ensure that gain from the disposition of the vessels is not attributable to an office or fixed place of business within the United States. In this respect, all material activities related to the disposition of the vessels (e.g., sourcing, negotiating contracts) should be performed by the asset manager outside the United States, and not by a fund manager with an office or fixed place of business within the United States. In addition, a fund manager with an office or fixed place of business within the United States should avoid overseeing day-to-day activities of the entity that could be viewed as disposing of shipping vessels (or any other entities in the proposed structure for that matter). However, the fund manager should still be able to make board-type decisions, such as determining the final sales price, without creating a U.S. trade or business for the selling entity.

1 State Street, "Pension Funds DIY: A Hands-on Future for Asset Owners," September 2014, www.statestreet.com/content/dam/statestreet/documents/Articles/Pensions/AssetOwners_FullReport.pdf.

2 For examples, see U.S. income tax treaties with Australia, Belgium, Canada, Germany, Italy, and Japan.

3 This article does not address any potential capital shift issues or the potential U.S. federal income tax consequences associated with exchange of a partnership interest for past or future services.

4 This article does not address any issues with respect to whether the nominal interests held by the general partner would be respected for U.S. or local country income tax purposes.

5 **Sections 701** , 704.

6 See CCA 200848032 (November 28, 2008) ("The purpose of tax treaties is to avoid or at least minimize double tax"); Secretary of the Treasury Statement (August 9, 1988) (1987 prior Protocol to the U.S.-Belgium treaty) ("The principal purpose of income tax treaties is to minimize international double taxation and thereby promote the free flow of capital, labor and technology unconstrained by tax impediments."); Staff of the Joint Committee on Taxation Report (April 26, 1984) (1980 U.S.-Canada treaty) ("It would be useful for the Committee to remind the negotiators that, as indicated above, tax treaties have two, and only two main purposes: the mitigation of double taxation, and the prevention of tax avoidance and evasion.").

7 For example, Art. 7 of the U.S. income tax treaties with Australia, Japan, and Spain all generally provide that profits of an enterprise of a contracting state are taxable only in that state unless the enterprise carries on business in the other contracting state through a permanent establishment situated therein. Similarly, Art. 10 of the Denmark, France, and Germany income tax treaties entered into with the U.S. all generally provide for a reduced rate of withholding on certain dividend income derived from sources within a contracting state.

8 U.K. Treaty Art. 8(2).

9 U.K. Treaty Art. 3(1)(f).

10 U.K. Treaty Art. 8(4).

11 U.K. Treaty Art. 13(4).

12 U.K. Treaty Art. 1(1) says: "...this Convention is applicable only to persons who are residents of one or both of the Contracting States."

13 U.K. Treaty, Arts. 4(3)(a), (b).

14 Technical Explanation to U.K. Treaty Art. 1(8).

15 U.K. Treaty Art. 1(8).

16 See note 14, *supra*.

17 *Id*.

18 U.K. Treaty, Arts. 4(3)(a), 4(3)(b), 23(2)(e).

19 Reg. 1.883-1(a) .

20 Reg. 1.883-1(c)(1) , (2), (3).

21 Reg. 1.883-1(e) .

22 Reg. 1.883-1(f)(1) .

23 Reg. 1.883-1(e)(2)(i) .

24 Reg. 1.883-1(e)(4), Ex. 4 .

25 Reg. 1.883-1(e)(2)(ii)(B) .

26 Reg. 1.883-1(d) .

27 Reg. 1.883-1(h)(1) .

28 Rev. Rul. 2008-17, 2008-1 CB 626 .

29 Reg. 1.883-1(c)(2) .

30 Reg. 1.883-4(a) .

31 Reg. 1.883-4(b)(1)(i)(A) .

32 Reg. 1.883-1(d) .

33 Reg. 1.883-1(h)(1) .

34 Rev. Rul. 2008-17 , *supra* note 28.

35 Regs. 1.883-4(d)(3)(iii)(B) , 1.883-4(d)(4)(v)(C)(1) .

36 Regs. 1.883-4(d)(1) , 1.883-4(d)(2)(i) .

37 Regs. 1.883-4(d)(3)(iii)(B) , 1.883-4(d)(4)(v)(C)(1) .

38 Reg. 1.883-4(a) .

39 Reg. 1.883-1(c) .

40 Reg. 1.883-1(b) .

41 Regs. 1.883-1(b)(2) , 1.883-1(h) .

42 Section 701 .

43 See generally Sections 701 , 702.

44 Reg. 1.883-1(e)(4), Ex. 2 (emphasis added).

45 Reg. 1.883-1(b) .

46 Regs. 1.883-1(b)(2) , **1.883-1(h)** .

47 Reg. 1.883-1(h) .

48 Reg. 1.883-1(h)(1) .

49 See **Rev. Rul. 2008-17** , *supra* note 28.

50 Section 887 applies only to gross income that is *transportation income*, as defined in **Section 863(c)(3)** . **Section 887(b)(1)** . "Transportation income" includes only income derived from, or in connection with, (1) the use (or hiring or leasing for use) of a vessel or aircraft, or (2) the performance of services directly related to the use of a vessel or aircraft. **Section 863(c)(3)** .

51 Section 887(b)(1) .

52 Section 863(c)(3) .

53 Rev. Proc. 91-12, 1991-1 CB 473 , section 3.04.

54 Section 863(c)(1) and (2).

55 Sections 862(a)(3) , 862(a)(4).

56 Section 887(b)(2) .

57 Section 887(b)(4) .

58 Section 887(b)(4)(A) .

59 Sections 883 , 887(b)(4); **Rev. Proc. 91-12** , *supra* note 53.

60 Sections 871(a) , 881.

61 Sections 871(b) , 882.

62 Section 881(a)(1) .

63 Sections 881(a)(2) , 631(b), (c).

64 Section 881(a)(3) .

65 Section 881(a)(4) .

66 Sections 862(a)(3) , 862(a)(4).

67 Regs. 1.1441-2(b)(1) , 1.881-2(b)(1) .

68 Reg. 1.1441-2(b)(2)(i) .

69 Section 864(c)(4)(A) .

70 See generally Section 864(c) .

71 Section 864(c)(4)(A) .

72 Section 865(a) .

73 Section 865(i)(5) .

74 *Unger*, 68 AFTR 2d 91-5204 936 F2d 1316 91-2 USTC ¶50328 (CA-D.C., 1991), *aff'g* TC Memo 1990-15 PH TCM ¶90015 58 CCH TCM 1157 (appellate court upheld attribution of U.S. partnership's office to foreign limited partner).

75 Section 865(c) .