DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ROB STANCHIK
SUPERVISORY ATTORNEY, GROUP 1116
OP:IN:D:C:EX:1116

FROM: W. Edward Williams
senior Technical Reviewer CC:INTL:BR1

SUBJECT: Advice concerning closing agreement

This Field Service Advice responds to your memorandum dated June 21, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

DISCLOSURE STATEMENT

Field Service Advice is Chief Counsel Advice and is open to public inspection pursuant to the provisions of section 6110(i). The provisions of section 6110 require the Service to remove taxpayer identifying information and provide the taxpayer with notice of intention to disclose before it is made available for public inspection. Sec. 6110(c) and (i). Section 6110(i)(3)(B) also authorizes the Service to delete information from Field Service Advice that is protected from disclosure under 5 U.S.C. § 552 (b) and (c) before the document is provided to the taxpayer with notice of intention to disclose. Only the National Office function issuing the Field Service Advice is authorized to make such deletions and to make the redacted document available for public inspection. **Accordingly, the Examination, Appeals, or Counsel recipient of this document may not provide a copy of this unredacted document to the taxpayer or their representative.** The recipient of this document may share this unredacted document only with those persons whose official tax administration duties with respect to the case and the issues discussed in the document require inspection or disclosure of the Field Service Advice.

LEGEND

A =
B =
Country C =
Country D =
Year E =
Period F =

ISSUES

Review of proposed Closing Agreement for legality and accuracy of facts.

CONCLUSIONS

!. The closing agreement as redrafted provides a basis for resolving the outstanding issues and fully protects the Internal Revenue Service. The closing agreements also bring noncompliant taxpayers back into the Federal income tax system and reasonably ensure future compliance.

2. We have attached a redrafted Closing Agreement containing more accurate representations with respect to the statutory requirements under section 887 of the Internal Revenue Code (Code).

FACTS

A is a corporation organized in Country C. A is engaged in the international operation of ships that transport cargo around the world. A does not have a U.S. permanent establishment but uses independent agents in the United States that receive commissions for finding customers for A. After paying expenses, the agents pay a net amount to A. A derives transportation income that is U. S. source income under sections 863(c)(1) and 863(c)(2). A files Form 1120-F, U. S. Income Tax Return of a Foreign Corporation, to report its United States source transportation income that is taxable under sections 861 and 887 of the Code. A is eligible for benefits under the income tax treaty between the United States and Country C.

A is the direct or indirect owner of a number of Country D subsidiaries that each own a ship. For purposes of this memorandum, these subsidiaries are collectively identified as “B.” A has entered into bareboat leases for the use of these ships with B. Since A uses these ships to transport cargo to the United States, a portion of the bareboat rental income received by B is treated as 50 percent U.S. source transportation income under section 863(c)(2) of the Code. A has represented that this income is “trade or business income” but is not “effectively connected with the

conduct of a U.S. trade or business" within the meaning of section 887(b)(4), because neither A nor B maintains an office or other fixed place of business in the United States. B is not entitled to an exemption for this income under section 883 of the Code. Thus, the income that is United States source income under section 863(c)(2) is "United States source gross transportation income" (USSGTI) under section 887(b)(1) and is subject to the 4 percent tax on the gross amount under section 887.

In addition, since A also uses these ships to transport cargo between United States ports, a portion of the bareboat rental income attributable to such use and received by B is treated as U.S. source transportation income under section 863(c)(1) of the Code. This portion of the bareboat rental income is considered "fixed and determinable annual or periodic " income (FDAP). Because this income is "trade or business income" but is not "effectively connected with the conduct of a U.S. trade or business" within the meaning of section 864, it is subject to the 30 percent tax under section 881.

Thus, B has both FDAP income subject to tax at a rate of 30 percent of gross and also USSGTI that is subject to tax at the rate of 4 percent of gross.

In the past, each of the Country D corporations, collectively referred to as B herein, obtained a U.S. taxpayer identification number if it owned a boat that was operated in U.S. waters in a given year. Each such corporation filed a Form 1120-F, U.S. Income Tax Return of a Foreign Corporation, with the Service to report its U.S. source income. Because a single boat might not operate in U.S. waters in a particular year or in any year, however, Forms 1120-F were not filed for each boat owning corporation in each taxable year.

A and B were current on their U.S. filing obligations through Year E when an internal reorganization occurred in the group responsible for tax compliance. As a result of this reorganization, the resignation and departure of the person whose duties included U.S. tax compliance, and mis-communication between the new tax group and its outside advisors, no US tax returns have been filed on behalf of any of the Country D subsidiaries, collectively referred to as B herein, and B has paid no U.S. tax for Period F. A and B are not currently under audit by the Service on this or any other tax issue, and B has not received any notice for its failure to file.

A and B wish to file all delinquent returns and to pay all the tax and interest due, but have requested that the Service not assert penalties for failure to file, failure to deposit , and failure to pay and that the Service enter into a Closing Agreement with A and B to that effect. A and B have provided the Service, and the Service has reviewed, redacted copies of all outstanding corporate income tax returns (Forms 1120F). A and B have agreed to identify themselves before the Service

enters into the Closing Agreement. Moreover, A/C (International) concurs with A and B's assertions that there is reasonable cause not to assert the penalties.

LAW AND ANALYSIS

Pursuant to your request, we have reviewed the closing agreement that taxpayer's counsel provided and your office forwarded to our offices on June 21, 2000.

In our view, the draft closing agreement forwarded requires a number of changes to correctly reflect certain statutory requirements with respect to the underlying tax imposed under sections 881 and 887 of the Code. In addition, there are certain other changes that should be made to more completely protect the Service's position. Therefore, we have enclosed a revised draft containing language that would be acceptable as an agreement in principal.

Any closing agreement with B should be entered into on behalf of the Commissioner only after A reveals its identity and the identities of each of its affected Country D subsidiaries. As you know, the Internal Revenue Service does not enter into closing agreements with anonymous taxpayers. A separate closing agreement should be made with each affected Country D subsidiary. The bracketed language in the attached draft agreement will permit the agreement to be tailored to the specific facts of each affected country D subsidiary.

In addition, prior to signing these agreements your office should--

• obtain the appropriate Forms 2848 (Power of Attorney) from each affected Country D subsidiary permitting A or its representatives to sign the closing agreement on its behalf;

• confirm that A and its affected Country D subsidiaries are not presently under examination and have not been notified of the initiation of any such examination;

• obtain from A corrected unredacted copies of the Forms 1120F that it filed in accordance with this agreement with the IRS for taxable years ended December 31, Period F, on behalf of each affected Country D subsidiary;

• For each affected Country D subsidiary that has bareboat rental income treated as FDAP income in taxable years during Period F, obtain separate schedules showing the calculation of the gross amount of bareboat rental income treated as FDAP, the amount of tax imposed on that income under section 881 of the Code, the amount of tax withheld under section 1441, if any, and the amount of tax reported on Forms 1120F, Section I, Line 10, for each taxable year and paid in accordance with this agreement;

• For each affected Country D subsidiary that has bareboat rental income treated as USSGTI in taxable years during Period F, obtain separate schedules showing the calculation of the gross amount of bareboat rental income treated as USSGTI, the amount of tax imposed on that income under section 887 of the Code, and the amount of tax reported on Forms 1120F, Section I, Line 9, for each taxable year and paid in accordance with this agreement;

It is our view that the closing agreement as redrafted provides a basis for resolving the outstanding issues, fully protects the Internal Revenue Service, brings noncompliant taxpayers back into the Federal income tax system, and reasonably ensures future compliance by this group of taxpayers.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

Pursuant to section 7121, a closing agreement may be entered into in any case in which there appears to be an advantage in having the case permanently and conclusively closed, or if good and sufficient reasons are shown by the taxpayer for desiring a closing agreement and it is determined by the Commissioner that the United States will sustain no disadvantage through the consummation of such an agreement. Your office has concluded that under the facts of this case, there is reasonable cause for failure to file and pay the tax. Further, we agree that entering into these closing agreements would bring noncompliant taxpayers back into the Federal income tax system and reasonably ensure future compliance. These taxpayers may never have been identified and examined in the absence of this request.

Thus, it is the opinion of this office that the Service will receive a greater benefit to tax administration and convenience by receiving payment of the tax liabilities and interest thereon for the taxable years at issue and by getting these taxpayers back into the system than any potential loss the United States would sustain from a waiver of the penalties for which any single taxpayer in the group would otherwise be liable. Accordingly, each closing agreement provides for a waiver of the failure to file penalty under §6651(a)(1) of the Code, the failure to pay penalty under §6651(a)(2), and the failure to deposit penalty under §6656 in regard to the Federal income tax liabilities set forth in the relevant agreement.

A has provided schedules setting forth the amounts of bareboat rental income from use of the ships to carry cargo between United States ports (§863(c)(1)) and between ports in the United States and foreign ports (§863(c)(2)). However, the tax liability reflected on these schedules and on the redacted returns was calculated by applying section 887 to all such income.

New schedules must be prepared to attach to each Closing Agreement demonstrating the proper application of the 30 percent tax rate of section 881 to the gross income sourced under section 863(c)(1), and the application of the 4 percent tax rate of section 887 to the USSGTI (50 percent of the gross amount sourced under section 863(c)(2)).

Simultaneously with the signing of the agreements, each relevant Country D subsidiary must file corrected unredacted Forms 1120F for Period F and pay the tax agreed in the closing agreement and reflected on these corrected schedules and returns, as well as any interest accrued at the prescribed rate in accordance with section 6621 of the Code for any tax liabilities resulting from filing these returns.

Nevertheless, we recommend that the Service should not agree to accept the income and tax calculations that are provided by B on the unredacted returns and corrected schedules to be attached to the agreements without reserving the right to examine the underlying books and records of B and make any necessary adjustments to the underlying tax liability or resulting interest. This recommendation is reflected in the language of the attached draft closing agreement.

If you have any questions or need further assistance, please do not hesitate to call me (622-3468) or Patricia Bray (622-5871).

W. EDWARD WILLIAMS
Senior Technical Reviewer

Attachment (1)

Closing Agreement On Final Determination Covering Specific Matters

_____

Under §7121 of the Internal Revenue Code of 1986, as amended, (the "Code"), [B] Corporation, a corporation with its principal place of business at _____ _____ (U.S. EIN # _____), and the Commissioner of Internal Revenue (referred to herein as the "IRS") make the following Closing Agreement ("Agreement"):

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[Alternative A1 in the case of a taxpayer that only has bareboat rental income that is United States source transportation income under §863(c)(2) and subject to tax under section 887:}

WHEREAS, [B Corporation] represents that it owns at least one ship and is in the business of bareboat leasing of a ship or ships for use in water transportation of cargo between ports in the United States and foreign ports;

WHEREAS, [B Corporation] represents that the income it receives from bareboat leasing of its ship or ships is "transportation income" as defined under §863(c)(3) of the Code, that is treated as 50 percent from sources within the United States under

§863(c)(2) and is also United States source gross transportation income, as defined in §887(b)(1) ("USSGTI"), taxable under section 887;

WHEREAS, [B Corporation] represents that it does not maintain a fixed place of business in the United States involved in the earning of USSGTI, and that, in the case of income from bareboat leasing of a ship, substantially all of the USSGTI of [B Corporation] (determined without regard to §887(b)(2)) is not attributable to a fixed place of business in the United States;

{Alternative A2 in the case of a taxpayer that has bareboat rental income that is United States source transportation income under §863(c)(1) and subject to tax under § 881, as well as bareboat rental income that is United States source transportation income under §863(c)(2) and subject to tax under section 887:}

WHEREAS, [B Corporation] represents that it owns at least one ship and is in the business of bareboat leasing of a ship or ships for use in water transportation of cargo partly between ports in the United States, and partly between United States ports and foreign ports;

WHEREAS, [B Corporation] represents that a portion of the bareboat rental income it receives is "transportation income" as defined under §863(c)(3) of the Code, 100 percent from sources within the United States under §863(c)(1) and taxable under §881 of the Code;

WHEREAS, [B Corporation] represents that a portion of the bareboat rental income it receives is "transportation income" as defined under §863(c)(3) of the Code, 50 percent from sources within the United States under §863(c)(2), and is also United States source gross transportation income, as defined in §887(b)(1)("USSGTI"), taxable under §887;

WHEREAS, [B Corporation] represents that it does not maintain a fixed place of business in the United States involved in the earning of USSGTI, and that, in the case of income from bareboat rental of a ship, substantially all of the USSGTI of [B Corporation], determined without regard to §887(b)(2) of the Code, is not attributable to a fixed place of business in the United States;

***

WHEREAS, [B Corporation] represents that during the taxable periods prior to , it filed Forms 1120-F to report its transportation income taxable under §887 of the Code and paid its annual **F**ederal income tax liability;

[*WHEREAS*, [B Corporation] represents that during the taxable periods prior to , it filed Forms 1120-F to report its transportation income taxable under §881 of the Code and paid its annual **F**ederal income tax liability not satisfied by withholding;]

WHEREAS, [B Corporation] represents that it had transportation income taxable under §887 of the Code of $_____ [and transportation income taxable under §881 of $_____] for the taxable period ; it had transportation income taxable under §887 of $_____ [and transportation income taxable under §881 of $_____] for the taxable period ; and it had transportation income taxable under §887 of $_____ [and transportation income taxable under § 881 of the Code of $_____] for the taxable period , but has not filed Forms 1120-F for these taxable periods or paid its Federal income tax liabilities for these taxable periods;

WHEREAS, [B Corporation] represents that it has not been notified by the Internal Revenue Service that it is or will be under audit;

WHEREAS, [B corporation] has voluntarily brought the above described failures to timely remit **F**ederal income taxes and file Forms 1120-F for the taxable periods through to the attention of the Assistant Commissioner, International, Internal Revenue Service ("the Service") in order to resolve the tax liability of [B Corporation] arising by reason of such failures;

WHEREAS, the parties wish to resolve the income tax liabilities of [B Corporation] that result from [B Corporation's] failure to file the above described Forms 1120-F and pay the required income taxes.

AND WHEREAS, in recognition of [B Corporation's] voluntary disclosure to the IRS of the above facts and circumstances, its immediate self-implementation of U.S. tax compliance, its immediate filing of its Forms 1120-F, and its full and immediate payment of the U.S. taxes and interest due, the parties desire to enter into this Agreement;

NOW THEREFORE, for good and adequate consideration, the receipt and sufficiency of which are acknowledged, and intending to be legally bound, *IT IS HEREBY DETERMINED AND AGREED* for Federal income tax purposes that:

(1) Contemporaneous with the execution of this Agreement, [B Corporation] shall file Federal income tax returns for the taxable periods , reporting income tax liabilities in accordance with paragraph 2.

(2) Contemporaneous with the execution of this Agreement, [B Corporation] shall pay to the IRS the sum of $_____, representing [B Corporation's] computation of its U.S. income tax [under section 887][and section 881] for the taxable year ended December 31, ; the sum of $_____, representing [B Corporation's] computation of its U.S. income tax [under section 887] [and section 881] for the taxable year ended December 31, ; and the sum of $_____, representing [B Corporation's] computation of its U.S. income tax [under section 887] [and section 881] for the taxable year ended December 31, , computed in accordance with this agreement. Attached as Exhibit A

is a schedule setting forth the basis for [B Corporation's] computation of this tax, based on a good faith and reasonable review of its accounting records.

(3) In addition, contemporaneous with the execution of this Agreement, [B Corporation] will pay all interest accrued at the prescribed rate in accordance with §6621 of the Code for any tax liabilities resulting from filing said returns required by paragraph 1.

(4) The IRS agrees to waive the failure to file penalty under §6651(a)(1) of the Code, the failure to pay penalty under §6651(a)(2), and the failure to deposit penalty under §6656 of the Code in regard to the Federal income tax liability set forth in paragraph 2 above.

(5) The IRS reserves the right to examine whether [B Corporation] maintained an office or other place of business in the United States during taxable years

(6) The IRS reserves the right to examine any issues arising under section 881 or section 887, and the regulations thereunder, for .

(7) The parties agree that no public disclosure of the existence of this Closing Agreement, or its terms, will be made without prior approval of the IRS.

NOW THIS CLOSING AGREEMENT WITNESSETH, that [B Corporation] and the IRS hereby mutually agree that this Agreement only resolves those issues relating to [B Corporation's] failure to file Federal income tax returns, Forms 1120-F, for the taxable periods , and to timely pay the tax reported on these returns. This agreement does not preclude the Service

from auditing and making adjustments to [B Corporation] or any entity related to [B Corporation] for any year in regard to any corporate income tax returns for any issues other than those issues being resolved by this agreement.

This Agreement is final and conclusive except that the matter it relates to may be reopened in the event of fraud, malfeasance, or misrepresentation of material fact and this Agreement is subject to the Internal Revenue Code sections that expressly provide that effect be given to their provisions (including any stated exception for Code §7122) notwithstanding any other law or rule of law.

By signing, the above parties certify that they have read and agreed to the terms of this document.

Taxpayer (other than individual):_____

_ [B Corporation]

By _____ Date signed _____

_____

Title_____

Commissioner of Internal Revenue

By _____ Date signed _____

_____

Title_____

I have examined the specific matters involved and recommend acceptance of the proposed agreement.

Receiving Officer: _____ Date signed: _____

Name: _____ Title: _____

I have examined the specific matters involved and recommend approval of the proposed agreement.

Receiving Officer: _____ Date signed: _____

Name: _____ Title: _____