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

OFFICE OF
CHIEF COUNSEL

Number: **200228002**
Release Date: 7/12/2002
CC:INTL:6
POSTF-154656-01
UILC: 927.01-00
7701.22-01

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

DATE: March 5, 2002

MEMORANDUM FOR: Tamara Moravia-Israel
Industry Counsel to Shipping Technical Advisor Team
CC:LM:RFP:MIA

FROM: Jacob Feldman
Special Counsel CC:INTL

SUBJECT: Application of FSC Provisions to Lease of Vessel by Bareboat Charter between Members of a Controlled Group Followed by a Time Charter of the Vessel to an Unrelated Customer

---

This Chief Counsel Advice responds to your memorandum dated November 8, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent.

LEGEND

USCorp =
USSub =
Owner =
Charterer =
USCorp-FSC =
IndustryA =
Location1 =

CountryA =
Service1 =
Service2 =
Taxable Year1 =
Date1 =

Amount1 =
Amount2 =
Amount3 =
Amount4 =
Activity1 =
Activity2 =

Activity3 =

ISSUE

Whether a bareboat lease of a vessel by a domestic corporation is treated as the lease of export property for foreign sales corporation purposes under section 927(a)(2)(A) and Temp. Treas. Reg. § 1.927(a)-1T(f)(2) where the lease is for use by a lessee that is a member of the lessor's controlled group and the lessee derives income from the time charter of the vessel to an unrelated person.

CONCLUSION

No. The lease of a vessel by a domestic corporation is not treated as the lease of export property for foreign sales corporation purposes where the lease is for use by a lessee that is a member of the lessor's controlled group and the lessee derives income from the time charter of the vessel to an unrelated person. Temp. Treas. Reg. § 1.927(a)-1T(f)(2) does not apply because the time charter transaction between the lessee and the unrelated person constituted a service contract, not a sublease.

FACTS

I. The Parties and Charters

USCorp, a domestic corporation, wholly-owned domestic corporation USSub (collectively "Taxpayer") which owns an ocean-going vessel. [1] In servicing IndustryA, the vessel was used to transport crews, equipment, and supplies between mainland and offshore locations. The vessel was used to perform Service1, provide Service2, and perform other specialized services. During the period at issue, the vessel was ported in CountryA and traveled only between CountryA and Location1; the vessel did not travel to destinations within the United States and performed services only within CountryA and Location1.

During Taxable Year1, Taxpayer transferred the vessel to its wholly-owned

[1] The related-lessee excluded property rule of section 927(a)(2)(A) aside, we assume, solely for purposes of this memorandum, that the vessel otherwise satisfied the definition of export property under section 927(a)(1). We received no facts as to whether the requirements of section 927(a)(1) were satisfied in this case.

subsidiary Owner, a CountryA corporation, by bareboat charter ("Bareboat Charter").[2] Taxpayer and Examination agree that the Bareboat Charter constituted a lease. Owner negotiated a time charter ("Time Charter") of the vessel with Charterer, an unrelated customer, during Taxable Year1. For a discussion of the distinction between bareboat and time charters, see page 11 of this memorandum. The vessel involved in this case is one of approximately Amount1 vessels that Taxpayer owns and charters using subsidiaries such as Owner.

During Taxable Year1, USCorp also wholly owned USCorp-FSC, a foreign corporation that made an election on Date1 to be treated as a foreign sales corporation ("FSC") under section 922(a)(2) of the Internal Revenue Code ("Code"), which election remained in effect at all relevant times thereafter. We assume, solely for purposes of this memorandum, that USCorp-FSC met all the requirements for FSC status under section 922(a)(1) at all relevant times and satisfied the foreign management and economic process requirements under section 924(b)(1) with respect to the Bareboat Charter.[3] Taxpayer paid a commission to USCorp-FSC with respect to the rental income that Taxpayer earned under the Bareboat Charter to Owner. Taxpayer, Owner, and USCorp-FSC are members of the same controlled group (as defined in section 927(d)(4)). Charterer is not a member of such controlled group.

II. The Terms of the Time Charter

The Time Charter consisted of a preamble, sections 1 through 23, and Attachments A through F.

Paragraphs A and B of the preamble state that Owner provides vessels and the crew and equipment necessary to conduct IndustryA-related activities and that Charterer desires that Owner provide such a vessel and crew.

Paragraph 1.1 of the Time Charter provides that Charterer shall "hire Owner's manned vessel."

Paragraph 1.2 provides that the vessel shall be "available" for Charterer's "use" 24 hours per day, shall be employed pursuant to the instructions of the Charterer regarding "services required, scheduling and destination in lawful activities necessary or incident to supporting" Activity1 Location1 and shall "perform such other duties as Charterer may direct from time to time" (including Activity2 and carrying cargo and personnel).

Paragraph 1.4 requires that the crew of the vessel chartered provide "all lawful

---

[2] Taxpayer holds title to the vessel. Owner, which is referred to as "Owner" in the Time Charter described below, is the lessee of the vessel under the Bareboat Charter.

[3] We received no information regarding these issues.

services" required by Charterer including services incident to Activity3, handling anchors, handling cargo, and securing aboard the vessel all cargo loaded from Charterer's base.

Section 2 sets forth rights and obligations concerning "Owner's Vessel and Crew." For example, paragraph 2.1(b) provides that Owner represents and warrants that it is qualified and has full authority to do business in all jurisdictions where the Time Charter is to be performed. Paragraph 2.2 requires, in part, that at all times during the Time Charter, Owner shall use all reasonable efforts to assure that the vessel be, (a) tight, strong and seaworthy; (b) sufficiently tackled, appareled, furnished, supplied and equipped in order to promptly and efficiently "perform Owner's obligations" under the Time Charter; and (c) "properly maintained in good running order and repair and in a state such as to obtain [the vessel's] most economic operation with regard to speed and consumption of fuel." In addition, paragraph 2.3 requires that the vessel be fully equipped for waterborne public transportation operations, be suitable for the performance of the services contemplated by the Time Charter, and be properly maintained.

Paragraph 2.4 provides Charterer with the right to inspect the vessel for compliance with the Time Charter. If the Vessel is not being properly maintained, repaired, or supplied in accordance with the Time Charter, and if Owner fails to initiate action to correct such deficiency within 72 hours of receipt of notice, Charterer "shall have the option to cease payment for the duration of such deficiency." Under paragraph 2.5, the Charterer has the right to inspect any aspect of Owner's operations and equipment under the Time Charter, and Owner, at its cost, shall correct any deficiency in operations or repair or replace any equipment rejected by Charterer.

Paragraph 2.6 lists the personnel required by the Time Charter for manning the vessel (e.g., the master, mate, and chief engineer) and the types of operations such personnel must be able to perform. See also Attachment C (list of crewing requirements). Paragraph 2.6 also requires that the vessel be crewed to be "available seven (7) days per week twenty-four (24) hours per day." Paragraph 2.7 provides that if Owner fails to correct any deficiency in the manning of the vessel within 72 hours from receipt of notice, Charterer may terminate the Time Charter. If the vessel is not properly manned at any time during the term of the Time Charter, adjustments shall be made in the day rate to which Owner is entitled during such periods.

Section 3 addresses the manner of performance of the Time Charter. Paragraph 3.1 states that "Owner shall perform promptly all services contemplated by this Time Charter with due diligence," and paragraph 3.2 states that "Owner shall operate the vessel or any replacement vessel that may be employed by Charterer" in accordance with governmental laws and regulations governing the transport of passengers and cargo over water.

Paragraph 3.3 requires Owner to pay all costs and expenses relating to the vessel, her master, and her crew, including all wages, shipping, and discharging fees

and all other expenses of the master, officers, and crew. Paragraphs 3.4 through 3.9 impose on Owner a list of expenses, duties, and responsibilities for the vessel, including the use of great care and due caution in the performance of ultrahazardous activities; the use of reasonable diligence to prevent pollution (and the requirement that Owner be responsible for cleaning up any such pollution); the cost and responsibility for obtaining all licenses, permits, visas, registrations, and certificates for the vessel and for Owner's personnel; the keeping of the vessel's log, a strict accounting of all cargo and passengers, and proper maintenance records.

Section 4 concerns compensation. Specifically, paragraph 4.1 requires Charterer to pay Owner for the hire of the vessel in accordance with the rates set forth in Attachment D and such rates shall be pro rated for any day during which the vessel is available for less than 24-hour service. Attachment D provides that in full "consideration of the provision of the Vessel complete with its full complement of Master and crew, Charterer will reimburse Owner" for the following sums: vessel's mobilization fee of $Amount2 lump sum; vessel's daily rate of $Amount3 or pro rata; $Amount4 per passenger per meal and $Amount4 per passenger per night. Under paragraphs 4.2 and 4.3, Owner is responsible for preparing invoices for delivery to Charterer, and Charterer is responsible for making the payments on such invoices to Owner.

Section 5 contains several provisions that govern insurance coverage. Paragraph 5.1 requires Owner, for the full term of the Time Charter, to procure and maintain solely at its own expense all insurance for the vessel and crew in amounts set forth in Attachment E. Under paragraph 5.2, any and all deductibles in the insurance policies are assumed by, for the account of, and at Owner's sole risk. Paragraph 5.3 requires Owner to obtain the prior written consent of Charterer before modifying or canceling any insurance policy. Under paragraph 5.4, Owner must furnish insurance certificates for itself and any of its subcontractors to Charterer. Paragraph 5.5 provides that all insurance policies required of Owner shall contain endorsements that, to the extent of liabilities assumed by Owner, underwriters will have no rights of recovery or subrogation against Charterer.

Section 6 contains mutual indemnification and hold harmless provisions. Generally, section 6 provides that any damage or loss to the property of Charterer shall be the loss of Charterer, and any damage or loss to the property of Owner shall be the loss of Owner. See paras. 6.6 and 6.7. Paragraph 6.14 provides that neither party shall be liable to the other for special or consequential damages for lost revenues or profits, cost of capital, lost production or products, loss of business opportunity with third parties, or punitive or exemplary damages. Under paragraph 6.15, the master of the vessel shall have the sole right to determine whether a voyage ordered by Charterer may be undertaken with "safety to Owner's crew, all persons on board, and the Vessel."

Section 7 governs downtime and loss of the vessel. Under paragraph 7.1, Owner must provide at no additional cost to Charterer a replacement vessel in the event that the vessel subject to the Time Charter is unavailable due to scheduled maintenance. If the vessel becomes unavailable due to any other cause, payment

generally will cease for the duration of the downtime. Owner also must provide a replacement vessel to Charterer, upon request, during any unscheduled downtime. Pursuant to paragraph 7.4, the Time Charter will cease immediately if the Vessel suffers actual or constructive total loss, and Owner shall have no rights to further compensation (except those sums due or accrued at the time of such loss).

Section 8 addresses taxes and duties. Paragraph 8.1 imposes on Owner responsibility for all taxes, levies, assessments, fines, etc., imposed on the vessel, Owner, and Owner's personnel, including corporate and personal income taxes, sales taxes, excise taxes, stamp taxes, use or compensating taxes, social insurance taxes, and contractor license. Paragraph 8.2 imposes on Charterer responsibility only for payment of harbor and port dues and certain other charges applicable to use of the vessel.

Under section 9, Owner is responsible for maintaining all books and records, subject to Charterer's right of inspection.

Pursuant to section 14, Owner and Charterer agree to share equally any salvage money earned by the vessel net of certain specified expenses.

Section 15 describes the relationship of the parties stating,

> Owner shall perform all services under this Time Charter as an independent contractor. Charterer shall exercise no control over the Owner's employees, or agents nor those of its subcontractor(s), nor the methods or means employed by Owner in the performance of such work or services. The Charterer is solely interested in the attainment of the desired results.

Section 17 addresses the duration of the Time Charter. Under paragraph 17.1, the primary term of the Time Charter is one year with six options of one month each to be exercised individually upon 24 hours notice to Owner.

In addition, Attachment C imposes on Owner responsibility for obtaining a Safe Manning Certificate and indicates that the master and crew of the vessel are Owner's personnel.

III. Summary of the Case

Taxpayer claimed FSC commission deductions with respect to rents that Taxpayer received from Owner under the Bareboat Charter.[4] Taxpayer does not argue that the FSC benefits apply to income received by Owner from Charterer pursuant to the Time Charter. Examination asserts that the FSC benefits do not apply to the rents from the bareboat charter because the vessel, which was leased to a related party, was not subsequently subleased or held for sublease to an unrelated party by Owner and, thus, was not export property under section 927(a).[5]

LAW AND ANALYSIS

I. Application of FSC Provisions to Leases

A. Generally

The FSC provisions provide an income tax exemption for a portion of certain commissions earned by a FSC. I.R.C. §§ 923(a)(3) and 925(b)(1); Temp. Treas. Reg. § 1.923-1T(a). A FSC may earn commissions that may qualify for this exemption with respect to a "lease or rental of export property for use by the lessee outside the United States." I.R.C. § 924(a)(2); Temp. Treas. Reg. § 1.924(a)-1T(c)(1). Under section 927(a)(1), property that is manufactured in the United States, has foreign content not in excess of 50% of its fair market value, and is held primarily for sale, lease, or rental for direct use, consumption, or disposition outside the United States may constitute export property.

B. Leases between Members of a Controlled Group

Section 927(a)(2)(A) excepts from the definition of export property property leased or rented by a FSC (or through a commission FSC) for use by any member of a controlled group of corporations (as defined under section 927(d)(4)) of which the FSC is a member is excluded property and does not constitute export property. This

---

[4] Your request for field service advice seeks the opinion of the National Office with respect to numerous bareboat/time charter transactions engaged in by multiple subsidiaries of Taxpayer with respect to approximately Amount1 vessels. This memorandum addresses only the specific fact pattern set forth above and should not be considered to apply to every bareboat/time charter transaction entered into by Taxpayer and its subsidiaries.

[5] Considering our conclusions that the FSC provisions do not apply to Taxpayer's rental income under the Bareboat Charter on the grounds that the Time Charter did not constitute a sublease and the Time Charter income was operating income, we do not address the Service's argument that the Time Charter was a true lease, but not a sublease with respect to the Bareboat Charter.

"related-lessee excluded property" rule was originally enacted as part of the domestic international sales corporation ("DISC") provisions. I.R.C. § 993(c)(2)(A).

Looking to the DISC legislative history, the purpose of the related-lessee excluded property rule was to prevent a leasing transaction from effectively converting income derived from the production of property outside the United States – which ordinarily would not fall under the DISC provisions – into DISC leasing income, while permitting the DISC provisions to apply in cases where the only operational income of the taxpayer and related entities with respect to the property was from leasing. In particular, Congress stated in the DISC legislative history that the purpose of the related-lessee excluded property rule in section 993(c)(2)(A) was to ensure that taxpayers were not able "to convert substantial amounts of what otherwise would be manufacturing or operational, as distinct from selling, income into" tax-favored DISC income. S. Rep. No. 437, 92d Cong., 1st Sess. 102 (1971), reprinted in 1972-1 C.B. 559, 616; H. Rep. No. 92-533, 92d Cong., 1st Sess. 69 (1971), reprinted in 1972-1 C.B. 498, 535. In other words, Congress intended the related-lessee excluded property rule to deny the DISC deferral[6] to rental income that arose from operating income, rather than rental income, earned under a purported sublease.

To illustrate this principle regarding the conversion of operating income to rental income, the DISC legislative history provided the following example:

> Thus, if a DISC leases a movie film to a foreign corporation which is a member of the same group of controlled corporations and that foreign corporation then leases the film to persons not members of that group for showing to the general public, the film is not to be considered non-export property by reason of the lease from the DISC to the foreign corporation. However, if the persons showing the film to the general public are members of the same group of controlled corporations as the DISC, the film is not to be considered export property.

S. Rep. No. 437, 92d Cong., 1st Sess. 102 (1971), reprinted in 1972-1 C.B. at 616. The Example stresses two principles. The ultimate sublessee must be an unrelated person, and the related sublessor must earn income from rental activity rather than business operations. Treas. Reg. § 1.993-3(f)(2) adopted this example as part of a rule that limited the scope of the related-lessee excluded property rule under the DISC provisions.

The FSC provisions substantially replaced the DISC provisions after December

---

[6] Whereas the FSC provisions exempt a portion of a FSC's income, the DISC provisions deferred tax on a portion of a DISC's income. See Pub. L. No. 92-178, 85 Stat. 497, § 501 (Dec. 10, 1971)), for the DISC tax deferral provisions in effect before their substantial replacement by the FSC provisions.

31, 1984. In order to resolve trade disputes arising from the tax treatment of DISCs,

> [t]he FSC system of taxation [was] designed to comply with the letter and spirit of the General Agreement on Trade and Tariffs (GATT) code, and to be revenue-neutral compared to the DISC system.

S. Prt. 98-169, 98th Cong., 2d Sess. (April 2, 1984). Accordingly, the FSC provisions preserved the related-lessee excluded property rule of section 993(c)(2)(A) in section 927(a)(2)(A); these two sections are materially identical. The FSC legislative history provides further:

> In general, where the provisions of the Act are identical or substantially similar to the DISC provisions under present and prior law, Congress intended that rules comparable to the rules in regulations issued under those provisions be applied to the FSC.

Staff of the Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, JCS-41-84, 1043 (December 31, 1984); S. Prt. 98-169, 98th Cong., 2d Sess. (April 2, 1984). Thus, the regulatory limitation on the related-lessee excluded property rule in Treas. Reg. § 1.993-3(f)(2) was carried forward into the FSC provisions in Temp. Treas. Reg. § 1.927(a)-1T(f)(2); these two regulations are materially identical.

Under Temp. Treas. Reg. § 1.927(a)-1T(f)(2)(i), property leased to a member of the lessor's controlled group does constitute export property during a period of time if, during the period: (A) the property is held for sublease or is subleased to a third person for ultimate use by the third person; (B) the third person is not a member of the same controlled group; and (C) the property is used predominantly outside the United States (as defined in paragraph (d)(4)(vi)).[7] Temp. Treas. Reg. § 1.927(a)-1T(f)(2)(iii) provides the following example – adopted nearly verbatim from the example quoted above from the DISC legislative history – to demonstrate the principle that the FSC provisions do not apply to operating income:

> [I]f X, a FSC for the taxable year, leases a movie film to Y, a foreign corporation which is not a member of the same controlled group as X, and Y then subleases the film to persons which are members of the controlled group for showing to the general public, the film is not export property. On the other hand, if X, a FSC for the taxable year, leases a

[7] Under Temp. Treas. Reg. § 1.927(a)-1T(d)(4)(vi), "property is used predominantly outside the United States for any period if, during that period, the property is located outside the United States more than 50 percent of the time."

movie film to Z, a foreign corporation which is a member of the same controlled group as X, and Z then subleases the film to Y, another foreign corporation, which is not a member of the same controlled group for showing to the general public, the film is not disqualified from being export property.

II. Time Charter, Service Contract, and Lease

A. Time Charter Defined

The FSC provisions do not define "time charter." However, under the common law definition of time charter, the owner's master, officers, and crew continue in possession of the vessel, its management, and operation. See, e.g., Randolph v. Waterman Steamship Corp., 166 F. Supp. 732, 733 (E.D.P.A. 1958). Under a time charter, the vessel's carrying capacity is taken up by the time charterer for a fixed period of time for carriage of cargo or other use of the vessel while the crew, navigation, and management remain in the control of the owner and its agents. Id. A voyage charter is similar to a time charter except that the vessel is chartered for a specified voyage rather than a specified period of time. See, e.g., Rev. Rul. 74-170, 1974-1 C.B. 175.[8] Section 7701(e)(1) provides a means for determining whether a particular time charter constitutes a lease or a service contract.

B. Characterization as a Service Contract or Lease under Section 7701(e)

For purposes of discussing section 7701(e)(1), an understanding of the following terminology is necessary: (1) if the Time Charter is a lease, Owner would be considered the "lessor" and the Charterer would be the "lessee" (or "sublessor" and "sublessee," respectively, if the Bareboat Charter is considered to be the basic or primary lease); and (2) if the Time Charter is a service contract, Owner would be considered the "service provider" and Charterer would be considered the "service recipient."

Section 7701(e)(1) and its legislative history provide factors which may be applied to determine whether a time charter of a vessel should be characterized as a lease or a service contract. The legislative history states that the factors set forth in section 7701(e)(1) apply for all purposes of the income tax provisions of the Code. Section 7701(e)(1) provides that a contract that purports to be a service contract shall be treated as a lease of property if such contract is properly treated as a lease of property, taking into account all relevant factors, including whether or not (A) the service

---

[8] See also Prop. Treas. Reg. § 1.883-1(e)(3)(ii) which defines time charter as a contract for the use of a ship for a specific period of time during which the ship's owner/lessor retains control of the navigation and management of the ship (e.g., the owner/lessor continues to be responsible for the crew, supplies, repairs and maintenance, fees and insurance, charges, commissions, and other expenses connected with the use of the ship).

recipient is in physical possession of the property, (B) the service recipient controls the property, (C) the service recipient has a significant possessory or economic interest in the property, (D) the service provider does not bear any risk of substantially diminished receipts or substantially increased expenditures if there is nonperformance under the contract, (E) the service provider does not use the property concurrently to provide significant services to entities unrelated to the service recipient, and (F) the total contract price does not substantially exceed the rental value of the property for the contract period.

Section 7701(e)(1) was added to the Code by the Deficit Reduction Act of 1984 ("Act"). Pub. L. No. 98-369, 98 Stat. 494, § 31(e) (1984). The Senate Finance Committee Report ("Senate Report") that accompanied the Act discusses, in great detail, the factors set forth in the statute. S. Rep. No. 98-169, 136-140 (1984). In particular, the Senate Report illustrates the rules of section 7701(e)(1) as follows:

> The service contract provision applies for all purposes of the income tax provisions of the Internal Revenue Code, including the depreciation provisions of the bill and the nontaxable use restriction on the investment credit (as modified by the bill). This provision applies to service contracts involving personal property or real property, regardless of whether the so-called service provider is the tax owner or the lessee of the property. . . .
>
> **Physical possession**
>
> Physical possession of property is indicative of a lease. Under the bill, property that is located on the premises of a service recipient, or located off the premises but operated by employees of such recipient, is viewed as in the physical possession of the recipient. However, property is not in the physical possession of the recipient merely because the property is located on land leased to the service provider by the tax-exempt entity.
>
> **Control of the property**
>
> The fact that the service recipient controls the property is indicative of a lease. Under the bill, a service recipient is viewed as controlling the property to the extent such recipient dictates or has a right to dictate the manner in which the property is operated, maintained, or improved. Control is not established merely by reason of contractual provisions designed to enable the recipient to monitor or ensure the service provider's compliance with performance, safety, pollution control, or other general standards.

Possessory or economic interest

A contract that conveys a significant possessory or economic interest to a service recipient resembles a lease. Under the bill, the existence of a possessory or economic interest in property is established by facts that show (1) the property's use is likely to be dedicated to the service recipient for a substantial portion of the useful life of the property, (2) the recipient shares the risk that the property will decline in value, (3) the recipient shares in any appreciation in the value of the property, (4) the recipient shares in savings in the property's operating costs, or (5) the recipient bears the risk of damage to or loss of the property.

Substantial risk of nonperformance

Under a service contract arrangement, the service provider bears the risk of substantially diminished receipts or substantially increased expenditures if there is nonperformance by the service provider or the property. Under the Act, facts that establish that the service provider does not bear any significant risk of nonperformance are indicative of a lease.

Concurrent use of property

The concurrent use of the property to provide significant services to entities unrelated to the service recipient is indicative of a service contract.

Rental value of property relative to total contract price

The fact that the total contract price (including expenses to be reimbursed by the service recipient) substantially exceeds the rental value of the property for the contract period is indicative of a service contract. If the total contract price reflects substantial costs that are attributable to items other than the use of the property subject to the contract, then the contract more closely resembles a service contract. Conversely, the fact that the total contract price is based principally on recovery of the cost of the property is indicative of a lease. A contract that states charges for services separately from charges for use of property is indicative of a lease.

Other rules

A contract will be treated as a lease rather than a service contract if the contract more nearly resembles a lease. Although each of the factors in the bill must be considered, a particular factor

> or factors may be insignificant in the context of any given case. Similarly, because the test for determining whether a service contract should be treated as a lease is inherently factual, the presence or absence of any single factor may not be dispositive in every case. For example, even if a tax-exempt entity or other service recipient does not have physical possession of property, the arrangement could still be treated as a lease after taking all other relevant factors into account.

Id.

Examples (1) and (2) in the Senate Report provide a sample application of the section 7701(e)(1) factors with respect to two time charters that have differing terms. S. Rep. No. 98-169, 138-140. Certain facts are common to both examples because Example (2) is based, in part, on the facts set forth in Example (1). In both examples, E, an agency of the Federal government, desires to obtain the use of a built-to-purpose vessel. A contractor arranges for the construction of the vessel and for the sale of the vessel to T. The contractor then leases the vessel from T, the shipowner, under a long-term bareboat charter. E and the contractor enter into a time charter with respect to the vessel. The time charter provides for the transportation of equipment, cargo, and personnel. Under the time charter, E has the right to designate the port of call and the cargo to be carried. The master, officers, and crew of the vessel are hired by the contractor, subject to E's approval. Example (1) continues by setting forth numerous additional facts that result in the conclusion that, under the factors set forth in the Act, the time charter is a lease. The additional facts in Example 1 differ from certain facts in Example 2.

Example (2) changes the following facts from those set forth in Example (1): (a) E has no right to make alterations to the vessel; (b) E's obligation to pay charter hire is set at a rate per deadweight ton and is subject to the condition that the vessel be in full working order; (c) the time charter has an initial term of 5 years, with an option to renew for one to five one-year periods, for a total of 10 years; (d) T bears the risk of damage to or loss of the vessel; and (e) E has no option to purchase the vessel. In addition, E is not required to pay Termination Value (or any other penalty) if it fails to exercise a renewal option. On these facts, the time charter will be respected as a service contract under the bill. The following factors provide the basis for that conclusion: (a) E has no control over the vessel; (b) E has no possessory or economic interest in the vessel; (c) the contractor bears a substantial risk of nonperformance because the contractor will receive no revenues if the vessel is unavailable for service; and (d) the facts do not indicate that any portion of the charter hire is based on the cost of the vessel.

III. Analysis

A. The Time Charter is a Service Contract, Not a Sublease

The FSC provisions apply to gross receipts from the lease or rental of export property for use by the lessee outside the United States. I.R.C. § 924(a)(2). The Service and Taxpayer agree that the Bareboat Charter involved in this case constituted a lease within the meaning of sections 924(a)(2) and 927(a)(2)(A). Although the use of the vessel otherwise meets the section 927(a)(1) definition of export property, the section 927(a)(2)(A) related-lessee excluded property rule excludes property from the definition of export property where the property is leased between members of the same controlled group (as defined in section 927(d)(4)). Taxpayer, Owner, and USCorp-FSC are members of the same controlled group under this definition.

The rules in Temp. Treas. Reg. § 1.927(a)-1T(f)(2) provide an exception to the related-lessee excluded property rule. The exception permits property leased between members of the same controlled group to be characterized as export property if the property is subsequently subleased or held for sublease by the lessee to a third person (not a member of the same controlled group) for such third person's ultimate use and if such third person uses the property predominantly outside the United States within the meaning of Temp. Treas. Reg. § 1.927(a)-1T(d)(4)(vi). Temp. Treas. Reg. § 1.927(a)-1T(f)(2)(i).

Owner entered into the Time Charter arrangement with Charterer, an unrelated third person customer that was not a member of the same controlled group as Taxpayer, Owner, or USCorp-FSC. The time chartered vessel was ultimately used by Charterer which used the vessel in IndustryA-related activities. Because these activities occurred exclusively outside the United States, the vessel was used under the Time Charter predominantly outside the United States within the meaning of Temp. Treas. Reg. § 1.927(a)-1T(d)(4)(vi). Thus, in determining whether the Temp. Treas. Reg. § 1.927(a)-1T(f)(2) exception to the related-lessee excluded property rule applies in this case, the controlling question is whether the Time Charter constituted a sublease of the vessel that was leased by Taxpayer to Owner under the Bareboat Charter.

Although the common law and other authorities provide definitions for a time charter transaction, such definition does not establish whether, for Federal income tax purposes, a particular time charter is a lease or a service contract. Therefore, a section 7701(e)(1) analysis is necessary to determine whether the Time Charter is a true sublease or a contract for services.

The Time Charter uses words throughout the agreement such as "charter," "charterer," "owner," and "hire" rather than leasing terms such as "lease," "lessee," "lessor," and "rent," or provisions of services terms such as "service contract," "service recipient," "service provider," and "fees." Numerous provisions use the term "services" to describe the nature or character of what Owner was obligated to provide to Charterer. See, e.g., paras. 1.2, 1.4, 2.3, and 3.1; section 15. In addition, Examples

(1) and (2) in the legislative history of section 7701(e)(1) illustrate the application of section 7701(e)(1) with respect to time charter agreements. These Examples demonstrate that a time charter may be either a lease or a service contract depending on the terms of the agreement. Therefore, application of section 7701(e)(1) is appropriate for the purpose of determining whether a particular time charter constitutes a lease or a service contract. Accordingly, we apply section 7701(e)(1) to determine whether the Time Charter is, in substance, a service contract as opposed to a lease.

1) Physical Possession

The first factor in section 7701(e)(1) concerns whether the service recipient is in physical possession of the property. According to the Senate Report, physical possession by the service recipient is indicative of a lease, and property operated by employees of the service recipient is viewed as in the physical possession of the service recipient. In this case, there is no indication in the Time Charter that employees of Charterer operated the vessel. Numerous provisions, however, require that the vessel be manned or operated, by a master and crew employed by Owner. See, e.g., paras. A and B of the preamble (requiring Owner to crew the vessel), 1.1 (stating "hire Owner's manned vessel"); 2.6 and Attachment C (listing the personnel required by the Time Charter for manning the vessel and placing such responsibility on Owner), 3.3 (requiring Owner to pay all costs and expenses relating to the vessel, "her master and her crew, including wages . . ."), 6.15 (giving the master the sole right to determine if a voyage may be undertaken "with safety to Owner's crew . . ."); sec. 15 (providing that Charterer "shall exercise no control over the Owner's employees [i.e., the crew]. . . ."). Because Owner's employees, not Charterer's employees, operate the vessel, we conclude that Owner did not transfer physical possession of the vessel to Charterer. Therefore, this factor favors characterizing the contract as a service contract, not as a lease.

2) Control of the Property

The second factor in section 7701(e)(1) is whether the service recipient controls the property. The Senate Report states that control of the property by the service recipient is indicative of a lease. Control is established if the service recipient dictates the manner in which the property is operated, maintained, or improved. Although Charterer has the right to require certain services concerning offshore operations for its IndustryA business from Owner (see paragraphs 1.1, 1.2, and 2.3 above), section 15 of the Time Charter provides that with respect to the vessel,

> Charterer shall exercise no control over the Owner's employees, or agents nor those of its subcontractor(s), nor the methods or means employed by Owner in the performance of such work or services. The Charterer is solely interested in the attainment of the desired results.

Numerous other provisions in the Time Charter place control of the operation,

maintenance, and repair of the vessel in the hands of Owner. See, e.g., paras. 2.2 and 2.3 (setting forth Owner's obligations and standards of performance of the services), 3.3 (requiring Owner to exercise due diligence in the performance of all services contemplated by the Time Charter), and 3.4 through 3.9 (setting forth a long list of duties and responsibilities of Owner with respect to the vessel and requiring Owner to use good care and due diligence or reasonable diligence in the performance of such duties).

Although paragraphs 2.4 and 2.5 give Charterer a right to inspect the vessel and to inspect any of Owner's operations and equipment under the Time Charter, the Senate Report clearly provides that a right of inspection designed to permit the service recipient to monitor or ensure the service provider's compliance with certain standards does not amount to control. Accordingly, we conclude that the provisions of the Time Charter clearly establish that Owner retained control of the vessel. Therefore, this factor supports characterizing the Time Charter as a service contract, not a lease.

3) Possessory or Economic Interest

The third factor in section 7701(e)(1) concerns whether the service recipient has a significant possessory or economic interest in the property. The Senate Report indicates that a contract that conveys a significant possessory or economic interest to the service recipient resembles a lease. Five elements are necessary to establish the conveyance of a significant possessory or economic interest in the property. First, in this case the term of the Time Charter is one year with six one-month renewal options. See para. 17.1. Therefore, the Time Charter did not dedicate the vessel's use to Charterer for a substantial portion of the vessel's useful life. This element suggests that the Time Charter did not convey a significant possessory or economic interest in the vessel to Charterer.

Under the second and third elements, the Time Charter does not contain any provisions suggesting that Charterer shares the risk that the property will decline in value or that Charterer will share in any appreciation in the value of the property. Fourth, paragraph 2.2 provides that the Charterer will share in any savings in the vessel's operating costs concerning, for instance, fuel consumption. Also, the reimbursement procedures in paragraphs 4.6 and 4.7 lead to a similar result. This fact favors treatment as a lease. The fifth element concerns whether the recipient bears the risk of damage or loss of the property. The terms of the Time Charter strongly suggest that Charterer did not bear the risk of damage or loss. Paragraphs 5.1, 5.4, and 5.5 impose on Owner the obligation to procure insurance for the vessel and its crew. Paragraph 6.7 provides that any damage or loss of Owner's property (i.e., the vessel) shall be Owner's, and any right of recovery against Charterer for such loss is waived. Paragraph 7.4 also provides that if the vessel is lost, the Time Charter terminates and Owner has no rights to further compensation other than sums due or accrued at the time of the loss. An analysis of the Time Charter with respect to these elements indicates that no significant possessory or economic interest in the vessel was conveyed to Charterer. Therefore, this factor indicates that the Time Charter is a

service contract, not a lease.

4) Substantial Risk of Nonperformance

The fourth factor in section 7701(e)(1) is whether the service provider bears any risk of substantially diminished receipts or substantially increased expenditures if there is nonperformance under the contract. According to the Senate Report, facts that establish that the service provider does not bear any significant risk of nonperformance are indicative of a lease. The terms of the Time Charter do not directly address diminished receipts or increased expenditures in the event of nonperformance. However, Attachment D provides that Owner will be reimbursed by Charterer according to the day rate for the vessel. Accordingly, for each day the vessel is not in use, Owner bears a risk of diminished receipts in the form of lower total reimbursements. This factor favors treating the Time Charter as a service contract.

5) Concurrent Use of Property

The fifth factor in section 7701(e)(1) concerns the concurrent use of the property. The Senate Report provides that the concurrent use of the property to provide significant services to entities unrelated to the service recipient is indicative of a service contract. In this case, paragraph 1.2 requires that the vessel be "available" for Charterer's use 24 hours per day for the duration of the Time Charter. Paragraph 4.1 provides for pro ration of the day rate for any day in which the vessel is available for less than 24 hours service. Because of the "exclusive" nature of these provisions, it is reasonable to conclude that the Time Charter does not permit the concurrent use of the vessel for entities unrelated to the service recipient. This factor favors lease treatment.

6) Rental Value of Property Relative to Total Contract Price

The final factor in section 7701(e)(1) concerns the rental value of property relative to total contract price. The Senate Report provides that the fact that the total contract price (including expenses to be reimbursed by the service recipient) substantially exceeds the rental value of the property for the contract period is indicative of a service contract. S. Rep. No. 98-169, 136-140 (1984). Conversely, contractual terms that base the total contract price principally on recovery of the cost of the property are indicative of a lease. The Time Charter neither discusses whether the total contract price substantially exceeds the rental value of the property nor indicates whether the total contract price is based on Owner's recovery of its cost of the property. Consequently, additional factual development is necessary to establish whether this factor supports characterization as a service contract or lease.

On balance, the factors set forth in section 7701(e)(1) and its legislative history support characterizing the Time Charter as a service contract, not a lease, for federal income tax purposes. Further support for characterizing the Time Charter as a service contract can be found in the sourcing rules which, historically, have treated income from time charters as compensation for services or operation of a vessel, rather than rental

income. See, e.g., Staff of the Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, JCS-41-84, 371 (December 31, 1984); Rev. Rul. 81-197, 1981-2 C.B. 166; Rev. Proc. 91-12, 1991-1 C.B. at 475.

B. FSC Benefits Do Not Apply to Income from the Provision of Services and Performance of Activities by Owner under the Time Charter

The conclusion that we reached applying the section 7701(e)(1) factors above is consistent with the policy that FSC benefits do not apply to income from the operation of a business. The legislative history of the related-lessee excluded property rule originally enacted in section 993(c)(2)(A) reflects Congress' intent to limit the DISC deferral mechanism to selling and leasing income and to prevent operating income earned at the lessee or sublessee level from being converted into leasing income at the lessor's level. Temp. Treas. Reg. § 1.927(a)-1T(f)(2) constitutes a narrow exception to the related-lessee excluded property rule. This exception is premised on the notion that FSC benefits do not apply to operating income. Thus, Temp. Treas. Reg. § 1.927(a)-1T(f)(2) enables a lessor to obtain FSC benefits on a lease of export property to a related lessee unless such property generated operating income in the hands of the related lessee or a related sublessee. This principle is illustrated in the Example in Temp. Treas. Reg. § 1.927(a)-1T(f)(2)(iii) taken from the DISC legislative history and regulations.

In the present case, Owner received income from Charterer under the Time Charter as compensation for Owner's provision of services such as Service1 and Service2 as well as performance of activities such as Activity2 and supporting Activity1. Owner's income was not leasing income because Owner did not lease the vessel to Charterer; Charterer paid Owner for providing services and performing activities. Owner received income for the active operation of a business, as distinguished from passive leasing activity. Owner's income from the operation of a business servicing IndustryA was converted into leasing income when Owner paid rent to Taxpayer under the Bareboat Charter lease.

This is precisely the situation anticipated by the DISC legislative history and by the related-lessee excluded property rule under section 927(a)(2)(A). A taxpayer may not circumvent the related-lessee excluded property rule and trigger the exception under Temp. Treas. Reg. § 1.927(a)-1T(f)(2) simply by labeling a time charter as a lease or a sublease. The exception to the related-lessee excluded property rule under Temp. Treas. Reg. § 1.927(a)-1T(f)(2) applies to a time charter by a bareboat lease charterer only where the time charter generates true leasing income.

The Example in Temp. Treas. Reg. § 1.927(a)-1T(f)(2)(iii) states that the exception does not apply where a related lessee shows a leased movie to the public. Because the related lessee did not sublease the movie but, rather, used the movie in the operation of its business, FSC benefits do not apply to the leasing income of the

movie's lessor. The same principle applies in the present case. Owner did not sublease the vessel to Charterer under the Time Charter.

CASE DEVELOPMENT, HAZARDS, AND OTHER CONSIDERATIONS

[redacted]

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

Please call CC:INTL:6 at if you have any further questions.

JACOB FELDMAN
Special Counsel
Office of Associate Chief Counsel
(International)