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Tax Planning for International Transportation Income

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According to the most recent estimates, the quantity of goods carried by containers has risen from around 100 million metric tons in 1980 to about 1.5 billion metric tons in 2012. Out of these numbers, one container in every 11 that is engaged in global trade is either bound for or originates in the United States, accounting for nine percent of worldwide container traffic. With these numbers growing steadily during the past 15 years, the U.S. federal income tax implications to U.S. companies engaged in the international transportation of goods by containers has become increasingly significant.

Taxation of International Transportation Income, in General

A number of code provisions specifically address various aspects of income arising from international transportation activities. Section 883(a) excludes income from the international operation of ships or aircraft from the gross income of certain foreign corporations that grant to the United States an equivalent exemption. Under Section 863(c), income attributable to transportation (transportation income) that begins or ends in the United States is treated as being 50 percent from U.S. sources. Moreover, foreign corporations will be subject to a four percent tax on their U.S.-source gross transportation income under Section 887, provided such income is not effectively connected to a U.S. trade or business.

The provisions discussed above, however, are applicable only to persons that either own or operate entire ships or aircraft. None of the cited provisions apply to international transportation companies that, for example, own containers, and arrange to ship goods stored in those containers using third-party shipping or rail companies, but do not operate the actual ships or railcars on which the containers are transported (such as a nonvessel operating common carrier).

Tax Efficient Structuring for International Transportation Activities

Assume a newly formed U.S. company (TransportCo.) plans to operate as described above by arranging for the transportation of goods stored in containers from the United States to various countries around the world by using third-party shipping or rail companies, but will not own or operate the actual ships or railcars on which the containers are transported. Also assume that TransportCo. will own the containers that are used to transport the goods, will issue its own bills of lading, and will be liable as a common carrier for the transportation of goods. Finally, assume that such company will be structured in the United States as a closely held pass-through entity (e.g., as an LLC taxed as a partnership or an S corporation) with no foreign subsidiaries. In other words, all of TransportCo.'s international transportation income will be taxed currently in the United States at ordinary income rates, and there will be no ability to defer from U.S. federal income tax any portion of such income.

One possible alternative to this scenario would be for TransportCo. to conduct its international transportation activities through a foreign subsidiary located in a jurisdiction that has a favorable income tax treaty with the United States with regard to transportation activities (e.g., the U.S.-Austria income tax treaty). Under this treaty, profits of an Austrian company from the use, rental, or maintenance of containers used in international traffic will be taxable only in Austria and are, therefore, exempt from U.S. federal income tax. The term "international traffic" is defined to mean any transport by ship or aircraft, except where such transport is solely between places within the borders of one treaty partner. The U.S. Treasury Technical Explanation to such treaty clarifies that this exemption applies regardless of whether the recipient of the income is engaged in the operation of ships in international traffic, and regardless of whether the recipient has a permanent establishment in the United States.

Accordingly, in the example described above, TransportCo. can operate its business from the United States, but will have the ability to defer from U.S. federal income tax any profits earned by the Austrian company that are derived from the international transportation of goods by containers. The treaty makes it clear that the existence of a permanent establishment in the United States will not cause the Austrian company to be subject to U.S. federal income tax on any income attributable to such permanent establishment.

Eventually the profits earned by the Austrian company could be repatriated to the United States at qualified dividend rates (i.e., 20 percent) as the Austrian company would be considered a "qualified foreign corporation".1 Therefore, not only would TransportCo. have the ability to defer the international transportation income from U.S. federal income tax, but it also would be able to convert such income into qualified dividend income (as opposed to having such income be taxed at ordinary income rates, the maximum rate of which is currently 39.6 percent).

In order to minimize the corporate income taxes in Austria but continue to take advantage of the favorable transportation provisions contained in the U.S.-Austria income tax treaty, it may be possible to conduct the international transportation activities through a low tax (nontreaty) jurisdiction (e.g., a Cayman company – CaymanCo.) that is wholly owned by an Austrian company and by electing to treat CaymanCo. as a branch of the Austrian company under the entity classification regulations (i.e., "check-the-box" rules). The profits earned by CaymanCo. could be repatriated to the United States through Austria without incurring any corporate level income taxes as Austria may exempt a dividend from CaymanCo. under its "participation exemption" regime.2

International Trucking and Rail Operations: Treaty with Canada

Similar to the benefits available to U.S. taxpayers with regard to international shipping and air transport under the U.S.-Austria treaty, the U.S.-Canada treaty provides favorable treatment for international transportation income derived from the use of trucking or railway cars by both common carriers and contract carriers, including those who own only the containers used to transport the goods or passengers. As with the U.S.-Austria treaty noted above, the relevant provisions of the U.S.-Canada treaty apply even if the company in question has a permanent establishment in the other treaty partner's jurisdiction.

Under the U.S.-Canada income tax treaty, profits derived by a Canadian company from the operation of motor vehicles as a common carrier or a contract carrier from the transportation of property between a point outside the United States and any other point are exempt from U.S. federal income tax. The treaty with Canada explicitly provides that this is the case notwithstanding the business profits provision of the treaty. The Treasury Technical Explanation to the treaty confirms this point, stating that irrespective of whether the carrier has a permanent establishment in the source country, income of a common carrier is taxable only by the country of the carrier's residence.

Unlike the structure discussed above, however, in which benefits are being sought under the U.S.-Austria treaty even though the international transportation income will be earned by a disregarded Cayman company, a similar structure would no longer be possible in Canada since the issuance of the 2007 protocol to the U.S.-Canada treaty. It may be possible to achieve a similar result, however, by using a Canadian business trust as the operating entity and, for U.S. federal income tax purposes, electing to treat such entity as a corporation under the check-the-box rules.

In PLR 200752029, a foreign investment trust that elected to be treated as a corporation for U.S. federal income tax purposes was found to be a qualified foreign corporation for such purposes and thus, distributions from the trust were taxed at qualified dividend rates. The ruling stated that, based on the taxpayer's representations, the trust was subject to tax on its worldwide income in the country of its residence, and that the trust was entitled to a deduction in its residence country for the amounts paid or payable to its beneficiaries during the year. The residence and limitation on benefits provisions of the applicable treaty were applied to the trust without regard to the entity's classification for U.S. federal income tax purposes (i.e., U.S. corporation pursuant to check-the-box election). Because, within the meaning of the relevant treaty, the trust was a resident of the foreign treaty partner and was a qualifying person, the trust was a "qualified foreign corporation".

Under this structure, Canada will impose tax on any retained income of the trust. Under Canadian law, however, the trust is permitted a distribution deduction for any distributions made during the tax year. Therefore, as long as all the net income of the trust is distributed out to the U.S. shareholders on an annual basis, no Canadian income tax should be imposed on the trust's earnings.36 While the Canadian tax authorities will impose a withholding tax on the distributions out of Canada, the U.S. generally permits a foreign tax credit to be taken against the U.S. shareholders' respective U.S. tax liabilities on the same amounts.

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1 An additional 3.8 percent Medicare tax would apply.

2 Section 894(c) currently only applies to passive income and not business profits.

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