Office of Chief Counsel
Internal Revenue Service

Memorandum

Number: **AM2013-005**

Release Date: 9/27/2013
CC:INTL:B01
PRENO-132107-13

UILC: 9999.98-00

date: September 18, 2013

to: Laura M. Prendergast
Industry Director
Heavy Manufacturing and Pharmaceutical Industry
(Iselin, New Jersey)
(Large Business & International)

from: Steven A. Musher
Associate Chief Counsel
(International)

---

subject: Tonnage Tax -- Section 1352 et seq.

This memorandum sets forth the legal analysis for determining whether certain qualifying shipping activities are core qualifying activities under section 1356(b) or qualifying secondary activities under section 1356(c), as they pertain to the tonnage tax exclusion under section 1357. This advice may not be used or cited as precedent.

ISSUE

Whether terminal activity, logistics activity, and other supportive functions such as maintenance and repair that are performed while a qualifying vessel is at a port terminal, or otherwise stationary, are classified as core qualifying activities under section 1356(b) or, alternatively, qualifying secondary activities under section 1356(c). Further, whether inland haulage of cargo such as trucking, whether preceding or following transportation by a qualifying vessel, is classified as a core qualifying activity under section 1356(b) or, alternatively, a qualifying secondary activity under section 1356(c).

CONCLUSION

Terminal activity, logistics activity, and other supportive functions such as maintenance and repair that are performed while the qualifying vessel is at a port terminal, or

otherwise stationary, are classified as qualifying secondary activities under section 1356(c). Certain otherwise supportive functions, such as maintenance and repair, undertaken by a qualifying vessel operator in the course of transportation by vessel (i.e., physical conveyance) of goods or passengers between a place in the United States and a foreign place, or between foreign places, constitute core qualifying activities under section 1356(b). Inland haulage of cargo, such as trucking, performed as an integral part of United States foreign trade, whether preceding or following transportation by a qualifying vessel, is qualifying secondary activity.

STATEMENT OF FACTS

The tonnage tax exclusion under Subchapter R may arise in different factual situations. An example of the tonnage tax exclusion may be illustrated by the facts discussed herein.

The taxpayer, a domestic corporation, operates a fleet of vessels and is a member of a domestic affiliated group that files a consolidated federal income tax return. The consolidated group ultimately may be owned by a foreign corporation. At all relevant times, the taxpayer is engaged in the business of marine shipping. The taxpayer is a qualifying vessel operator, within the meaning of section 1355(a)(3), and has properly elected the application of the tonnage tax under subchapter R (Election to Determine Corporate Tax On Certain International Shipping Activities Using Per Ton Rate) of the Code. The other members of its consolidated group are members of the electing group, within the meaning of section 1355(a)(2).

The taxpayer's shipping business involves the transportation of cargo for its customers. The taxpayer's customers may include both governmental entities and private businesses. For certain customers, the taxpayer, or a member of the taxpayer's controlled group, agrees to transport specified cargo from a point of origin to a destination pursuant to a bill of lading or equivalent. The taxpayer may also time charter the vessel to a related entity for a period of months or years, but continues to be responsible to crew, supply, repair and maintain the vessel, in exchange for compensation at a periodic rate specified in the time charter. For other customers, the taxpayer enters into an operating agreement pursuant to which the taxpayer agrees to crew, supply, repair and maintain the vessel in exchange for compensation at a periodic rate plus certain expense reimbursements, as specified in the operating agreement. Finally, in some cases, the taxpayer enters into contracts to provide services for vessels, including maintenance, repair and other supportive functions solely to maintain their readiness, in exchange for compensation at a periodic rate plus expense reimbursements, while the vessels remain at port for an extended period of time.

In each of these four situations (i.e., cargo transportation, time charter, operating agreement and services agreement for stationary vessels), the taxpayer, or a related member of its controlled group, is responsible for providing numerous support services relating to the vessels. In the course of transporting cargo and performing its other

contractual obligations, the taxpayer and its related entities operate shipping terminals for the loading and unloading of cargo on vessels, provide trucking services for inland haulage of cargo, provide logistical services, operate, maintain and repair cargo vessels and perform other supportive functions that are integral to the taxpayer's business of transporting cargo.

LAW AND ANALYSIS

A. *Background of the Tonnage Tax*

Enacted as part of the American Jobs Creation Act of 2004, Subchapter R, including sections 1352 through 1359, is referred to as the tonnage tax. The tonnage tax is an elective tax regime for corporations that allows them to be taxed on the basis of "notional shipping income" under section 1352. Notional shipping income is an amount based on a formula, under section 1353, that is derived from the net tonnage of the vessels that are used for qualifying shipping activities. Thus, taxpayers that elect the application of Subchapter R pay tax based on their notional shipping income, and receive a corresponding exclusion from the corporate income tax under section 1357 for certain income attributable to their qualifying shipping activities.

Under section 1357, the exclusion from gross income applies only to income from qualifying shipping activities. Qualifying shipping activities mean core qualifying activities under section 1356(b), qualifying secondary activities under section 1356(c) and qualifying incidental activities under section 1356(d). The exclusion from gross income under section 1357 applies to income from qualifying shipping activities in the following manner: (a) core qualifying activities are 100-percent excluded from gross income, (b) qualifying secondary activities are excluded to the extent of 20-percent of the gross income derived from the taxpayer's core qualifying activities and (c) qualifying incidental activities are excluded from gross income to the extent of 0.1-percent of the gross income derived from the taxpayer's core qualifying activities. This memorandum discusses the first two categories, which are core qualifying activities and qualifying secondary activities.

Under section 1356(b), the term core qualifying activities means activities *in operating qualifying vessels in United States foreign trade*. Under section 1355(a)(4), a qualifying vessel is a self-propelled (or a combination self-propelled and non-self-propelled) United States flag vessel of not less than 6,000 deadweight tons used exclusively in United States foreign trade during the period that the taxpayer's election under Subchapter R is in effect. Section 1355(a)(7) provides that United States foreign trade means the transportation of goods or passengers between a place in the United States and a foreign place or between foreign places.

Section 1356(c) defines qualifying secondary activities as follows:

> (c) QUALIFYING SECONDARY ACTIVITIES. – For purposes of this section—

(1) IN GENERAL. – The term "qualifying secondary activities" means secondary activities but only to the extent that, without regard to this subchapter, the gross income derived by such corporation from such activities does not exceed 20 percent of the gross income derived by the corporation from its core qualifying activities.

(2) SECONDARY ACTIVITIES. – The term "secondary activities" means—

(A) the active management or operation of vessels other than qualifying vessels in the United States foreign trade,

(B) the provision of vessel, barge, container, or cargo-related facilities or services to any person,

(C) other activities of the electing corporation and other members of its electing group that are an integral part of its business of operating qualifying vessels in United States foreign trade, including—

(i) ownership or operation of barges, containers, chassis, and other equipment that are the complement of, or used in connection with, a qualifying vessel in United States foreign trade,

(ii) the inland haulage of cargo shipped, or to be shipped, on qualifying vessels in United States foreign trade, and

(iii) the provision of terminal, maintenance, repair, logistical, or other vessel, barge, container, or cargo-related services that are an integral part of operating qualifying vessels in United States foreign trade, and

(D) such other activities as may be prescribed by the Secretary pursuant to regulations.

Such term shall not include any core qualifying activities.

B. *Distinction Between Core Qualifying Activities and Qualifying Secondary Activities*

Because the income derived from performing qualifying secondary activities cannot exceed 20-percent of the gross income derived from core qualifying activities (section 1356(c)(1)), it is necessary to determine which activities are "core" and which are "secondary." Accordingly, in each of the four contractual arrangements described above (i.e., cargo transportation, time charter, operating agreement and contract to provide supportive services while the vessel remains at port), there must be a determination of which activities are "core" and which are "secondary."

Core qualifying activities comprise the operation of qualifying vessels in United States foreign trade, namely, consisting of the activities in transporting goods or passengers between a place in the United States and a foreign place, or between foreign places. The term "core qualifying activities" means "activities in operating qualifying vessels in United States foreign trade." Section 1356(b). The relevant Code provisions include definitions of a "qualifying vessel" and "United States foreign trade." Sections 1355(a)(4) and (a)(7). By application of these definitions, core qualifying activities occur while the vessel is engaged in "the transportation of goods or passengers between a place in the United States and a foreign place or between foreign places." Sections 1356(b) and 1355(a)(7). In sum, core qualifying activities consist of activities occurring in the transportation of goods or passengers on qualifying vessels between a place in the United States and a foreign place, or between foreign places.

Secondary activities comprise subsidiary or ancillary activities other than the core transportation of goods or passengers; other than on qualifying vessels; or other than during the transportation between a place in the United States and a foreign place, or between foreign places. Thus, even when secondary activities are an integral part of the business of operating qualifying vessels in United States foreign trade, they are distinct from the core transportation of goods or passengers in United States foreign trade.

Secondary activities are defined in section 1356(c)(2) and are divided into groupings, each distinct from core activities, as defined, in one or more material dimensions. Under section 1356(c)(2)(A), secondary activities include the active management or operation of vessels *other than qualifying vessels in the United States foreign trade*. Under section 1356(c)(2)(B), secondary activities include vessel, barge, container, or cargo-related facilities or services that are provided to *any person*. The context (e.g., the contrast vis-à-vis the preceding grouping of "active management or operation of vessels") makes clear that such services must be less than what would rise to the level of actual operation of a vessel, or otherwise fall short of full transportation of goods or passengers on qualifying vessels in United States foreign trade. Under section 1356(c)(2)(C)(i), secondary activities include the ownership or operation of barges, containers, chassis, and other equipment that are the complement of, or used in connection with, a qualifying vessel in United States foreign trade. As defined, these activities exclude ownership or operation of a qualifying vessel, and therefore do not constitute core qualifying activities. Under section 1356(c)(2)(C)(ii), secondary activities include the inland haulage of cargo shipped, or to be shipped on qualifying vessels in United States foreign trade. As inland haulage occurs either before or after the transportation by vessel in United States foreign trade and does not occur on a qualifying vessel, it similarly does not constitute core qualifying activity. Finally, under section 1356(c)(2)(C)(iii), secondary activities include the provision of "terminal, maintenance, repair, logistical, or other vessel, barge, container, or cargo-related services that are an integral part of operating qualifying vessels in United States foreign trade…." These shipping-business activities under section 1356(c)(2)(C)(iii) are

classified as secondary activity because they occur apart from transportation between a place in the United States and a foreign place, or between foreign places.

Pursuant to the flush language of section 1356(c), qualifying secondary activities do not include any core qualifying activities. The flush language must be interpreted so as to consistently construe core qualifying activities and qualifying secondary activities in accordance with the statute, and cannot render parts of the statute inoperative. United States v. Voigt, 89 F.3d 1050, 1087 (3rd Cir. 1996), quoting Connecticut Nat'l Bank v. Germain, 503 U.S. 249, 253 (1992) ("courts should disfavor interpretations of statutes that render language superfluous"). Qualifying secondary activities described in section1356(c)(2) are distinct from core qualifying activities, as discussed above. The flush language, by way of emphasis, reinforces these distinctions. For example, activities such as terminal functions, maintenance and repair, and inland haulage are classified as secondary activity because they occur apart from the transportation by vessel between a place in the United States and a foreign place, or between foreign places. However, where activities, such as maintenance and repair, occur during the transportation (i.e., physical conveyance) of goods or passengers by vessel, the flush language confirms that such activities are core qualifying activities.

Taxpayers are taking varying positions, including positions based on interpretations of legislative history. In some cases, taxpayers may be treating some or all of the activities listed in section 1356(c)(2) as core qualifying activities, without regard to whether such activities occur in the transportation of goods and passengers by a qualifying vessel while engaged in United States foreign trade. Such interpretation is contrary to the statute. In particular, the functions listed under section 1356(c)(2)(C) specifically refer to support functions that are "an integral part of [the taxpayer's] business of operating qualifying vessels in United States foreign trade." If these support functions were core qualifying activities, there would be no reason to describe such activities in the statute as qualifying secondary activities. For example, some taxpayers have taken the position that inland haulage constitutes core qualifying activity on the basis that inland haulage is associated with the transportation of cargo in United States foreign trade. However, such interpretation is contrary to the statute, which defines qualifying secondary activity to include "the inland haulage of cargo shipped, or to be shipped, on qualifying vessels in United States foreign trade." Section 1356(c)(2)(C)(ii). The interpretation of core qualifying activities as including all support functions for qualifying vessels would render superfluous significant portions of the statute under section 1356(c). Accordingly, such an interpretation of core qualifying activity should be rejected.