



Market Segment Specialization Program



The Port Project

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FOREWORD

The Port Project Examination Audit Techniques Guide is the product of Group 1304 in the Houston District of the IRS.

As of December 1992, the group had explored, evaluated, and examined various related industries of the Port of Houston for a year. This information package represents a summary of their findings. This package is by no means all inclusive, but is meant to assist the examiner in audits of industries which are related to coastal and inland waterways.

We thank William R. Pfeil, Shipping Industry Specialist, for his assistance.

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Chapter 1

INTRODUCTION

DEFINITION

By definition, a Port consists of a terminal for water traffic which includes a harbor and the necessary terminal facilities. In reality, our ports include all international ports of entry, including our airport facilities as well as our border crossings and water facilities. This project addresses only water transportation ports.

SCOPE

Having narrowed the scope to water transportation ports, it is our next objective to identify where the Port "begins and ends." Typically, a "Port" includes the harbor facility and related channels connecting it to at ocean or gulf. The facilities include wharves, docks, storage facilities, mechanical devices for handling cargo, parking facilities, and more.

Traffic in the waterways includes liners, tramp steamers, barges, tugboats, lightering vessels, supply boats, crew boats, and repair boats to name only some of the vessels. Services provided include port pilots, ships chandlers providing everything from cable to toilet paper, and mobile repair units to repair vessels before entering port.

Various facilities are available along the waterways from drydocks to warehouses; however, the "Port" is extended to include operations contained in a "Commercial Zone." (In Houston this zone includes an area within a 50-mile radius of the Houston Port facilities.) The Commercial Zone contains various related activities such as stevedores, cartage haulers, container terminals, packing facilities, foreign freight forwarders, customs brokers, warehouses, shipping lines and agents, rail transportation, and container trucking. Miscellaneous servicemen related to the port include electricians, mechanics, tire repairmen, and travel agents. Nearly any conceivable occupation or industry is represented by activity at the port.

SELECTION

Because of the extent of port activities, it was necessary to limit the activities to be considered to those unique to the port operations. Initially seven business were

selected for this project using the Service's PIA codes for identification purposes. The PIA codes and Industries selected were:

PIA	Business Category
3730	Ship and Boat Building and Repair
4200	Trucking and Warehousing
4400	Water Transportation
4700	Miscellaneous Transportation Services
7389	Business Services #except Advertising
7600	Miscellaneous Repair Services
8980	Miscellaneous Services

Using a computer printout of the above PIA codes, the entities listed were cross referenced with a Port of Houston Directory. A sort was performed on selected businesses. Those returns with positive taxable income, no recent prior audits, and desired activity codes were selected for potential examination.

After classification there were 13 potential industries to consider in the beginning of the project. These industries were:

- Chandlers
- Customs Brokers
- Freight Broker/Forwarder
- Port Captain
- Ship/Barge Construction & Repair
- Ship Terminal
- Steamship Agents
- Steamship Line
- Stevedores/Longshoremen
- Tow Boat Services
- Trucking and Warehousing
- Miscellaneous: Cargo & Marine Survey, Packing & Crating, Mooring

As the project progressed and additional information was learned about the Port some industries were excluded or limited in scope and others including Port/Ship Pilots were added.

PURPOSE

The initial work on the Port is necessarily broad in scope due to the volume of entities performing services related to the port whether it is importing or exporting of goods and materials. However, this guide provides some insight into the unique terminology and technical information to provide a basis for understanding Port industries and their related issues.

Chapter 3 related to the Industry Specialization Project (I.S.P.) on Shipping is included to give an overview of the work being done by the I.S.P. Coordinator as it relates to port activity.

The specific information contained in this study is expected to contribute to quality audits in the port industries resulting in the conservation of Service resources and voluntary compliance in the targeted industries. We hope that the general information contained in this study will lead to additional specialization projects within selected Port related industries providing additional specific information useful to all those involved with port industries. Data collected by others working port related industries is welcome and will be used to update the present Guide to provide for consistent treatment by all those working in this industry.

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Chapter 2

PORT RELATED INDUSTRIES

INTRODUCTION

There are many industries whose business revolves around the port, not all of which are obviously connected to the shipping industry. The categories listed below are discussed in this chapter.

- Chandler
- Customs Broker
- Freight Broker/Forwarder
- Pilot
- Port Captain
- Ship and Barge Construction and Repair
- Ship Terminal
- Steamship Agent
- Stevedores/Longshoremen
- Towboat services
- Trucking & warehousing
- Miscellaneous

Chandlers

They provide food and general supplies for ships visiting their port of call. That may include anything from fresh vegetables to a new anchor chain or a replacement motor. Discounts on the quoted price are normal.

Customs Brokers

Arrange customs inspection, duties, and paperwork on goods imported or exported. The broker is responsible for all paperwork, pays the fees, etc.

Freight Broker/Forwarder

Brings together cargoes and carriers. The broker generally makes his or her income on the difference between what he or she charges his or her customers and the rate he or she pays. By combining cargoes, the broker can receive a lower rate.

Pilot

Licensed to direct ocean going vessels in and out of one or more ports, and between berths in the port. The pilot is paid based on time spent, the size of vessel involved, and for special services. It is mandatory for a ship to hire a pilot to enter or leave a U.S. Port. See Chapter 9, Miscellaneous, for more detailed information on pilots.

Port Captain

Acts as the operator's agent at the port. This job is similar to a steamship agent, in that the Port Captain arranges for whatever the ship needs in port. However, the Port Captain would be responsible for paying a cash bonus to the crew chief of the stevedores, while the Agent would contact the Stevedore company. The Port Captain deals with smaller amounts, deals in person rather than by phone, fax, etc., as does the agent, and is most active in foreign ports.

Ship and Barge Construction and Repair

Ship building is a very specialized field, and generally concentrated in a few areas generally located on the East Coast. Ship repair is much more common. Repairs may be done by a related company to a ship owner, or by a third party.

Ship Terminal

A facility for loading and unloading ships. It is highly mechanized, and designed for specialized cargoes, usually containerized or grain. While the capital investment required is quite high, the terminal operator enjoys lower labor costs.

Steamship Agents

Act for the owner/operator of a ship to arrange customs, stevedores, repairs, pilots, etc. An agent may be a general agent, and represent the ship anywhere it sails, or may represent it only in one or more geographic locations. The agent is paid a commission based on the cost of services contracted. If the agent books cargo for the ship, he or she is also entitled to a commission on the freight charges. Normal commissions are in the 5 percent to 15 percent range. Since agents not only arrange for the services and supplies, but also pay for them, their cash flow is many times their income. Generally, the agent keeps his or her client's funds in some sort of separate account, and transfers his or her own commission to his or her operating account when he or she settles with the client. See Exhibit 2-1 for a sample of an Agency Agreement.

Steamship Line

Operates ocean going vessels carrying passengers/cargo. A tramp steamer has no regular route or schedule, but goes wherever cargoes are arranged. A liner has a

regular route and takes only cargoes or passengers along that route. The company may own the vessels, or charter them. The shipping line is an Operator of one or more ships. Most small operators charter their ships, rather than own them. The operator bears the general risk of profit or loss on a voyage.

Stevedores/Longshoremen

The stevedores provide a number of services at the Port. They still provide some physical labor; however, most loading and off loading of ships is highly mechanized. Modern stevedores operate the cranes and forklifts used in handling cargoes. Most stevedores in the United States are union members. Hiring of union stevedores is done through the union hall, with the union setting minimum crew size and minimum time period. If the work is completed in less time, the full fee must still be paid. If no work can be done because of problems not caused by the stevedores, such as equipment failure, the minimum hours must be paid for the crew. Generally., this will cover about 4 hours for each member of the crew.

Towboat Services

Includes tugboats and barges.

1. Tugboat companies: Responsible for helping to move ocean vessels in and out of port, between berths, etc. Frequently used to tow barges. (Note: Tugboats usually push the other vessel, not pull it.) A similar boat is also used to transport port pilots to ships waiting to enter the ship channel or port.
2. Barge lines: Small ships, usually not powered, which generally operate on the Intracoastal waterways, moving freight. Grain, gravel, and petrochemicals are frequent cargoes. Barges have shallow draft (that is, can operate in shallow water), so are heavily used on major rivers and canals, as well as near ocean ports. Larger vessels, called "Blue Water" tugs or barges, can operate offshore. One example is the lighters used to transport oil between supertankers and the coast. Barge traffic is monitored and regulated by the Coast Guard, with crews moving barges limited in the numbers of days they can operate the tug boat that provides the propulsion for the barges. Coast Guard certification of each barge is required before the vessel can be placed in service. Crew changes and loading of supplies are normally performed while the boat is under way.

Trucking and Warehousing

Move cargoes to and from the port, store cargo, etc. Although trucking and warehousing are sometimes provided together with one another, the two services need not always be performed by the same company. A growing area of trucking is intermodal, which involves containerized cargoes that can be moved from one mode of transportation (rail, truck, or ship) to another. It is common for intermodal companies

to have very little capital investment, using all leased equipment. Bonded warehouses are authorized to hold cargoes that have not yet cleared customs.

Connected with this growth in the intermodal aspect of trucking, there has been a replacement of other types of ships by container ships. All major ports now have dockside cranes designed specifically to load and unload containers.

The increase in the intermodal form of transportation is due to the three main attributes of containers: (1) portability (2) reusability and (3) versatility. Due to these attributes, containers can be used to hold many types of commodities.

These containers are: (1) of permanent character and strong enough for repeated use; (2) specifically designed for transporting goods by more than one mode of transportation without intermediate loading; (3) has fittings that permit easy handling when transferred from one mode to another; (4) designed for easy filling and emptying; and (5) has an internal volume greater than 1 cubic meter.

There are over 20 different types of containers. They are divided into two broad groups. These are general and specific cargo containers. The general cargo containers will handle all types of cargo. The specific cargo containers will handle specific cargo such as those that require temperature control, liquids and gases, dry bulk solids, and automobiles.

There are three general physical types -- boxes, platforms, and tanks. The box container is the most prevalent general purpose container. It is totally enclosed and waterproof. It has a rigid roof, with rigid side and end walls. It is suitable for carrying the greatest possible variety of cargo. The platform container is a "flat rack" which is used to carry oversized and odd-shaped cargo that can't fit easily into a box. This would be cargo such as machinery and earth moving equipment. The tank container is a tank that is enclosed within a structural steel frame work.

Miscellaneous

Cargo and Marine Survey, Mooring, Packing and Crating. **Cargo and Marine Surveyors** evaluate the condition and value of cargoes and vessels, and the seaworthiness of vessels. **Mooring** covers tying up a vessel at a dock and providing necessary services, such as telephone, to the vessel. **Packing and Crating** is simply packing cargo for shipment. There can be some overlap between this and the work of the Freight forwarder; however, packing and crating does not generally mean packing into containers. Containers are the specialized boxes that fit into especially designed holds on container ships, onto special railroad cars, or onto special trailers pulled by 18-wheel trucks. Their use dramatically reduces handling costs on shipment of containerized cargoes. See Exhibit 2-2 for a sample memo regarding cargo loading. (There are also memos available for cargo unloading.)

Sample of an Agency Agreement

AGENCY AGREEMENT

THIS AGREEMENT made between _____ LINES, INC.

(hereinafter called "L") of the first part and

_____ AGENCIES, INC.

Houston, Texas 77056 (United States of America) hereinafter called "A" of the second part.

WHEREAS, L are operating ships on their own account and for and on behalf of other persons for the carriage of cargoes throughout the world.

AND WHEREAS, A are General Agents in the business of the operating, management, employment and control of shipping and cargoes.

AND WHEREAS _____ AGENCY _____ NV (hereinafter called EA are L's General Agents in Europe.

IT IS HEREBY AGREED:

THAT A shall act as Agents for L in and about the matters hereinafter more particularly described.

1. GENERAL

- A. A shall be appointed and act as L's exclusive Agents in the United States of America, Canada, Mexico and all parts of the Caribbean including, but not limited to, Freeport (Bahamas) and San Juan (Puerto Rico), as well as South America (hereinafter called "the Americas.")
- B. A shall be at liberty to appoint such sub or substitute Agents, servants or representatives (hereinafter called "Sub-Agents) as they may from time to time think fit, provided always A shall remain responsible to L for all matters of whatever nature handled by such Sub-Agents if A have acted themselves within the scope of their authority hereunder.

- C. A shall at all times carry out their duties and obligations so as not to violate any Conditions or Rules of any Authority, Body or Organization engaged in the business of shipping.
- D. Remuneration to and expenses of Sub-Agents shall be paid by A as particularized in paragraph 10 herein.

2. CARGO SHIPPED FROM THE AMERICAS

- A. A shall make such arrangements as may be necessary for the calling forward of cargoes in good and sufficient time for loading upon L's vessels so as not to cause delay to the vessels and/or cargoes.
- B. For the purpose of calling forward and loading cargoes, A shall reasonably engage and supervise such modes of transportation of whatever nature as may from time to time be necessary and they shall be at liberty to transship, delay, refuse or reject any cargo which is not suitable for loading on a particular voyage (notwithstanding the said cargo may have been called forward for that voyage) or as L may direct.

3. CARGO HANDLING

- A. A shall in the name of L engage such stevedoring or other companies as may from time to time be necessary for the loading, stowing, discharging, tallying lashing, and securing of cargoes.
- B. For the purposes of supervising cargo handling and assisting stevedores, L's ships, Captains and the like, A shall appoint or employ from time to time, as may be necessary, a sufficient number of properly qualified Cargo Superintendents or Port Captains.

4. ATTENDANCES

- A. A by themselves or through their Sub-Agents shall make arrangements for and attend to the needs of all L vessels in the Americas including, but not limited to, customs, clearances, consular and sanitary documents, cargo lists, manifests, repatriation of crew, supervision of repairs and the like.

- B. A by themselves or through their Sub-Agents shall prepare and issue Booking Notes, Bills of Lading or other documents of carriage pertaining to cargo and shall ensure all the necessary export licenses, import licenses, permissions and formalities have been carried out for all cargo to be loaded on and discharged from L's vessels.
- C. As and when necessary, A shall act as Husbandry Agents for L's vessels and shall use due diligence in the arranging of and paying for supplies, stores, and necessaries for the said vessels.
- D. Where L have themselves or through EA chartered vessels on terms whereby L are not able to pay for harbourages, pilotages, towage, crew expenses, necessaries, stores and the like, A are at liberty to make such arrangements as they think fit with the Owners of the said vessels with regard to port disbursements and Agency. Any monies, commissions or profits made by A shall not be accountable to L.

5. FREIGHTS

- A. A shall themselves or through their Sub-Agents collect all freights, tariffs, costs, surcharges and the like promptly and shall keep a running check list upon all monies outstanding. Subject to paragraph 5 C herein, should any aforesaid freights and the like not be paid in full five weeks after the Bill of Lading date or sailing date, whichever is the earlier, A shall inform L and EA immediately and take such steps as may be necessary to obtain payment forthwith.
- B. Provided A have used reasonable diligence to obtain payment of freights, tariffs, costs, surcharges and the like they shall not be liable to L for any such non-payment for any cause whatsoever.
- C. Where Bills of Lading are marked "freight pre-paid" A or their Sub-Agents shall not release Bills of Lading or other documentation whatsoever until the freight has been received in full.

6. ACCOUNTING

- A. A shall be responsible for the keeping of proper and accurate accounting of all receipts and expenditures in accordance with Accounting Rules and Practices and shall promptly and diligently ensure all invoices of whatever nature are checked and verified as the case may be.

- B. A shall prepare accounting on a per-ship basis.
- C. All accounts of A appertaining directly or indirectly to L's vessels shall be open to inspection by L any time on demand and A shall send copies of all accounts properly audited to EA for forwarding to L at the end of every financial year.
- D. A shall keep accounts between themselves and Sub-Agents, Sub-Contractors or their servants in whatever currency A in their absolute discretion think fit. Accounting between A and L shall be in United States Dollars and whenever converting any other currencies to United States Dollars A shall ensure the best rate is obtained.

7. CLAIMS

If so instructed by EA, A shall process, prosecute, defend, negotiate, settle at law or at equity any actions or other proceedings of whatever nature, including, but not limited to, arbitration proceedings, arising directly or indirectly out of any contract or transaction whatsoever entered into by L whether through A as Agents or otherwise. For the purposes thereof, A may appoint and dismiss such Brokers Agents, Average Adjusters, Solicitors, Lawyers, Advocates or other persons as may from time to time be necessary.

8. STAFF AND SERVICES

A shall maintain a sufficient number of properly qualified persons together with an efficient telex telegraph, telephone and office services to diligently and properly carry out A's duties and obligations hereunder.

9. CONDUCT

- A. A will use due diligence and their best endeavors to develop and expand L's business in the Americas.
 - B. A will make regular reports to L and to any other persons as directed by L upon cargo bookings and availability, freight rates, market changes and trends as may assist in the development and expansion of L's business worldwide.
10. A. A will pay customary commissions for Forwarding Agents upon freights as follows:
- (i) where freight is pre-paid upon receipt of freight;
 - (ii) where freight is payable at destination one month after sailing.

- B. A will pay for and on behalf of L such commissions, remunerations, and expenses to Sub-Agents as may be agreed between them from time to time but unless expressly authorized by L the said commissions, remunerations and expenses shall not exceed that which would be payable hereunder to A had A themselves performed the services.
- C. L shall pay A:
 - (i) Booking commission of 1¼% for all freights whether earned or not earned, paid or not paid, booked by A themselves or by their Sub-Agents.
 - (ii) Commissions, remunerations and expenses incurred by Sub-Agents and paid by A in accordance with paragraph 10 B, herein.
 - (iii) A Supervisory fee of U.S. \$1,500.00 per vessel for all L's vessels loading in the Americas.
 - (iv) The appropriate Custom of the port fee pertaining to Houston, Texas City, Galveston, Freeport all in the State of Texas.
- D. L shall reimburse A for all sums expended on behalf of L's vessels and for the purposes thereof A may deduct from time to time sufficient sums as may be necessary from freights and monies received for and on behalf of L. Should the freights and monies retained by A be insufficient to cover the sums expended or reasonably foreseen as about to be expended, L shall either reimburse A immediately or put them in funds (as the case may be) or in their absolute discretion pay any creditors direct.
- E. A shall pay all their staff, offices, services and associated expenses themselves.

11. INSTRUCTIONS

- A. To facilitate and coordinate L's chartering business worldwide all messages, accounts documents and the like passing between A and L shall be routed through and passed on by EA in Antwerp.
- B. All instructions given and requests made to A by EA shall be deemed to emanate from L unless and until L shall inform A to the contrary in writing.

12. TERMINATION

This Agreement may be terminated by either party by giving six (6) months notice in writing.

13. LAW AND JURISDICTION

This Agreement shall be governed by English law and the English Court shall have exclusive jurisdiction.

Sample of a Memo Regarding Cargo Loading

FAX
 DATE:
 TO:
 ATTN:
 RE:

PORT TIMES: LAKE CHARLES

TIME	DATE	
23:12	3-Feb	All Fast___ NOR Tendered
23:40		Tanks Inspected
0:10	4-Feb	Hose On Triethane
0:30		Hose On Caustic
0:55		Commenced Loading Caustic
3:20		Commenced Loading Triethane
8:35		Completed Loading Triethane
9:15		Completed Loading Caustic
9:30		Hose Off Triethane
9:35		Hose Off Caustic
10:15		Cargo Gauged
11:00		Vessel Released

Cargo Loaded (VSL Figures)	N/BBLS	LT
Caustic	35,631.52	8,585.91
Triethane	2,553.28	527.54

ETA Bayonne — 15-Feb-92
 ETA Paulsboro — 17-Feb-92

Regards,

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Chapter 3

SHIPPING ISP

INTRODUCTION

The Shipping Industry Program Specialist provided information on the sourcing of income, Capital Construction Fund, excise taxes relating to shipping, direct and indirect taxation relating to shipping and a list of countries granting equivalent exemptions for income from the operation of ships in international traffic. These items relate to shipping companies involved in international trade, and are discussed below. As these issues are identified, contact with the Shipping Industry Program Specialist and/or referral to an International Specialist should be considered.

SOURCING INCOME

The most important area is the sourcing of income. This is the determination of whether income from a voyage should be taxed as U.S. income or foreign income. The authorities for this determination are Internal Revenue Code Sections 863, 883, 887, and Revenue Procedure 91-12.

IRC section 863(c)(1) states that all transportation income attributable to transportation that begins **and** ends in the United States shall be sourced as U.S. income. Also, 50 percent of all IRC section 863(c)(2) transportation income attributable to transportation which begins **or** ends in the United States shall be sourced as U.S. income. Under IRC section 863(c)(3), transportation income is any income derived from or in connection with, the use, hiring, or leasing for use of a vessel, or the performance of services directly related to the use of the vessel. The term "vessel" includes containers used in connection therewith.

Revenue Procedure 91-12 covers the specifics of sourcing income and it divides income into leasing and nonleasing income. One item which must be determined is whether the income is effectively connected with a U.S. trade or business. If the income is effectively connected, the foreign entity must file a tax return and pay tax on the basis of its net income. [See IRC sections 871(b) and 882.] To be *effectively connected nonleasing income*, the foreign person must maintain a fixed place of business in the United States involved in the earning of the U.S. transportation income and "substantially all" of the foreign person's U.S. transportation income is attributable to regularly scheduled transportation. To be *effectively connected leasing income*, the foreign person must maintain a fixed place of business in the United States that is involved in the earning of U.S. transportation income and "substantially all" of the person's U.S. transportation income from leasing must be attributable to that fixed place of business. Per IRC section 887(2) the term "Substantially all" means at least 90 percent. Normally liner operations are regularly scheduled (a ship follows a

published schedule with repeated sailings at regular intervals that begin or end in the United States) and tramp shipping is not regularly scheduled. This also applies to leasing income. Leasing income means the bare boat charter of a vessel. Time or voyage charter income is not considered income from leasing; however, it is considered income from the use of a vessel.

Under IRC section 887(a), a nonresident alien individual or a foreign corporation is subject to a four percent tax (without allowances for deductions) on United States source gross transportation income. U.S. Source Gross Transportation Income does not include any income taxable as effectively connected income under IRC section 871(b) or section 882. [IRC section 887(b)(2), Rev. Proc. 91-12, and Treas. Reg. section 2.02(3).] They must file a Federal income tax return annually and report the tax liability in United States dollars, and pay the tax in United States dollars by check or money order attached to the return. A nonresident alien who is subject to Federal income tax on transportation income must file Form 104ONR, U.S. Nonresident Alien Income Tax Return. A foreign corporation which is subject to Federal income tax on its transportation income must file Form 1120F, U.S. Income Tax Return of a Foreign Corporation.

Items required to be on a schedule attached to the return are:

1. Taxpayer's name, identification number and taxable year.
2. For bare boat lessor of vessels:
 - a. Names and Lloyd's register number of vessels that were bare boat leased out by the taxpayer and that made voyages that began or ended in the United States during the tax year for which the operator derived United States source gross transportation income;
 - b. The country of registration of each such vessel;
 - c. Name and address of each lessee or person chartering each such vessel from the taxpayer, the term of each lease, and the number of days during the taxable year the vessel or aircraft was under lease;
 - d. Description of method used to determine the U.S. source gross transportation income from the leases for each vessel listed, and the calculation used to apply this method;
 - e. Total amounts of gross rents for the taxable year for each vessel and for all such vessels.
3. For taxpayers earning income from the operation of vessels including time or voyage charter hire:
 - a. U.S. Customs Service International Carrier's Bond Number (if any);

- b. Names and Lloyd's register number of each vessel operated by the taxpayer during the tax year that made a voyage to or from the United States during the taxable year from which the operator derived U.S. source gross transportation income; and
 - c. Total U.S. source gross transportation income earned from the operation of each vessel and for all such vessels for the taxable year.
 - d. If the taxpayer operates a vessel which is under a bare boat lease the following items must be included:
 - 1) Name and address of the lessor of the vessel and
 - 2) Term of the lease or charter and method for calculating the rental portion of the payment.
4. For persons providing services directly related to the use of vessels:
- a. Description of types of services performed;
 - b. Names of vessels on which such services were performed;
 - c. Amount of U.S. source gross transportation income derived from each type of service for each vessel for the calendar year;
 - d. Total amount of U.S. source gross transportation income derived from all types of services for the calendar year.

There are provisions for claiming exemptions from the tax. IRC section 872(b) covers the provisions for individuals. These involve nonresident aliens who are residents of a foreign country that provides an equivalent exemption to individual residents of the United States. IRC section 883 provides for exclusion from gross income. One of the exclusions granted is for gross income derived by a corporation organized in a foreign country from the international operation of a ship, if that foreign country grants an equivalent exemption to corporations organized in the United States. The foreign corporation must also satisfy one of the following rules:

- 1. Show that more than 50 percent of the value of its stock is owned by individual residents of the foreign country where the corporation was organized or of another foreign country that grants such an equivalent exemption to corporations organized in the United States (listing of countries granting equivalent exemptions is attached); **or**
- 2. The foreign corporation is a controlled foreign corporation as defined in IRC section 957(a); **or**

3. The stock of the foreign corporation is primarily and regularly traded on an established securities market in the foreign country where the corporation is organized, in another foreign country that grants such an equivalent exemption to corporations organized in the United States, or in the United States.

To claim an exemption under IRC section 872(b) or IRC section 883, the foreign person must file a return and specifically claim the exemption. Port related industries listed in Chapter 2 of these materials are **not** entitled to exemptions under IRC section 883. (See Rev. Rul. 89-42 listing countries granting equivalent exemptions.)

Foreign persons also may claim an exemption from U.S. taxation of their shipping income under an applicable income tax convention (treaty) and IRC section 892. To claim such an exemption, a foreign person must file a return and meet the requirements of IRC section 6114 and the regulations thereunder. Other effects of income tax treaties are discussed below.

Another aspect of sourcing income is lightering. The taxpayers take the position that all income is foreign sourced up to the point of transfer. Therefore, if they transfer the cargo to another vessel (a lighter, which is a smaller vessel) outside the U.S. territorial 3-mile water limit, then the income is foreign sourced up to the point of the transfer. An example is a shipment of crude oil from Saudi Arabia (a 7,000 mile trip) the oil is transferred to a "lighter" after 6,982 miles, then the taxpayer only reports 18/7,000 or .257 percent as U.S. sourced income. The same is true if the taxpayer unloads the shipment at a pipeline outside the 3-mile territorial limit. The IRS takes the position that the final destination of the crude oil is the key. Because the final destination is in the United States and the point of origin is not, 50 percent of the income of both the host and lighter vessels should be sourced as U.S. income; the balance is foreign sourced. (The result would be the same 50/50 sourcing -- if the host and lighter were exporting oil from the U.S. to another country.)

CAPITAL CONSTRUCTION FUND

The capital construction fund program is a part of the Merchant Marine Act of 1936, as codified in section 1177 of Title 46 of the United States Code. The tax provisions of the capital construction fund (the "CCF") were recodified in section 7518 of the Internal Revenue Code. Designed to foster the development of a merchant marine fleet, a CCF is a tax deferral mechanism which allows taxpayers to deduct from income certain types of income deposited into it and the earnings therefrom. Once a fund is established, amounts deposited in the fund are deductible in computing taxable income and the earnings from the fund are deductible from income. (See Form MA-172, Financial Report, Department of Transportation, Maritime Administration.)

Qualified withdrawals made for the acquisition, construction, or reconstruction of a qualified vessel, for the acquisition, construction, or reconstruction of barges and containers which are part of the complement of a qualified vessel, or the payment of the principal on indebtedness incurred in connection with the acquisition, construction,

or reconstruction of a qualified vessel or a barge or container are not included in the taxpayer's income. Conversely, the Code provides that any withdrawal from a CCF which is not a qualified withdrawal shall be treated as a nonqualified withdrawal. Examples include payments against indebtedness in excess of basis, amounts remaining in a fund upon termination of the fund, and amounts attributable to failure to fulfill substantial obligations under the agreement.

Taxes are recaptured in the CCF program after monies are withdrawn for payment on a vessel. This results because when a vessel is built with CCF funds, its depreciable basis is reduced, decreasing the amount of the available depreciation deduction, which increases the amount of the taxable income attributable to the taxpayer.

EXCISE TAX

IRC section 4471 imposes a tax of \$3 per passenger on each covered voyage. The tax should be paid by the person providing the voyage. IRC section 4472 states that a covered voyage is a voyage of a commercial passenger vessel which extends over one or more nights or a commercial vessel transporting passengers engaged in gambling aboard the vessel beyond the territorial waters of the United States. The passengers must embark or disembark the vessel in the United States. These provisions do not apply to vessels owned or operated by the United States, a State or any agency or subdivision thereof.

Revenue Notice 90-10 states that a commercial passenger vessel should have berth or stateroom accommodations for more than 16 passengers if the voyage extends over one or more nights. If the vessel is engaged in gambling, the territorial limit of the United States is the 3-mile limit.

IRC section 4042 imposes a tax on fuel in commercial transportation on inland or Intracoastal waterways. Commercial waterway transportation is the use of a vessel on any inland or Intracoastal waterway of the United States in the business of transporting property for compensation or hire, or in transporting property in the business of the owner, lessee, or operator of the vessel (whether or not a fee is charged). The total rate of tax varies. For example, for fuel used during 1990, the tax was 10.1 cents per gallon; for fuel used during 1993, the tax was 17.1 cents per gallon through September 30, 1993, and 21.4 cents per gallon from October 1, 1993, through December 31, 1993. Beginning January 1, 1994, the rate increases to 23.4 cents per gallon.

TAXATION OF FOREIGN ENTITIES AND NONRESIDENT ALIENS (NRAs)

The United States may impose tax on foreign persons under the following sections of the Code:

1. **Section 871(a).** Certain income (generally passive income, including dividends and interest) of a foreign taxpayer that is not treated as effectively connected with the foreigner's U.S. trade or business is subject to 30 percent tax and withholding; see sections 871(a) and 1441 (in the case of NRA individuals).
2. **Section 871(b) and 882.** Where a foreign taxpayer has income that is effectively connected with the conduct of a U.S. trade or business, net basis tax (that is, taking into account the deductions attributable to the business activity) is imposed under section 871(b) (in the case of NRA individuals) or section 882 (in the case of foreign corporations or other entities taxable as associations).

The performance of personal services within the United States is a trade or business for this purpose. A foreign corporation that derives operating income or whose vessel is under full rental will be engaged in a U.S. trade or business if it derives a portion of its operating income or charter hire from sources within the United States. See IRC section 887(b)(4) for the definition of "effectively connected income" in the case of transportation income.

3. **Section 884.** Where a foreign corporation conducts a U.S. trade or business, the corporation may, in addition to the net basis tax imposed under IRC section 882, be liable for the 30 percent branch profits tax (BPT) under IRC section 884(a). In general, the BPT applies if the branch is treated as remitting (because it does not reinvest its profits in the United States) a "dividend equivalent amount" to its notional foreign parent. Under IRC section 884(f), a branch also may be subject to a 30 percent tax and withholding on "excess interest" it is treated as paying to its national foreign parent.
4. **Section 887.** Under IRC section 887, a NRA or foreign corporation may liable for a 4 percent tax on its "U.S. source gross transportation income" that is not (1) treated as effectively connected with the conduct of a U.S. trade or business (under the rules of IRC section 887(b)(4), or (2) taxable, under the Code, in a U.S. possession.
5. **Indirect Taxation.** In general, under subpart F of the Code (sections 951-964), a U.S. shareholder of a controlled foreign corporation (CFC) is required to include in income his or her pro rata share of the CFC's subpart F income. This can include its "portable" income or other types of disfavored income, such as foreign base company sales, services, or shipping income, but not including any income that is effectively connected with a U.S. trade or business. A CFC that operates or leases vessels carrying cargo or passengers in or out of U.S. ports, or that is related to the operator of such vessels and performs certain services, may have

such income. For subpart F purposes, a "U.S. shareholder" means a United States person who owns, or is treated as owning, 10 percent or more of the total combined voting power of all classes of foreign corporation's stock that is entitled to vote.

6. **Tax Treaties.** Under a tax treaty, certain U.S. activities of foreign taxpayers that otherwise would constitute a U.S. trade or business may not rise to the level of a U.S. "permanent establishment," so that the U.S. source income derived therefrom may not be subject to tax under generally applicable Code rules. Moreover, tax treaties may limit or preclude the application of the branch profits tax. Treaties also may expand upon the exclusion of IRC section 861(a)(3) for certain personal services income performed by a NRA within the United States. Treaties may have other effects not here described, including the exemption of business profits derived from U.S. activities of the foreign taxpayer that do not rise to the level of a permanent establishment.

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Chapter 4

ACCOUNTING METHODS

INTRODUCTION

Accounting methods used by the port related industries include cash, accrual, and hybrid methods along with a specific method called voyage accounting. Most taxpayers utilize the accrual method, and properly match revenue with expenses, but some service companies may have attempted to defer income while deducting expenses currently. The agent needs to verify whether income and expenses are properly matched. Within this section we discuss accounting methods used by the following port related industries:

1. Ship owners and operators
2. Shipping Agents
3. Barge Companies
4. Ship Repair Companies
5. Ship Construction Companies
6. Trucking Companies

Other port related industries generally record their income and expenses as other non-port related industries do, and, therefore, are not included in this section.

SHIP OWNERS AND OPERATORS — VOYAGE ACCOUNTING

The voyage method of accounting holds revenues and expenses in suspense until the voyage is completed, then all income and expenses are reported. This is similar to job order cost accounting. Records are maintained for each vessel and voyage as a separate job.

Voyages may start at one port with their final destination at another port, or the ship may have two home bases. Alternatively, a voyage may consist of a complete round trip that a ship takes from home base to home base, with several stops in between. How a particular company defines a voyage should be included in the initial interview questions. (See Exhibit 4-1 for a sample of a vessel schedule.)

A ship operator or owner will usually have contracts with his or her clients. These can be long-term or short-term contracts depending on the type of ship and/or the needs of

the client. These contracts include the details of how the particular shipments of that company will be handled. They are similar to lease agreements.

In voyage accounting the income is not reported and the expenses are not deducted until the voyage is completed. The difficulty with this method occurs when a voyage starts in one tax year and is completed in the following tax year. If using the completed voyage method of accounting, the income and expenses of the particular voyage are deferred to the year when the voyage is completed. Some companies estimate the income and expenses at the time incurred and adjust to actual upon completion of the voyage; some companies report part of the total income and expenses in the year the voyage started and the remainder in the year the voyage is completed. Either may be an acceptable method of accounting depending on the facts and circumstances of the case. See below for when the completed voyage method of accounting will be acceptable. The examiner must determine if the method of accounting clearly reflects income, matches revenue with expense, and is consistently used by the taxpayer from year to year.

There are two court cases, *Planet Line Inc. v. Commissioner*, 89 F.2d 16 (2 Cir. 1937), and *Falketind Ship Company v. Commissioner*, 6 BTA 44 (1927), which determined whether the completed voyage method of accounting is acceptable. Each company used the completed voyage method of accounting and in each case this method of accounting was determined to clearly reflect income. Although these two cases indicate that this method is acceptable, the Internal Revenue Service has determined that there have been new court cases since these which limit the acceptability of the completed voyage method of accounting.

In *Automobile Club of Michigan v. Commissioner*, 353 U.S. 180 (1957), *American Automobile Association v. Commissioner*, 367 U.S. 687 (1961), and *Schlude v. Commissioner*, 372 U.S. 128 (1963), it was that determined that accrual method taxpayers must report advance payments as income upon receipt even though the services have not yet been provided. The advance payments were received under a claim of right by these taxpayers without a restriction to their disposition and therefore the advance payments should be reported in the year that they were received.

In the *Falketind* case noted above, Falketind Ship Company received an advance payment. Under the new cases, the advance payment should be included as income upon receipt. See discussion on Revenue Procedure 71-21 later in this chapter for how a shipping company may defer some advance payments.

The contract between the shipper and the client will determine the proper time to accrue income. The completed voyage method of accounting will be acceptable if the contract specifically provides that payment is contingent upon the successful completion of the voyage. This is the only time that the completed voyage method of accounting will be acceptable.

In other circumstances, the performance of the shipping services will cause the accrual of income prior to the completion of a round-trip voyage. If the contract gives the

shipper a right to payment prior to performance or prior to completion of the voyage, income should be accrued the earliest of (1) when the payment is due or (2) payment is made as stated under Rev. Rul. 74-607, 1974-2 C.B. 149 and Rev. Rul. 79-195, 1979-1 C.B. 177.

REVENUE PROCEDURE 71-21

Revenue Procedure 71-21, 1971-2 C.B. 549 allows an accrual method taxpayer who receives payment for services in one year and performs the services in the succeeding year to defer reporting at least a part of the income until the next succeeding year.

In general, tax accounting requires that payments received for services to be performed at a later date must be included in income in the year of receipt. Quite often complete payment from the ship operator's client is received before the voyage begins. Rev. Proc. 71-21 allows the taxpayer to include in income in the year of receipt, the ratable portion of income based on the percentage of the voyage that is completed in the first year and the remainder in the succeeding year. The voyage also must be completed in the first succeeding year after payment is received. Therefore, for a calendar year taxpayer who received total payment on December 10 for a voyage that begins on December 15 and concludes on January 15 of the following year, one-half of the income is includible in income in the first year and the remainder is includible in income in the following year. (Note: Rev. Proc. 71-21 only applies to situations where there are advance payments received on or prior to the date the voyage begins.)

The ship owner or operator will need to meet the other requirements to use this method of accounting as stated in the revenue procedure. The ship owner or operator to use this method of accounting must request permission to do so by filing Form 3115 (Application for Change in Accounting Method).

SHIPPING AGENTS

A shipping agent generally provides various services to the ship operator or owner for a commission. The agent takes care of placing cargo with a particular ship and arranges for pilots, stevedores, repairs, etc. In addition, he or she may pay all the expenses and handle all paper work for the ship owner or operator. The ship agent is paid a commission based on the services contracted. Usually at the time the shipping agent's services are contracted, the ship owner will advance funds to the agent to cover the anticipated expenses. These are not advance payments as discussed above under ship owners or operators and they should not be included in income. The agent keeps track of all expenses, including his or her commission, and the remaining funds are forwarded to the ship owner at the completion of the voyage. If the advance payment is inadequate to cover the expenses, the shipping agent invoices the ship owner for the amount due. (See Exhibit 4-2 for a sample of an invoice.)

The shipping agent may have one or more trust bank accounts and one operating bank account. In instances where the shipping agent represents several ships, a separate trust account may be maintained on each ship. Directly related income and expenses of the ships go through the trust accounts and are not recorded in the agent's general ledger. Then at the successful completion of the voyage, commissions due the shipping agent are usually transferred from the trust account(s) to the agent's operating account. The commission will not be transferred until there is successful completion of the voyage. The other expenses directly attributable to the shipping agent's business go through the operating account. The shipping agent also maintains records on each ship. He or she generally will file all records of one ship together in a file folder or box. These also may be further segregated by each voyage that particular ship makes. [See Exhibit 4-3 for a sample Laytime Statement (specifies date and time of specific action at beginning and ending port).]

The shipping agent must include the commissions as income upon performance of his or her services whether the taxpayer is using the cash or accrual method of accounting. The shipping agent has already deposited his or her unearned commissions in the trust account(s). Therefore the shipping agent should recognize the commissions upon the successful completion of the voyage. The shipping agent may not transfer the commissions from the trust account(s) to the operating account in a timely manner after successful completion of the voyage. The shipping agent under the cash method of accounting should include the commissions earned but not transferred by him or her under the doctrine of constructive receipt as stated in *Miele v. Commissioner*, 72 T.C. 290 (1979). Examiners should ensure that commissions are recorded to clearly reflect income as required by IRC section 446.

BARGE COMPANIES

Barges are either owned or chartered. The barge company's purpose is to place cargo with the barge and transport the cargo to its desired destination.

A barge is a vessel that does not contain its own propeller devices. The barge must be moved by a separate vessel, a towboat. There are several different types of barges for the movement of different types of cargo. The tank barge, for instance, is a barge with an enclosed compartment commonly used to transport oil. The unique aspect of a barge is it must be moved by a towboat.

Generally, barge companies do not use voyage accounting as ship operators do. However, for companies with several barges, each barge is treated as a separate cost center and all records for each barge are kept together.

SHIP CONSTRUCTION COMPANIES

Ship construction companies may spend 2-3 years (or more) on the construction of one ship. Generally, they use completed contract accounting.

SHIP REPAIR COMPANIES

Ship repair companies usually are on the accrual method of accounting. They do not bill their customer until a particular job is completed. The jobs on the larger ships usually take between 2 and 3 months for completion. These companies, therefore, do not request payment until the completion of the entire job. The income and expenses on jobs that have not been completed at the end of the year are deferred to the following year when the customer is billed. Note: Ship repair companies do not generally receive advance payments on their jobs. Ship repair income is not transportation income under IRC section 886, so it does not qualify for the exclusion from U.S. income tax.

TRUCKING COMPANIES

Accounting methods used by many trucking companies consist of unsophisticated single entry systems. Records are not maintained in an orderly fashion, and are generally incomplete. Large amounts of cash are exchanged without documentation, and asset schedules are often inaccurate and incomplete.

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Sample of a Vessel Schedule

FAX

PAGE 1 OF 1

TO: Pittsburgh

ATT:

FROM:

DATE: 7-Feb-92

RE: Vessel Schedule Update

M/V Vessel #1

M/V Vessel #2

	V9202	V9203 (Tentative)	V9203 (Tentative)
Lake Charles		13-Mar-92	23-Feb-92
Providence			1-Mar-92
Bayonne	15-Feb-92	23-Mar-92	2-Mar-92
Paulsboro	17-Feb-92	25-Mar-92	4-Mar-92
	8,550 LT Caustic		7,800 LT Caustic
	525 LT Triethane		

N/V Vessel #3

	V9201	V9202 (Tentative)
Lake Charles	12-Feb-92	4-Apr-92
San Pedro	28-Feb-92	20-Apr-92
Richmond	3-Mar-92	24-Apr-92
	11,600 LT ET Caustic	
	1,075 LT Triethane	

Regards.

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Sample of an Invoice

6-Feb-92
Invoice #083M02

Attention:

Re: 202
C/P 11/30/89

OCEAN FREIGHT

CARGO:	Caustic	8,562.23	LT
	Tri-ethane	527.21	LT
	TOTAL	9,089.54	LT

LOAD PORT/TERMINAL: Lake Charles/

LOAD DATE: 2/4/92

DISCHARGE PORTS/TERMINALS: Bayonne/RD & Paulsboro/Seaview

DISCH DATES: 2/15/92 & 2/17/92

FREIGHT DUE:

9,089.54	LT @ \$17.08	= \$155,249.34
TOTAL AMOUNT DUE:		= \$155,249.34

DATE DUE: 2/17/92

PLEASE PAY BY WIRE TRANSFER AS FOLLOWS

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Sample of a Laytime Statement

February 27, 1992

LAYTIME STATEMENT

CHARTERER:
C/P DATED: 11/30/89

LOAD PORT (LAKE CHARLES)

DOCKED 2/3/92 23:12
LAYTIME COMMENCES 2/3/92 23:12
TANKS PASSED 23:40
STARTED LOADING 0:55
FINISHED LOADING 2/24/92 9:15
HOSE OFF 9:35
VESSEL RELEASED 11:00
LAYTIME ENDS 2/4/92 11:00

USED LAYTIME LOAD PORT(GROSS) 11.80

CARGO LOADED LONG TONS
CAUSTIC 8,562.33
TRIETHANE 527.21

TOTAL 8,089.54

LAYTIME SUMMARY

USED LAYTIME LOAD PORT 11.80
USED LAYTIME DISCH PORT 1 13.67
USED LAYTIME DISCH PORT 2 10.75
TOTAL USED LAYTIME 36.22
LESS PUMPING PERFORMANCE ADJUST. 0.00
TOTAL LAYTIME USED (NET) 36.22
ALLOWABLE LAYTIME 42.36
EXCESS LAYTIME USED -6.14

DISCHARGE PORT 1 (BAYONNE)

DOCKED P.D. TERMINAL 2/16/92 7:00
LAYTIME COMMENCES 2/16/92 7:00
CARGO GUAGED 8:00
START DISCHARGING 8:40
FINISH DISCHARGING 2/16/92 20:00
HOSES OFF 20:20
VESSEL RELEASED 20:40
LAYTIME ENDS 2/16/92 20:40

USED LAYTIME DISC PORT (GROSS)

DISCHARGE PORT 2 (PAULSBORO)

DOCKED SEAVIEW 2/17/92 17:00
LAYTIME RESUMES 2/17/92 17:00
HOSE ON 17:10
START DISCHARGING 2/17/92 18:25
FINISH DISCHARGING 2/18/92 3:20
HOSES OFF 3:45
VESSEL RELEASED 3:45
LAYTIME ENDS 2/18/92 3:45

USED LAYTIME DISCH PORT (GROSS)

DEMURRAGE CALCULATION

PUMPING PERFORMANCE ADJUSTMENT DEMURRAGE = 0 HRS × \$1,276.35/HR

BAYONNE 11.33 HRS
PAULSBORO 8.92 HRS
TOTAL PUMPING TIME 20.25 HRS
ALLOWABLE PUMPING TIME 18.18 HRS
PRESSURE AT MANIFOLD N/A PSI
PUMPING UNDER-PERFORMANCE 0.00 HRS

DEMURRAGE DUE \$0.00

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Chapter 5

INCOME

INTRODUCTION

Since many businesses around the port are small and/or closely-held, it is vital for the examiner to pay close attention to internal controls and to tracking cash. Wire transfers are the most common means of payment in this industry, but cash is used to a surprising extent. Analysis of CTR information can be helpful, as well as analysis of deposits.

UNUSUAL TYPES

Generally, income in port-related industries is like that received in other types of business. There are a few unusual types.

Steamship Agents

Generally, steamship agents receive an advance from their client designed to cover the estimated expenses for which the agent will be responsible before the ship reaches the port. The agent pays the expenses as they are incurred, keeping a copy of all invoices in a voyage or ship file. When all expenses have been billed and paid, the agent sends a statement to the client that shows all items of income and expense, the amount of the agent's commission, and the balance due to the agent or refund due to the client. Depending on the length of the voyage, and the size of the amounts involved, interim statements may be issued to the client rather than just one at the end.

Steamship Agents handle large income and expense items for their clients, and receive commissions and fees for their services. Generally, the agents have one or more trust bank accounts used to handle these items, and most of the money they handle never passes through their operating bank account -- or their general ledger. When the voyage is completed, the agent sends a statement to the client showing all items of income and expense (including the agent's commissions) and transfers the commission amount from the trust account to the operating account. It is only at this point that the transaction would be reflected in the general ledger. This gives the agent great control over timing of income recognition. Examiners should be alert for unreasonable delays in recognizing earned income. See Voyage Accounting in Chapter 4, Accounting Methods, for a further discussion of when the commissions should be recognized as earned income. (See Exhibit 5-1 for a sample of an Economic Analysis of one voyage.)

Agents receive commissions for: booking cargoes, based on so much per ton of cargo booked for their clients (they may also receive commissions from the person shipping

the cargo); expenses arranged for the ship, based on a percentage of the costs involved; and general representation, such as \$150 per month during the time that the ship is in the Western hemisphere. They also receive fees for particular services provided for clients, such as bookkeeping or filing tariff reports and revisions. Not all agents will receive every type of fee or commission.

Wharfage Fee

The Port of Houston charges a **wharfage** fee for anything which goes over the dock into or out of the Port. This fee is based on the weight of each ship, and the Port allows agents a 2 percent discount on the price if they collect it and pay it over to the Port so that the Port doesn't have to collect it from each ship. The agent may charge based on the amount of each shipment, rather than the size of the ship. The agent keeps the difference between what he or she pays to the Port and what he or she collects from the operator.

Trucking Companies

Trucking companies will have income for shipment of cargo. Usually, the payment is received before the cargo is shipped, or immediately on delivery of the cargo at the destination. We encountered several instances in which unusual items of income (sales of equipment, for instance) were not reported. Record keeping and accounting are likely to be haphazard among the smaller companies since the persons actually keeping the books may have little or no accounting or bookkeeping knowledge.

Surveyors

Surveyors are paid on an hourly rate that depends on the complexity of the cargo being surveyed and how much business the surveyor does with the client. In addition, the client reimburses the surveyor for out of pocket expenses such as travel and telephone. Since the surveyor probably will be deducting these reimbursed expenses, it is important to discover how the reimbursements were treated in determining gross receipts.

Barge Companies

Barge companies receive commissions from shippers based on the volume shipped, that is, barrels of oil, tons of wheat, or containers of manufactured goods. They also receive a fee if they transport the shipment in a shorter time than requested.

Another way for barge companies to receive income is from the charter of a barge. Any time that a barge is not in service represents lost revenue for the taxpayer. Therefore, the barge owners try to keep their barges in service 24 hours a day, 7 days

a week, only removing them from service for repairs and maintenance. If they don't have work for the barge, they will charter it to another company (usually a related one). The charge for the charter varies depending on the type of charter, and is usually so much per day. The amount will vary from month to month depending on the number of days that a barge was actually chartered.

Stevedore Income

Stevedore income is generally based on a set fee in advance. The stevedoring company bids for a job loading or unloading a ship. In the bid, they calculate the hours, men, and equipment needed to complete the job. In the event of equipment breakdowns or inclement weather, the actual charge may vary from the bid. (Assuming the equipment that breaks belongs to the ship, rather than the stevedoring company, the operator must pay for the stevedores' wasted time.)

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Sample of an Economic Analysis of One Voyage

ECONOMIC ANALYSIS				
VOYAGE 8901D				
6/20/89 REV #2	START	FINISH	DAYS	
	5/23/89 18:22	6/16/89 19:00	24.03	
FRONTHAUL CARGOES				
CHARTERER	PRODUCT	LONG TONS	RATE(S/LT)	REVENUE
	CUMENE	0.00	\$18.54	\$0.00
	MTBE	17,496.30	\$17.47	\$305,669.10
	CAUSTIC	0.00	\$21.55	\$0.00
	PERC	0.00	\$24.50	\$0.00
	PARAFFIN (1012)	4,772.58	\$20.37	\$97,217.45
	MTBE	5,838.16	\$19.50	\$113,844.12
	REFORMATE	0.00	\$9.00	50.00
	NATURAL GASOLINE	12,023.69	\$9.48	\$113,940.91
TOTAL FRONTHAUL CARGO		40,131.23	\$15.72	<u>\$830,571.58</u>
BACKHAUL CARGOES				
CHARTERER	PRODUCT	LONG TONS	RATE(S/LT)	REVENUE
	ACETONE (R&H)	0.00	\$13.65	\$0.00
	ACETONE (ARISTECH)	0.00	\$13.65	\$0.00
	ACETONE (DEADFREIGHT)	0.00	\$13.65	\$0.00
	HEARTCUT REFORMATE	6,400.00	L.S.	\$0.00
BACKHAUL/TOT	LT/AVGS/LT/TOT REV	6,400.00		\$0.00
MISC REVENUE				\$0.00
OFF-HIRE DUE TO RED SPEED DUE TO M.E. PROBLEMS		3.0 DAYS		\$66,000.00
OFF-HIRE DUE TO RED SPEED DUE TO M.E. REPAIRS		0.00		\$0.00
	EXTRA BERTH CHARGE			\$15,000.00
	EXTRA BERTH CHARGE			\$0.00
TOTAL MISC REVENUE				\$81,000.00
TOTAL REVENUE				<u>\$711,571.58</u>
EXPENSES				
CHARTER HIRE		\$23,000.00/DAY		\$528,733.33
IFO (MT)		460.00	\$28.00	\$40,480.00
MGO (MT)		125.00	\$170.00	\$21,250.00
PORT CHARGES		\$7,000.00	8	\$56,000.00
BROKER'S COMMISSION				\$11,808.01
BARGING EXPENSE NEW YORK/PHILADELPHIA				\$49,000.00
CHARTERER'S LEGAL LIABILITY INSURANCE				\$1,200.00
- DISPATCH				\$4,000.00
- FUEL DE-ESCALATION/(ESCALATION)				\$0.00
- FUEL DE-ESCALATION/(ESCALATION)				\$4,843.56
- FUEL DE-ESCALATION/(ESCALATION)				\$0.00
- FUEL DE-ESCALATION/(ESCALATION)				\$0.00
- FUEL DE-ESCALATION/(ESCALATION)				\$5,840.06
TOTAL FUEL DE-ESCALATION/(ESCALATION)				\$10,683.63
	SHARE OF PROFIT = (\$5,741.69)			\$0.00
TOTAL EXPENSES				<u>\$723,154.97</u>
SUMMARY				
FRONTHAUL(JP)	REVENUE/DAY	EXPENSE/DAY	PROFIT/DAY	VOYAGE PROFIT
40,131.23	\$29,611.85	\$30,089.67	(\$477.81)	<u>(\$11,483.39)</u>
VGS/LT FRTHAU	VSL UTILIZATION	BACKHAUL(LT)	T.C. EQUIVALENT	BUDGETED PROFIT
\$15.72	102.90%	\$6,400.00	\$21,522.19	\$0.00

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Chapter 6

REPAIRS

INTRODUCTION

There are two common areas of concern for repairs. The first is the inclusion of personal items within the expense; the second is expensing items that should have been capitalized.

FIRST COMMON AREA

The audit technique used to discover the first is to sample the account. If possible, a statistical sample would be useful, otherwise use a judgmental sample. If personal items are discovered, the items can be constructive dividends to the shareholder or included as part of the shareholder's compensation.

SECOND COMMON AREA

The second area is more difficult to prove. When looking at the larger specific items under repair expense, determine whether the cost should have been capitalized. Treas. Reg. section 1.263(a)(1) specifies that amounts paid to adapt property to a new or different use, or which add to the value or substantially prolong the life of property owned by the taxpayer, are capital expenditures not repair or maintenance expenses. In determining whether the useful life has been extended, you must consider the economic life. The recovery period for ACRS and MACRS is the average life of a composite of assets used in a particular industry, and is not relevant to the determination of the economic life. In this industry you should not make the determination based solely on the amount of the expense. There are times when a large expense is actual maintenance and a smaller amount may be a capital item. A marine vessel's life may be determined by the condition of its hull. When auditing a barge company or any company that depreciates marine vessels, review closely all work performed on the hull because it may be capital. For example, periodically the vessel must be drydocked to receive Coast Guard certification. When in drydock, the vessel could have various parts of the hull replaced, seams in the hull welded, and the hull sandblasted and painted. All of these items are potential capital expenditures. Also if enough "crop and renew work" (replacing parts of the hull) is performed, it will increase the life of the vessel, and therefore, be a capital expenditure.

Many of these companies perform their own drydocking and repairs. In order to do so, they usually keep various materials on hand to perform these services quickly. Those materials should be inventoried and not expensed when purchased. If the

materials are inventoried, a decision can be made during the drydocking process as to which items are capitalized and which are expensed.

There are several court cases relating to repair versus capitalizing items on barges. The court case *Phillip Shore and Ann E. Shore, et al. v. Commissioner*, T.C. Memo 1959-166 specifies that amounts expended by a corporation for the purchase and installation of marine engines in a ship owned by it were ordinary and necessary business expenses. The reasoning is that the engines did not prolong the life of the marine vessel. *R.K. Walling Est.*, 67-1 U.S.T.C. 9238, states that the cost of putting two barges in operating condition by a partnership prior to transfer to a corporation in exchange for stock is a deductible repair expense. *P. Dougherty Co.*, 47-1 U.S.T.C. 9117 shows that the cost of rebuilding the stern of a barge is a capital expenditure and not currently deductible as a repair expense. *L & L Marine Services, Inc.*, 54 TCM 312, Dec. 44,150(M) stated that frequent repairs are necessary on transport barges because of the punishing use for which the barges are subjected. Therefore these expenses are currently deductible repair expenses. However, these court cases are old and may be unique situations. For example, under *Shore*, new marine engines were considered as repairs. Usually, marine engines outlast the vessel, and, therefore, should be capital expenditures.

It is important to remember when capitalizing repairs that were performed overseas, that U.S. Customs imposes a 80 percent *ad valorem* tax on unnecessary repairs performed overseas. If we change an item from repair to capital, and the Customs *ad valorem* tax was imposed, the taxpayer should be notified of a potential refund from Customs of the 50 percent tax. Furthermore, the taxpayer will benefit considering the income tax rate is a maximum of 34 percent, and capital items receive depreciation treatment. The Customs *ad valorem* tax can be located at 19 USC 1466; it applies to U.S. flagged ships which are licensed for foreign trade. The ships are only allowed to receive repairs which are necessary for the protection of the vessel from overseas. If the vessel can safely arrive in the United States without the repair, then it is a taxable event. Modifications of the vessel are tax free.

Some useful audit techniques:

1. Examine the M-1 adjustments. In many companies the cost accountants want the expenditure to be capital because this will not affect earnings and profits. The tax accountants want it to be a repair because this will reduce taxable income. When there is a disagreement within the company, there is a good possibility that the item is a capital expenditure.
2. Consider the value of the vessel. If the vessel's value is \$2 million and the expenditure is \$500,000, there is a good possibility that it is a capital expenditure.
3. Consider the 5-year repair record of the ship and the fleet. If the amount is listed normally as repairs this is probably correct. However, if the amount is substantially larger than normal repairs, it is possibly a capital expenditure. To make the determination of whether an expense is currently deductible or not, it is

necessary to look at the complete picture and talk to the taxpayer. If the amount is significant, it would be advisable to contact an engineer. You may contact the marine specialist engineer in New York with specific questions.

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Chapter 7

EMPLOYMENT TAX

INTRODUCTION

This chapter describes various issues that may arise regarding employment tax as it relates to port-related industries. The chapter has five sections:

1. Meals and lodging
2. Services performed for foreign vessels
3. Services performed for U.S. vessels
4. Stevedores
5. Ship pilots.

MEALS AND LODGING

Prior to 1981, the Internal Revenue Service took the following position regarding the value of meals and lodging. Revenue Ruling 71-290 (C.B. 1971-2, 340) stated that the value of meals and lodging furnished to officers and members of the crew of a vessel constitutes "wages" for purposes of FICA and FUTA tax. These wages were not subject to income tax withholding at the time. In 1981, the Rowan case was settled by the U.S. Supreme Court that changed the Service's position.

Rowan Companies, Inc. v. United States, 101 S.Ct. 2288 (1981) stated that the Treasury Regulations interpreting the definition of "wages" for purposes of FICA and FUTA tax were invalid. Therefore, the value of meals and lodging provided to the employees on offshore oil rigs **for the convenience of the employer** (emphasis added) are excluded from employee's wages for FICA and FUTA to the same extent that they are excluded for income tax withholding.

Revenue Ruling 81-222 (C.B. 1981-2, 205) then revoked Revenue Ruling 71-290 quoted above by stating that the value of meals and lodging furnished to employees by employers for the convenience of the employer is not subject to FICA and FUTA tax. Sections 3121(a)(19) and 3306(b)(14) of the Code reflect the new treatment to be accorded meals and lodgings as they relate to FICA and FUTA tax.

Therefore, the key fact to be determined is whether the meals furnished to officers and members of the crew are for the convenience of the employer.

SERVICES PERFORMED FOR FOREIGN VESSELS

Treasury Regulation section 31.3121(b)(4)-1 describes services performed for foreign vessels. The services performed by an individual on or in connection with a foreign flag vessel are exempt from FICA and FUTA tax if:

1. The individual is employed on or in connection with such vessel when outside the United States, and
2. Such individual is not a U.S. citizen or the employer is not an American employer.

Conversely, an individual who performs services on or in connection with a foreign flag vessel outside the United States is covered if the individual is a United States citizen and the employer is an American employer. An American employer is any of the following:

1. United States or any instrumentality thereof
2. An individual who is a resident of the United States
3. A partnership, if 2/3 or more of the partners are residents of the United States
4. A trust, if all of the trustees are residents of the United States
5. A corporation organized under the laws of the United States or of any state.

SERVICES PERFORMED FOR UNITED STATES VESSELS

Treasury Regulation section 31.3121(b)-3(c)(2) describes services performed for United States vessels outside the United States. Services performed by an individual on or in connection with a United States vessel constitute employment if:

1. The employee is also employed "on and in connection with" such vessel outside the United States;
2. The contract of employment was entered into within the United States or the vessel touches at a port in the United States while the individual is working on the vessel;
3. The services are not otherwise excepted under IRC section 3121(b).

STEVEDORES

The following factual situation was described in a Social Security Administration ruling numbered S.S.T. 69 (CB 1937-11 386): A group of stevedores was organized as an unincorporated association. One member of the association acts as a business agent in securing contracts with various vessel owners. All members of the association perform services in carrying out such contracts. Amounts received under the contracts from the vessel owners are divided equally among the members. The business agent in this case is not acting as an independent contractor but is merely a representative of the stevedores and is acting for them in dealing with vessel owners. The members of the association then in performing services as stevedores are employees of the vessels.

In another court case involving stevedores a different employer was determined. The facts were quite different since it involved a company rather than an association. In *Martin v. Federal Security Agency*, CA-3, 174 F.2d 364 (1949), the services were performed by a stevedore for a stevedoring company under contract to a railroad company. The court decided that in this case the stevedoring company was an independent contractor. The stevedores, therefore, were determined to be employees of the stevedore company rather than the railroad company.

SHIP PILOTS

Two revenue rulings were issued simultaneously that deal with ship pilots. In Revenue Ruling 68-338 (C-B. 1968-1, 434), it was determined that a pilot who was engaged by a steamship company to pilot a vessel into and out of a port is not an employee. Meanwhile, in Revenue Ruling 68-339 (C.B. 1968-1, 435), it was determined that a pilot engaged by a steamship company to pilot its vessels on a river located completely within the United States is an employee.

In Revenue Ruling 68-338, the ship pilot is a member of an association of licensed pilots. The pilot operates through the medium of the association. Each pilot receives payment of a set fee. No vessel is allowed into the port where the association works without being guided by a pilot. Furthermore the owners of the vessels have no right to select a particular pilot or to bargain with respect to the compensation to be paid the pilot. The pilot here assumes full and exclusive control over the navigation of the vessel and is not subject to the master of the vessel.

In Revenue Ruling 68-339, the owner of the vessel is free to select the pilot of its choice (sometimes a member of the crew who holds a pilot's license). The company is able to bargain with the pilot as to the amount of compensation for the service provided. The ship owner has ultimate direction and control over the pilot through the master of the vessel.

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Chapter 8

DRAWBACKS

IN GENERAL

A drawback is defined in Section 191 of the Customs Regulations:

"Drawback" means a refund or remission, in whole or in part of a Customs duty, Internal Revenue tax, or fee lawfully assessed or collected because of a particular use made of the merchandise on which the duty, tax, or fee was assessed or collected.

Basically, through a drawback a taxpayer can get a refund of 99 percent of the import duties paid when and if the product is exported whether in the same form or different form. The drawback actually refers to the refund of import duties.

TYPES OF DRAWBACKS

There are two basic drawbacks, **Direct Identification Drawback** and **Substitution Drawback**. A Direct Identification Drawback is a drawback of duties paid on imported materials that are manufactured or produced in this country and later exported. Thus, if a taxpayer imports crude oil into the United States and pays import duties on it, processes it into gasoline and then exports it, the taxpayer can get a drawback when the product is exported. A Substitution Drawback, on the other hand, is when one product is imported and a product of the same kind and quality is exported. The taxpayer is entitled to a drawback even if none of the materials imported are exported. For instance, if fabric is imported from China which is used in the production of clothing and other clothing is exported that was made from domestic fabric, a drawback can be received even though none of the imported material was used in the clothing that was exported.

Listed below are several other types of drawbacks and their respective sections in the Customs Regulations (CR). As these drawbacks are uncommon they are not discussed further in this document:

1. Merchandise not conforming to sample or specifications or shipped without the consent of the consignee. This refers to imported products that don't meet the specifications of the manufacturer. (Subpart A, Section 191.4 and Subpart N, Section 191.142 of the CR.)
2. Drawback of Internal Revenue taxes: This refers to taxes paid on alcohol, flavoring extracts and medicinal preparations and perfumes. (Subpart A, Section 191.4 and Subpart H, Sections 191.81 through 191.85 of the CR.)

3. Imported Salt for curing fish. (Subpart A, Section 191.4 of the CR.)
4. Exportation of meats cured with imported salt. (Subpart A, Section 191.4 and Subpart J, Sections 191.101 through 191.103 of the CR.)
5. Material for construction and equipment of vessels and aircraft built for foreigners. (Subpart A, Section 191.4 and Subpart K, Sections 191.111 through 191.113 of the CR.)
6. Foreign built jet aircraft engines processed in the United States. (Subpart A, Section 191.4 and Subpart L, Sections 191.121 through 191.24 of the CR.)
7. Direct Identification same condition drawback. (Subpart A, Section 191.4 and Subpart N, Section 191.141 of the CR.)
8. Substitution same condition drawback. (Subpart A, Section 191.4 and Subpart N, Section 191.141(h) of the CR.)
9. Packaging Materials. (Subpart A, Section 191.4 of the CR.)
10. Supplies for certain vessels and aircraft. (Subpart A, Section 191.4 and Subpart I, Sections 191.91 through 191.94 of the CR.)
11. Merchandise exported from continuous Customs custody. (Subpart A, Section 191.4 and Subpart M, Sections 191.131 through 191.39 of the CR.)
12. Merchandise transferred to a foreign trade zone from Customs territory. (Subpart A, Section 191.4 and Subpart P, Sections 191.161 through 191.166 of the CR.)
13. Refund of Internal Revenue taxes on imported distilled spirits, wine or beer. (Subpart A, Section 191.4 and Subpart O, Sections 191.151 through 191.158 of the CR.)

INCOME TAX ISSUES AND PROPER ACCOUNTING FOR DRAWBACKS

The taxpayer correctly deducts import duties paid as part of cost of goods sold, but may not report drawbacks received as income or a credit to cost of goods sold. Import duties should be debited to cost of goods sold when paid or incurred. Then, when a drawback claim is filed and/or a refund is received, that amount should be credited to cost of goods sold. There can be as much as an 8-year time lapse between the payment of the import duties and the receipt of a drawback, thus making it difficult to reconcile amounts and ensure proper treatment. See **TIME LIMITATIONS** below.

PROCEDURES FOR FILING AND DOCUMENTATION MAINTAINED

The taxpayer must have a **Specific Drawback Contract** or a **General Drawback Contract** to be able to claim drawbacks. In most situations the taxpayer Will have a specific drawback contract. The taxpayer must submit a **Drawback Proposal** to secure a specific drawback contract. The drawback proposal includes information about the manufacturing operation and products on which drawback can be claimed. The Regional Commissioner of Customs then approves the contract. Each contract can be renewed by request to the Regional Commissioner every 15 years and the contract can be terminated by the manufacturer at any time. The taxpayer can also have a **General Drawback Contract**. This contract is offered by Customs Headquarters through a publication called Customs Bulletin to manufacturers who have similar operations. The manufacturer who complies with the terms can apply for its use by notifying the Regional Commissioner in writing. The Regional Commissioner then acknowledges in writing. The General Drawback Contract is also effective for 15 years and can be renewed every 15 years and can be terminated at any time by the manufacturer.

Customs Form 331 must be completed for direct identification drawbacks and substitution drawbacks to file for a drawback claim. Evidence of exportation must be attached to Form 331. Evidence of exportation should include either a Notice of Exportation or an Exporter's Summary. The Notice of Exportation shall show the name of exporting vessel, number and kinds of packages and their marks and numbers, description of merchandise, name of exporter and country of destination. Form 7511 also can be used as Notice of Exportation. The Exporter's Summary is available by request from the Regional Commissioner or District Director of Customs. The taxpayer shall support the drawback entry with a Chronological Summary and any additional evidence required by Customs officers to fully establish the identity of the exported articles. The format of the Chronological summary is as follows:

Drawback Entry No. _____ Exporter Claimant _____ Period from ____ to ____							
Date of Export	Exporting Carrier	Freight or air waybill, bill of lading, Manifest No., Etc.	Marks and numbers	Description	Net Quantity	Schedule B No.	Destination

For additional details on the forms to be completed and documentation to be maintained by Claimant, see Subpart E and Subpart F of the Customs Regulations.

TIME LIMITATIONS, TIME FOR FILING, AND LIQUIDATION OF CLAIMS

Time Limitations

The time limitations are different for direct identification drawbacks and Substitution drawbacks. For direct identification drawbacks the imported merchandise must be exported within 5 years from the date the manufacturer or producer received the imported merchandise. In substitution drawbacks the manufacturer must **use** the imported merchandise within 3 years of its receipt and, during the same 3-year period, the exported articles must be **manufactured or produced**. (Remember, in substitution drawbacks the articles exported do not have to include any of the imported merchandise. The articles exported only have to be of the same kind and quality as the merchandise imported.) The manufacturer also must export the completed articles within 5 years after importation of the designated merchandise.

Time for Filing

The drawback entry must be filed within 3 years after exportation of the articles on which the drawback is claimed. No extensions are granted unless a Customs officer was responsible for the delay.

Liquidation of Claims

Liquidation of claims or payment is made after Customs determines the drawback due based on the drawback entry and documentation furnished. Though not specifically stated in the Customs Regulations, drawbacks are usually paid within 1 year, but there are extensions available. There is also Accelerated Liquidation that allows the taxpayer to receive their payment within 2-4 weeks if they post bond in the total amount due.

PROBLEMS WITH THE APPLICATION OF DRAWBACKS

There are 11 Customs offices nationwide that pay drawbacks and taxpayers can file in any of those offices. Quite often a taxpayer will ship out of several ports in the United States and will file claims in those offices located at those shipping points. Customs does not maintain any centralized recording of the filing and liquidation of claims. Therefore it is possible for some taxpayers to file for the same drawback more than once at different offices. In addition, Customs does not record claims filed and paid, so records on drawbacks filed and liquidated by a specific taxpayer are not readily available.

The Income Tax Division of the IRS does not have a Customs liaison in Washington. However, both International Exam and Excise Tax have liaisons and these liaisons have offered all records on drawbacks available. The local Customs officials should be contacted to verify the availability of taxpayer information at their level.

RECOMMENDED AUDIT TECHNIQUES

All drawback claims for the year(s) under audit should be requested as soon as it is known that the taxpayer imported and exported merchandise. In addition, in the initial interview the taxpayer should be asked if they imported merchandise from outside the country and if they also exported products to foreign countries. If the taxpayer has imported and exported merchandise, proceed with an inquiry about drawbacks filed and how they accounted for drawbacks in their books.

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Chapter 9

ILLEGAL BRIBES AND KICKBACKS

GENERAL BACKGROUND

Illegal bribes and kickbacks may be identified in port related industries in the forms of checks, cash, gifts, and lavish entertainment. Illegal bribes and kickbacks may be deducted under a variety of names such as commissions, referral fees, crew bonuses, miscellaneous expense, or within cost of goods sold. Some may be shown as a deduction to gross receipts. One type of kickback is money paid as a commission to the customer, based on a percentage of the sale. The customer is usually a foreign company, and the commission is paid to the individual owner of that company.

Another type of kickback is encountered when dealing with ship repair companies. Checks are written to cash, and the cash is given to the chief engineer or captain of the ship to be repaired. This individual will then approve the repair work performed by the taxpayer, or also may approve extra hours or a higher rate of pay.

A shipping agent may pay the port captain or the ship captain cash to be distributed to the crew. This is an incentive for them to expedite or properly handle a cargo. This type of payment is normal and legal. However, an employment tax issue may be raised. See Chapter 7.

AUDIT TECHNIQUES

1. At the pre-planning stage, be aware of commissions, referral fees, crew bonuses, and large miscellaneous expenses.
2. At the initial interview, ask if there are any customary cash payments made and where they are expensed on the return.
3. Scan canceled checks or the check register for checks written to cash.
4. Ask questions about any checks written to customers to find out why they were paid.
5. In sampling purchases, be aware of recurring payments to anyone who is not a normal supplier.
6. Consider badges of fraud and if potential fraud attributes exist a fraud referral may be required.

LAW

IRC Section 162(c) deals with illegal bribes, kickbacks, and other payments.

IRC section 162(c)(1) disallows deductions for any illegal payments to an official or employee of any Government, or of any agency or instrumentality of any government, whether they are made directly or indirectly. Payments to officials or employees of foreign governments should only be disallowed if the payment violates the Foreign Corrupt Practices Act of 1977. The burden of proof of illegality is on the Secretary, the same as in IRC section 7454 (related to fraud). IRC section 162(c)(2) disallows other illegal payments made directly or indirectly to any person, if the payment constitutes an illegal bribe, illegal kickback, or other illegal payments, under any law of the United States, or under any law of a State (but only if such State law is generally enforced), which subjects the payer to a criminal penalty or the loss of license or privilege to engage in a trade or business. For purpose of this paragraph, a kickback includes a payment in consideration of the referral of a client, patient, or customer. The burden of proof as to whether a payment constitutes an illegal payment is on the Secretary.

Treas. Regs. section 1.162-18(a)(2) provides that an indirect payment to an individual shall include any payment that inures to his or her benefit or promotes his or her interest, regardless of the medium in which the payment is made and regardless of the identity of the immediate recipient or payor. This denial of a deduction applies to an indirect payment into the treasury of a foreign country for the benefit of a foreign official or employee. An independent contractor is ordinarily not treated as a foreign official or employee. A group in rebellion against an established government is treated as a foreign country.

The burden of proof of the illegality of the payment is a lesser burden than proving guilt "beyond a reasonable doubt" in a criminal case. A taxpayer may be found not guilty in a criminal bribery case but still lose his or her deduction if the Government is able to meet the lesser burden in the tax case.. However, the Commissioner failed to carry his burden of proof in *Farnsworth v. Commissioner* involving alleged bribes made by an independent contractor to Mexican officials.

Treas. Reg. section 1.162-18(b)(3) provides that the "not generally enforced" State law, means "never enforced." However, there is doubt as to the validity of this Section in the regulations. (See court case *Boucher v. Commissioner*). In Rev. Rul. 62-194 the IRS adopted the district court decision in *Dixie Machine Welding & Metal Works, Inc. v. Commissioner*, which disallowed as a deduction a ship repair company's payments to captains and engineers of foreign ships, since such payments were illegal under Louisiana's Commercial Bribery statute. The ruling states that "Many Federal laws and regulations make kickbacks illegal under certain circumstances and, therefore, they are not deductible where such statutes or regulations are applicable." The *Texas Penal Code, Ninth Edition*, makes it illegal to give bribes or kickbacks to any government official (Sections 36.1 through 36.10), and in Section 32.43, it prohibits commercial briberies as well. Check in your state about the local law.

COURT CASES

The following is a summary of court cases on kickbacks and bribes:

Name of Case	Deduction Disallowed	Deduction Allowed	Comments
<i>Raymond Bertolini Trucking Co.</i> , 84-2 U.S. T. C., 959 (6th Cir. 1984)	✓		By Tax Court
" " "		✓	By 6th Circuit as ordinary & necessary.
<i>Brizill v. Commissioner</i> , 93 T.C. 151 (1989)		✓	Ordinary & necessary.
<i>Boucher v. Commissioner</i> , 77 T.C. 214 (1981)	✓		State law was interpreted as being generally enforced.
<i>Curtis v. Commissioner</i> , T.C. Memo, 1982-196		✓	State law was not shown to be generally enforced.
<i>Kirtz v. United States</i> , 304 F.2d 450 (Ct. Cl. 1962)		✓	State law was not shown to be generally enforced.
<i>Conway Import v. United States</i> , 311 F. Supp. 5 (D. N.Y. 1970)		✓	There was proof that kickbacks were customary in the trade, and that the applicable state statutes were "in a state of innocuous desuetude" or had been "strictly construed."
<i>Kane v. Commissioner</i> , T.C. Memo, 1971-221		✓	State law was not shown to be generally enforced.
<i>Dixie Machine Welding & Metal Works, Inc. v. Commissioner</i> , 315 F.2d 439 (5th Cir. 1963), aff'g 207 F. Supp. 84 (D. La. 1962)	✓		Violation of Federal/Louisiana State Law.
<i>T.D. McCormick Contracting Inc. v. Commissioner</i> , T.C. Memo 1988-365.	✓		Violation of Labor Management Relations.
<i>Farnsworth v. Commissioner</i> , T.C. Memo, 1973-195		✓	IRS failed to prove illegality of payments to Mexican officials.

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Chapter 10

MISCELLANEOUS

INDUSTRIAL DEVELOPMENT BONDS

When auditing a taxpayer who has built a wharf or tank farm or other large asset during the year, be aware of the potential use of Industrial Development Bonds. Industrial Development Bonds are tax free. Ask the taxpayer whether they used these as financing for the new asset. If so refer to the Internal Revenue Code sections relating to Industrial Development Bonds. Also refer to the IRM supplement 42RDD-60 (3/29/88). There is a potential depreciation issue relating to double declining balance not being allowed on assets financed with Industrial Development Bonds.

TRAVEL AND ENTERTAINMENT

Travel and entertainment is an area with low compliance in many industries, and the port related companies are no exception. In a few of the port businesses such as customs house brokers and freight forwarders, some travel and entertainment is required for maintaining business relationships with existing clients and obtaining new clients. Travel also may be incurred by steamship companies for agents who travel to meet the company's vessels at their destinations.

For travel and entertainment expense to be deductible, two tests must be met:

1. IRC Section 162(a). - Trade or Business Expenses.

"(a) In General. - There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business."

and

2. Section 274. - Disallowance of Certain Entertainment, Etc., Expenses.

"(d) Substantiation required. - No deduction shall be allowed * * * unless the taxpayer substantiates by adequate records * * *"

The issue that arises from the lack of substantiation for travel and entertainment expenses is the disallowance of the expense to the corporation. Another possible issue may arise if the agent determines that a shareholder(s) has been expensing travel and entertainment for personal use. In this case, the expense is disallowed to the corporation and a constructive dividend is given to the shareholder receiving the benefit from the corporation's deduction. The agent should scrutinize these expenses

as to their business purpose and ensure that the proper documentation to substantiate the expense is maintained in the company's records. The agent also should be aware that for tax years beginning after December 31, 1986, IRC section 274(k) states that no deduction is allowed for any meal that is "lavish or extravagant" and IRC 274(n) limits the deduction for meals and entertainment to 80 percent. For taxable years after December 31, 1993, the deductible portion of otherwise allowable business meals and entertainment expenses has been reduced from 80 percent to 50 percent. Note: This should be reflected in the Schedule M-1; if it is not, an adjustment may be required. Additionally, IRC section 274(l) places limitations on entertainment tickets and IRC section 274(m) limits certain travel expenses.

SHAREHOLDER PERSONAL EXPENSES

Another area to be considered in closely held corporations is the shareholder(s) deducting personal expenses through the corporation. Expenses such as insurance, auto (personal vs. business usage), utilities, and miscellaneous are areas where you may find personal expenses hidden.

IRC section 262 states that no deduction shall be allowed for personal, living, or family expenses. Like travel and entertainment expenses, personal expenses disallowed on the corporation become a constructive dividend to the shareholder(s) who benefited from this deduction.

LOANS TO SHAREHOLDERS

As in any smaller, closely held corporations, the agent should be alert to loans to the shareholder. This balance sheet asset account may represent outright advances of money by the corporation to the shareholder. Calling an advance a loan does not necessarily make it a loan. It may be an informal dividend. The real question to raise is whether the advances for the benefit of a shareholders are true loans, or a way for the shareholders to receive dividends without paying tax thereon. Some elements to consider are:

1. Closely held corporation
2. Poor dividend history
3. Note given, interest paid, security given
4. Definite date of repayment
5. Efforts to enforce collection
6. Corporation's retained earnings account.

IRC section 385 and the regulations for this section provide guidelines to use in determining whether a debtor-creditor relationship exists versus a corporation-shareholder relationship. If it is determined that the advances to the shareholder are in fact actual loans and interest income has not been reported by the corporation, interest on the loan must be imputed (IRC section 7872) and picked up as interest income. Additionally, the amount of the advances that are not loans results in a constructive dividend to the shareholder. Remember that a constructive dividend follows the same rules for distribution. as an ordinary dividend. The corporation must have enough E&P for it to be a taxable dividend.

PORT PILOTS: BACKGROUND

A **Port Pilot** is an individual who is required to hold Federal and State licenses to direct or navigate ships entering a particular port. In Houston, Texas, a 2-year apprenticeship is required to qualify for a pilot's license, a similar requirement may exist in states other than Texas. Port piloting is mandatory under both Federal and State laws, so a ship owner must use the service of a port pilot. A port pilot does not have a choice which ship he or she wants to pilot, and he or she cannot set his or her own rates or fees. However, all port pilots belong to an organization, an association, or a partnership of some sort, which controls the distribution of work to its members.

BUSINESS ENTITY

Analysis of pilot returns showed that many pilots had personal corporations that received the compensation for the pilot's services and paid a salary to the pilot (the sole employee of the corporation). Many corporations also had a pension plan and an employee benefit plan that provided medical coverage.

Validity of Corporation: In *Moline Property, Inc. v. Commissioner*, 319 U.S. 436 (1943) the court established that a one-employee corporation will be recognized as a viable entity so long as there is a valid business purpose to incorporate. If these pilots have good reasons to incorporate, much in the same manner as doctors, lawyers, and other professional service corporations, the use of the corporate structure is valid. However, the facts and circumstances of each case should be developed in the initial interview.

Personal Service Corporation: Pilot corporations are required to use the calendar year by IRC section 441(I), and may elect to use cash accounting since they are treated as personal service corporations for the purposes of IRC section 441. However, although the corporate pilots perform personal services, they do not appear to be personal service corporations under IRC section 448(d)(2). Since the pilots apparently do not meet the definition of "consultants" or fall within any of the other categories of personal service corporation listed in IRC section 448(d)(2), their corporations are not required to pay tax at the flat 34 percent rate. Whether the

services performed are "consulting" or not is a question of fact, depending on the facts and circumstances of the case.

ISSUES

Local transportation is a universal expense for pilots. Generally, the pilot drives or takes a taxi to the location where he or she is to meet a boat that will take him or her to the ship. After piloting the ship, the pilot is returned to shore in a different location. Most pilots and other taxpayers are required to maintain records of auto usage. When reviewing the pilot's records or reconstructed records, check to insure commuting costs were not deducted. In *Steinhort v. Commissioner*, 14 A.F.T.R.2d 5433 (335 F.2d 496), which involved several port pilots, the court ruled that the first and last trip of the day must be treated as commuting. Therefore, the expenses associated with commuting (car and truck expenses, depreciation, car insurance, etc.) are not deductible.

Dues and Subscriptions include dues paid to the American Pilots Association (APA), and the Master Mates & Pilots (MMP). There may be other local professional dues and subscriptions. See SHAREHOLDER PERSONAL EXPENSES.

Entertainment and Gifts: Since pilots do not set their own fees or control their assignments, this expense should be minimal. A pilot may serve on the Executive Committee of the pilot organization, and incur some unreimbursed entertainment or gift expenses in this capacity. However, this should not be material.

Travel expenses: Pilots may attend local, state, and national meetings as representatives of their local pilot organization, for which they would usually be reimbursed, or attend on their own behalf, in which case they would pay their own expenses.

Insurance Expenses: The pilots may participate in liability, health, disability, and life insurance through pilots' associations. Premiums paid by an individual for his or her personal disability insurance providing indemnity for accidental loss of life, limb, and sight, and for loss of earnings during disability are not deductible as business expenses. See Rev. Rul. 58-480, 1958-2 C.B. 62. The following terms may be found in the pilot's books:

MOPS: Merchant Officer Pilot Syndicate (liability and legal expense insurance):
Deductible on 1120 or 1040.

MMP: Master Mates & Pilots (health insurance): Deductible on 1120, partly
deductible on 1040 Schedule C.

GLOSSARY

INTRODUCTION

This glossary defines certain terminology found in port related industries. It is divided into five sections:

1. General terms
2. Individuals who work in port-related industries
3. Types of business charters
4. Documentation and accounting terminology
5. Types of vessels and their parts.

GENERAL TERMS

Bunker: The storage compartment of a ship where the ship's fuel, coal, etc. is stored.

Container rentals: Marine cargo containers are used for the domestic and international shipment of manufactured and other goods. Container lessors assume responsibility for furnishing containers to each lessee in good condition for a specified period of time.

Demurrage: The compensation received by the shipowner when the lay time exceeds the time agreed upon in the voyage charter at either the loading or unloading ports.

Dispatch: The reward payable by the shipowner to the charterer for loading or unloading the vessel in less than the specified lay time. Note: The rate of the demurrage is usually double the rate of the dispatch.

Lay time: The days allowed for the loading and unloading of cargo.

Port: The terminal for water traffic that includes a harbor and the necessary terminal facilities. There are five requirements for all ocean terminals:

1. There should be adequate docks and wharves for vessels.
2. There should be sufficient storage facilities for commodities.
3. There should be modern mechanical appliances for handling freight.

4. There should be ample motor access and belt-line railway connections.
5. There should be a large parking area for automobiles.

Regulatory agencies:

1. U.S. Customs Service
 - a. Inland waterways
 - b. Coastwise trade
 - c. Intercoastal trade
2. Maritime Administration
 - a. Offshore trade between U.S. and its territories/possessions
 - b. International trade
3. U.S. Coast Guard
 - a. Certifies barges for safe operation
 - b. Inspects and certifies vessels, masters and pilots

Reletting: The practice of oil companies to charter out owned or chartered-in tonnage to other companies.

Tickler directories: The directories of the shipping industry published by Knight-Ridder Newspapers. They are organized by geographic location and services provided.

Transportation income:

1. **Use of leasing vessels.** Income from, or in connection with the use or hiring or leasing for use of a vessel is transportation income. This includes:
 - a. income derived from transporting passengers or property by vessel, or
 - b. income derived from hiring or leasing a vessel for use in the transportation of passengers or property on the vessel. This includes income from the actual operation of a vessel and income from time, voyage and bare boat charters. See below for definitions of these different charters.
2. **Related services income.** Transportation income includes income directly from or in connection with the performance of services directly related to the use of the vessel. This includes on board services such as renting accommodations,

furnishing meals and entertainment, performance of personal services, income from demurrage, dispatch and dead freight. It also includes off board services derived by an operator for services incidental to the operation of vessels by such operator. This would include such services as terminal services (dockage, wharfage, storage, lights, water, refrigeration and refueling); stevedoring and other cargo handling services, and maintenance/repairs.

INDIVIDUALS OR OTHER ENTITIES WHO WORK IN PORT-RELATED INDUSTRIES

Custom broker: A person or other entity who makes arrangements for movement of goods through United States Customs. They are bonded by United States Customs. They prepare the necessary filings for tariffs, custom fees, etc.

Freight forwarder: A person or other entity who serves as a middleman between the shipping company and the person who owns the merchandise that is being shipped. His or her responsibility is to ensure that the goods are shipped where the owner of the merchandise is shipping less than the total space on the specific ship.

Longshoreman: A worker who is hired through a hiring hall or a pier for a specific job. The worker is usually hired as part of a team of 20 workers known as a gang. The worker loads and unloads cargo at a port.

Operator: A person or other entity that operates a vessel. The operator is entitled to depreciate the vessel or deduct lease payments.

Port agent: A person or other entity that represents the owner's interest when a vessel calls into port. He or she deals with freight forwarders, port authorities (for clearance to enter and leave a port), public health and customs authorities, tug boat operators, pilots, ship chandlers, and bunker suppliers. He or she also arranges for vessel repairs and crew transfers.

Port pilot: Licensed pilots who navigate ships into a particular port. They are regulated by the Port Commissioner(s).

Ship captain: A person who is in control of the ship after leaving the port.

Ship chandler: A person or other entity who supplies food, stores and other items for vessel operations.

Steamship agent: A person or other entity representing the owner/operator of a vessel or line of vessels. The agent arranges for services and supplies for the ship, such as pilots, stevedores, fuel, etc. The agent is paid a commission for these services. It is usually based on a percentage of the expenses paid on behalf of the vessel, plus a percentage of the freight charges booked, and sometimes a base fee.

Stevedore: A person or other entity who operates equipment to handle the cargo on the dock and in the hold of the vessel. The person may be hired as part of a team.

TYPES OF BUSINESS CHARTERS

Bare boat charter: A bare boat charter is a contract for the use of a vessel whereby the charterer performs functions normally performed by the owner of the boat such as furnishing of the crew and supplies. The charterer is in complete possession, control, and command of the vessel. The owner bears none of the expense or responsibility of operation of the vessel. The revenue and expenses are recorded on a monthly basis for tax purposes. Consideration should be given to passive loss rules where the owner does not participate in the business.

Space charter: A space charter is a charter for a certain amount of space on a vessel. The amount is less than the total space on the vessel. This may be done on a time or on a voyage basis.

Time charter: A time charter contract is for the use of a vessel for a specific period of time. The shipowner retains control of the navigation of the vessel and is responsible for the crew, supplies, repairs and maintenance, fees, and insurance. The charterer controls the vessel's load and destination and pays fuel charges, port charges, commissions and other expenses connected with the cargo. The revenue and expenses of the charter are recorded on a daily basis for tax purposes.

Voyage charter: This is similar to a time charter except the vessel is chartered for a specific voyage rather than for a period of time.

DOCUMENTATION AND ACCOUNTING TERMINOLOGY

Bill of lading: The evidence that the cargo has been sent by the shipper to the port of final destination. The bill will show the amount of tonnage and the rate per ton. The bill will state the terms of payment since the cargo will not be released at the final destination without this information.

Charter party: A written agreement between two parties for shipment of bulk cargo. The two parties are usually a shipper and a shipowner. This agreement will usually contain the following clauses:

1. Name of the contracting parties.
2. Name and description of the vessel to be used.
3. A description of the cargo and the quantity to be shipped.
4. Remuneration and payment to be made to the shipowner.
5. The number of lay days that the vessel will be loaded and unloaded.
6. A statement describing the port where the cargo will be loaded and then discharged.
7. A statement as to whether or not a broker will also be used.
8. A description as to dispatch and demurrage.
9. A statement detailing any canceling date.
10. A statement regarding an Act of God that would prevent fulfillment of the agreement.
11. A statement regarding any arbitration that may be necessary.
12. A statement regarding the general average.
13. A statement regarding a penalty for non-fulfillment of the contract.
14. A statement regarding any required liens that may be necessary.
15. A statement regarding whether there can be any subletting by the shipowner.

Completed voyage method of accounting: This type of accounting does not recognize income or expenses until the voyage is completed. The IRS does not

recognize this as an acceptable method of accounting unless the contract specifically provides that payment is contingent upon the successful completion of the voyage.

Contract of affreightment: A contract whereby the carrier will undertake certain obligations for a specified period of time. This includes the hiring of the vessel or a portion thereof and the attendant affreightment services. These affreightment services are for the movement of that vessel to a desired port for loading and the carriage of cargo. No specific vessel usually would be required except in general terms.

Freight manifest: An accounting and shipping document based on the bill of lading. It will contain the following information:

1. Name of the vessel
2. Date of sailing
3. Port of loading
4. Port of destination
5. Number of bills of lading
6. Number of packages and contents
7. Name of shippers and consignees
8. A notification address
9. Weight of the shipment
10. Cubic measurement of the shipment
11. Freight rates
12. Gross freight revenue
13. Rebate
14. Freight prepaid or collect.

Vouchers: These are prepared by the evidence of source documents listed above. These are the used to make bookkeeping entries. There are four types of vouchers that are usually used:

1. Receiving voucher
2. Disbursing voucher
3. Petty cash voucher
4. Journal voucher.

TYPES OF VESSELS AND THEIR PARTS

Types of Vessels

Liner: A vessel that offers regularly scheduled service between ports over particular routes. They are paid at published shipping rates.

Specific barges:

1. **Covered Hopper Barge:** Used to transport cargo that has to be protected from the weather, such as grain.
2. **Hopper Barge:** Used to transport cargo that does not require protection from the weather such as coal, sand and gravel.
3. **Liquid Cargo Barge:** Used to transport liquid cargo, such as gasoline, kerosene, and many other liquids. These barges also carry several different types of chemicals.
4. **Lighter Barge:** Used to load and unload ships.

Tramp operator: A tramp operator is a vessel that does not operate on any regularly schedule between ports over particular routes. Their rates are determined by market forces related to the supply and demand for vessels at a point in time.

Tug boats and barges: Boats and barges are vessels that must be tied together to accomplish their purpose. The barges must be carried by the towboat. They are connected by means of wires and lines or rigging. They are tied together by deck fittings that are listed in the next section.

Parts of Barges

Tug Boat and Barge Deck Fittings:

1. Tightening Devices
2. Power Winches
3. Capstans
4. Ratchets
5. Timberheads or Bitts
6. Horned Bitt
7. Double Bitt
8. Button
9. Caval
10. Spool
11. Pad Eye.

Main parts of barge:

1. **Barge coaming** — The vertical plating fitted around the entire area of the cargo hold.
2. **Bilge** — This runs the entire length of the barge and is under the cargo hold.
3. **Bilge Knuckles** — This is the reinforcement of all four corners of the barge to prevent damage to the corners.
4. **Cargo hold** — This is where the product that is being transported will be placed. It can be covered or open depending on the product that is being transported.
5. **Cargo Floor** — Floor or deck of the cargo hold.
6. **Collision Bulkhead** — This is a reinforced part of the cargo hold to protect the cargo in case of a collision.

7. **Gunwale** — Walkway done each side of the cargo hold, where wing tanks are located.
8. **Read Log** — This is found at the bow and stern of a rake barge and is a reinforcement from pressure.
9. **Line Deck** — Storage area for all excess riggings and lines.
10. **Man hole** — The opening located on the top of the wing tanks, or the gunwale.
11. **Rake** — Slanted portion at the bow of a barge.
12. **Rake Knuckle** — This is the bottom portion of the rake that is reinforced to prevent damage to the bottom of the barge.
13. **Rake Compartment** — This is used to reach the interior of the barge to check for leaks in the rake or the cargo hold.
14. **Timberheads** — This is a deck fitting mounted on the barge to tie lashings of wire.
15. **Wing Tanks** — These are located down the length of the barge and are used to check the water in the bilges, inspect the cargo hold, and to insure the flotation of the barge.