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D.C. Circuit: Exclusions from gross income of foreign corporations; regulations (2003) held invalid

The U.S. Court of Appeals for the D.C. Circuit today reversed a decision of the U.S. Tax Court that upheld the then-applicable Treasury regulations as valid. The D.C. Circuit reversed finding that the regulations "unreasonably interpreted the Code."

At issue were regulations promulgated in 2003* under section 883 concerning an exemption available to certain foreign corporations on U.S.-source gross transportation income if a certain percentage of the taxpayer's stock was owned by residents of a country that provided a reciprocal tax exemption. The then-applicable regulations, however, prohibited any consideration of "bearer shares" (securities owned by whoever holds physical certificates issued by the company) in determining whether a sufficient amount of a foreign shipper's stock was owned by qualifying shareholders. The D.C. Circuit concluded that the 2003 regulations did not justify treating all bearer shares as incapable of proving ownership, and that the regulations were "unreasonable and therefore invalid under *Chevron* Step Two."

The case is: *Good Fortune Shipping SA v. Commissioner,* No. 17-1160 (D.C. Cir. July 27, 2018). Read the D.C. Circuit's **decision** [PDF 74 KB]

*The exclusion rule in the 2003 regulations was revised by regulations issued in 2010.

Summary

The taxpayer—a foreign corporation organized under the laws of the Republic of the Marshall Islands—issued its stock shares in bearer form. In other words, all of the taxpayer's stock was made up of bearer shares.

The taxpayer on its Form 1120-F, *U.S. Income Tax Return for a Foreign Corporation*, filed for tax year 2007, claimed that it was not described in section 883(c)(1) and that therefore it was entitled under section 883(a)(1) to exclude from gross income and exempt from U.S. taxation certain income. The taxpayer made this claim even though the regulations under section 883 (as applicable for the tax year 2007)—referred to as the “bearer share regulations”—precluded a foreign corporation the shares of which were issued in bearer form from taking these shares into account in establishing the ownership of the stock of the foreign corporation for purposes of determining whether the foreign corporation is described in section 883(c)(1) and thus whether it is entitled to the benefits of section 883(a)(1).

The taxpayer asserted that the bearer share regulations were invalid. The Tax Court, however, found that the 2003 regulations were valid under the two-step analysis under *Chevron.*

The D.C. Circuit today reversed the Tax Court, finding that the IRS had not justified treating all bearer shares as incapable of proving ownership and thus that the 2003 regulations (as then in effect) were unreasonable and invalid.

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