

**DESCRIPTION OF REVENUE PROVISIONS
TO BE CONSIDERED
IN CONNECTION WITH A MARKUP OF
TRADE MATTERS**

Scheduled for Markup

by the

SENATE COMMITTEE ON FINANCE

on

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of the

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CONTENTS

	<u>Page</u>
INTRODUCTION	1
DESCRIPTION OF REVENUE PROVISIONS	2
1. Penalty for Failure to File Disclosure of Exemption for Shipping Income of Foreign Persons.....	2
2. Expansion of Definition of Vessels Qualified for Capital Construction Fund Treatment	3

INTRODUCTION

This document¹, prepared by the staff of the Joint Committee on Taxation, contains a description of revenue proposals to be considered by the Senate Committee on Finance in connection with a markup of trade matters, scheduled for September 11, 1997.

This document contains descriptions of the following revenue proposals: (1) the imposition of a reporting requirement for foreign persons claiming an applicable exemption from U.S. tax on certain international shipping income and (2) the expansion of the definition of vessels qualified for capital construction fund treatment.

¹ This document may be cited as follows: Joint Committee on Taxation *Description of Revenue Provisions to be Considered in Connection With a Markup of Trade Matters* (JCX-42-97), September 9, 1997.

DESCRIPTION OF REVENUE PROVISIONS

1. Penalty for Failure to File Disclosure of Exemption for Shipping Income of Foreign Persons

Present Law

The United States generally imposes a 4-percent tax on the U.S.-source gross transportation income of nonresident alien individuals and foreign corporations (collectively, foreign persons) that is not effectively connected with the foreign person's conduct of a U.S. trade or business (sec. 887 of the Internal Revenue Code of 1986). Foreign persons generally are subject to U.S. tax at regular graduated rates on net income, including transportation income, that is effectively connected with a U.S. trade or business (secs. 871(b) and 882).

Transportation income is any income derived from, or in connection with, the use (or hiring or leasing for use) of a vessel or aircraft (or a container used in connection therewith) or the performance of services directly related to such use (sec. 863(c)(3)). Transportation income attributable to transportation that begins and ends in the United States is treated as derived from sources in the United States (sec. 863(c)(1)). Transportation income attributable to transportation that either begins or ends in the United States generally is treated as derived 50 percent from U.S. sources and 50 percent from foreign sources (sec. 863(c)(2)). U.S.-source transportation income is treated as effectively connected with a foreign person's conduct of a U.S. trade or business only if the foreign person has a fixed place of business in the United States that is involved in the earning of such income and substantially all of such income of the foreign person is attributable to regularly scheduled transportation (sec. 887(b)(4)).

An exemption from U.S. tax is provided for gross income derived by a nonresident alien individual or foreign corporation from the international operation of a ship, provided that the foreign country in which such individual is resident or such corporation is organized grants an equivalent exemption to individual residents of the United States or corporations organized in the United States (secs. 872(b)(1) and 883(a)(1)).

Pursuant to guidance published by the Internal Revenue Service, a foreign person that is entitled to an exemption from U.S. tax for its income from the international operation of a ship must file a U.S. income tax return and must attach to such return a statement claiming the exemption (Rev. Proc. 91-12, 1991-1 C.B. 473). If the foreign person is claiming an exemption based on an applicable income tax treaty, the foreign person must disclose that fact as required by the Secretary of the Treasury (sec. 6114). The penalty for failure to make disclosure of a treaty-based position as required under section 6114 is \$1,000 for an individual and \$10,000 for a corporation (sec. 6712).

Description of Proposal

Under the proposal, a foreign person that claims exemption from U.S. tax for income from the international operation of ships but does not satisfy the filing requirements for claiming such exemption would be subject to the penalty of the denial of such exemption and any deductions or credits otherwise allowable in determining the U.S. tax liability with respect to such income. If a foreign person that has a fixed place of business in the United States fails to satisfy the filing requirements for claiming an exemption from U.S. tax for its income from the international operation of ships, such person would be subject to the additional penalty that any foreign source income from the international operation of ships that is attributable to such fixed place of business would be treated as effectively connected with the conduct of a U.S. trade or business. Income so treated as effectively connected with a U.S. business would be subject to U.S. tax at graduated rates (and would be subject to the disallowance of deductions and credits described above). These penalties would be subject to a reasonable cause exception. The proposal would not apply to the extent the application would be contrary to any treaty obligation of the United States.

The proposal also provides that the U.S. Customs Service would provide to the Secretary of the Treasury the information specified by the Secretary to enable the Secretary to identify foreign-flag ships engaged in shipping to or from the United States.

Effective Date

The proposal would be effective for taxable years beginning after December 31, 1997.

2. Expansion of Definition of Vessels Qualified for Capital Construction Fund Treatment

Present Law

Under section 7518 of the Internal Revenue Code of 1986, in determining taxable income for regular tax purposes, a qualified taxpayer who owns or leases a qualified vessel (an "agreement vessel") is allowed a deduction for certain amounts contributed to a fund established under section 607 of the Merchant Marine Act, 1936 (a "capital construction fund"). In addition, the investment earnings on amounts contributed to a capital construction fund are excluded from gross income for regular tax purposes.

If a withdrawal from a capital construction fund is used to acquire, construct, or reconstruct a qualified vessel, the amount withdrawn generally is not included in gross income and the basis of the qualified vessel generally is reduced by the amount withdrawn to the extent attributable to amounts previously deducted or excluded from income. In the case of any other withdrawal from a capital construction fund, the amount withdrawn generally is included in gross income to the extent attributable to amounts previously deducted or excluded from income and interest on the tax liability attributable to such inclusion generally must be paid from the date of the deduction or exclusion.

Any term (including the definition of "agreement vessel") provided in section 607(k) of the Merchant Marine Act, 1936, as in effect as of the date of enactment of the Tax Reform Act of 1986, applies for purposes of section 7518. Under section 607(k) of the Merchant Marine Act, 1936, as in effect as of the date of enactment of the Tax Reform Act of 1986, an agreement vessel generally is a vessel constructed or reconstructed in the United States (the "U.S.-build requirement") and documented under the laws of the United States (the "U.S.-flag requirement"). In addition, the person maintaining the capital construction fund must agree with the Secretary (of Commerce or Transportation) that the vessel will be operated in the United States foreign trade, Great Lakes trade, or noncontiguous domestic trade or in the fisheries of the United States.

Description of Proposal

The proposal would provide that any term provided in section 607(k) of the Merchant Marine Act, 1936, as in effect as of the date that the OECD Shipbuilding Trade Agreement Act enters into force with respect to the United States, would apply for purposes of section 7518 of the Internal Revenue Code of 1986. Thus, in general, for purposes of the tax benefits provided by capital construction funds, an agreement vessel would include any vessel constructed or reconstructed in any nation that is a signatory to the OECD shipbuilding agreement entered into on December 21, 1994. In effect, the proposal would eliminate the "U.S.-build requirement" of present law for vessels constructed or reconstructed in a signatory nation.

Effective Date

The proposal would be effective as of the date that the OECD Shipbuilding Trade Agreement Act enters into force with respect to the United States.