

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

Scheduled for Markup

by the

SENATE COMMITTEE ON FINANCE

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## CONTENTS

	<u>Page</u>
INTRODUCTION .....	1
DESCRIPTION OF REVENUE PROVISIONS .....	2
1. Modify treatment of foreign trusts .....	2
2. Repeal advance refunds of diesel fuel tax for diesel cars and light trucks .....	11
3. Penalty for failure to file disclosure of exemption for shipping income of foreign persons .....	12

## INTRODUCTION

This document<sup>1</sup>, 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 May 8, 1996.

This document contains descriptions of the following revenue proposals: (1) provisions relating to the tax treatment of foreign trusts; (2) a provision to repeal the advance refunds of the diesel fuel tax for diesel cars and light trucks; and (3) imposition of a reporting requirement for shippers claiming exemption.

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<sup>1</sup> 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-15-96), May 1, 1996.

## DESCRIPTION OF REVENUE PROVISIONS

### 1. Modify treatment of foreign trusts

#### Present Law

##### Inbound grantor trusts with foreign grantors

Under the grantor trust rules (secs. 671-679), a grantor that retains certain rights or powers generally is treated as the owner of the trust's assets without regard to whether the grantor is a domestic or foreign person. Under these rules, U.S. trust beneficiaries can avoid U.S. tax on distributions from a trust where a foreign grantor is treated as owner of the trust, even though no tax may be imposed on the trust income by any jurisdiction. In addition, a special rule provides that if a U.S. beneficiary of an inbound grantor trust transfers property to the foreign grantor by gift, that U.S. beneficiary is treated as a grantor of the trust to the extent of the transfer.

##### Foreign trusts that are not grantor trusts

Under the accumulation distribution rules (which generally apply to distributions from a trust in excess of the trust's distributable net income for the taxable year), a distribution by a foreign nongrantor trust of previously accumulated income generally is taxed at the U.S. beneficiary's average marginal rate for the prior 5 years, plus interest (secs. 666, 667). Interest is computed at a fixed annual rate of 6 percent, with no compounding (sec. 668). If adequate records of the trust are not available to determine the proper application of the rules relating to accumulation distributions to any distribution from a trust, the distribution is treated as an accumulation distribution out of income earned during the first year of the trust (sec. 666(d)).

If a foreign nongrantor trust makes a loan to one of its beneficiaries, the principal of such a loan generally is not taxable as income to the beneficiary.

##### Outbound foreign grantor trusts with U.S. grantors

Under the grantor trust rules, a U.S. person that transfers property to a foreign trust generally is treated as the owner of the portion of the trust comprising that property for any taxable year in which there is a U.S. beneficiary of any portion of the trust (sec. 679(a)). This treatment generally does not apply, however, to transfers by reason of death, to transfers made before the transferor became a U.S. person, or to sales or exchanges of property at fair market value where gain is recognized to the transferor.

##### Residence of trusts

A trust is treated as foreign if it is not subject to U.S. income taxation on its income that is neither derived from U.S. sources nor effectively connected with the conduct of a U.S. trade or

business. Thus, if a trust is taxed in a manner similar to a nonresident alien individual, it is considered to be a foreign trust. Any other trust is treated as domestic.

Section 1491 generally imposes a 35-percent excise tax on a U.S. person that transfers appreciated property to certain foreign entities, including a foreign trust. In the case of a domestic trust that changes its situs and becomes a foreign trust, it is unclear whether property has been transferred from a U.S. person to a foreign entity and, thus, whether the transfer is subject to the excise tax.

### **Information reporting and penalties related to foreign trusts**

Any U.S. person that creates a foreign trust or transfers money or property to a foreign trust is required to report that event to the Treasury Department without regard to whether the trust is a grantor or a nongrantor trust. Similarly, any U.S. person that transfers property to a foreign trust that has one or more U.S. beneficiaries is required to report annually to the Treasury Department. In addition, if the transfer of any appreciated property by a U.S. person is subject to section 1491, the transferor is required to report the transfer to the Treasury Department.

Any person that fails to file a required report with respect to the creation of, or a transfer to, a foreign trust may be subjected to a penalty of 5 percent of the amount transferred to the foreign trust. Similarly, any person that fails to file a required annual report with respect to a foreign trust with U.S. beneficiaries may be subjected to a penalty of 5 percent of the value of the corpus of the trust at the close of the taxable year. The maximum amount of the penalty imposed under either case may not exceed \$1,000. A reasonable cause exception is available.

### **Reporting of foreign gifts**

There is no requirement to report gifts or bequests from foreign sources.

## **Description of Proposal**

### **Overview**

The proposal would modify certain aspects of the tax treatment of foreign trusts with U.S. beneficiaries as follows:

- a. The grantor trust rules generally would apply only to the extent that they result, directly or indirectly, in income or other amounts (if any) being currently taken into account in computing the income of a U.S. person. Certain exceptions would apply.
- b. Beginning on January 1, 1996, the interest rate applicable to accumulation distributions from foreign nongrantor trusts would be the rate imposed on underpayment of tax under section 6621(a)(2), with compounding. The accumulation distribution generally would be allocated proportionately to prior trust years in which the trust had undistributed net income.

The full amount of a loan of cash or marketable securities by a foreign nongrantor trust to a U.S. grantor or a U.S. beneficiary (or a U.S. person related to such a grantor or beneficiary) generally would be treated as a distribution to the grantor or beneficiary.

c. A nonresident alien who transfers property to a foreign trust and then becomes a U.S. resident within 5 years after the transfer would be treated as making a transfer to the foreign trust on his residency starting date. In determining whether a foreign trust paid fair market value to the transferor for property transferred to the trust, obligations issued by the trust, by any grantor or beneficiary of the trust, or by any person related to any grantor or beneficiary generally would not be taken into account.

d. The proposal would authorize the Secretary of the Treasury to issue regulations to prevent abusive transactions to avoid the purposes of these rules.

e. A two-part objective test would be established for determining whether a trust is foreign or domestic for tax purposes.

f. The proposal would expand the reporting requirements with respect to foreign trusts if there is a U.S. grantor of the foreign trust or a distribution from the foreign trust to a U.S. person. The proposal would require the responsible parties to file the designated information reports with the Treasury Department upon the occurrence of certain events. A failure to comply with the reporting requirements would result in increased monetary penalties under the proposal. Unless a U.S. owner of any portion of a foreign trust appoints a limited agent to accept service of process with respect to requests and summons by the Treasury Department in connection with the tax treatment of items relating to the trust, special sanctions would apply.

g. Any U.S. person (other than certain tax-exempt organizations) that receives purported gifts or bequests from foreign sources totaling more than \$10,000 during the year would be required to report the gift to the Treasury Department. Monetary penalties and certain sanctions would apply to a failure to comply with the reporting requirement.

The proposal is described in more detail below.

**a. Inbound grantor trusts with foreign grantors**

**Foreign grantors not treated as owners**

Under the proposal, the grantor trust rules generally would apply only to the extent that they result, directly or indirectly, in income or other amounts (if any) being currently taken into account in computing the income of a U.S. citizen or resident or a domestic corporation. Thus, the grantor trust rules generally would not apply to any portion of a trust where their effect would be to treat a foreign person as owner of that portion. The proposal would provide certain exceptions to this general rule. The grantor trust rules would continue to apply to a portion of a trust where only a portion of the trust is revocable by the grantor, or the only amounts

distributable from that portion during the lifetime of the grantor are to the grantor or the grantor's spouse. The general rule denying grantor trust status would not apply to trusts established to pay compensation, and certain trusts in existence as of September 19, 1995.<sup>2</sup> In addition, the grantor trust rules generally would apply where the grantor is a controlled foreign corporation. The grantor trust rules would apply in determining whether a foreign corporation is characterized as a passive foreign investment company ("PFIC"). Thus, a foreign corporation could not avoid PFIC status by transferring its assets to a grantor trust.

If a U.S. beneficiary, or a person related to such a beneficiary,<sup>3</sup> of an inbound grantor trust transfers property to the foreign grantor, such beneficiary generally would be treated as a grantor of a portion of the trust to the extent of the transfer. This rule would apply without regard to whether the foreign grantor would otherwise be treated as the owner of any portion of such trust. However, this rule would not apply if the transfer is a sale of the property for full and adequate consideration.

In a case where a foreign grantor, that would be treated as the owner of a trust but for the above rule, actually pays tax on the income of the trust to a foreign country, it is anticipated that Treasury regulations would provide that, for foreign tax credit purposes, U.S. beneficiaries that are subject to U.S. income tax on the same income would be treated as having paid the foreign taxes that were paid by the foreign grantor. Any resulting foreign tax credits would be subject to applicable foreign tax credit limitations.

The proposal would provide a transition rule for any domestic trust that has a foreign person that is treated as the owner of the trust under present law. If such a trust becomes a foreign trust before January 1, 1997, or if the assets of such a trust are transferred to a foreign trust before that date, such trust would be exempt from the excise tax on transfers to a foreign trust otherwise imposed by section 1491. However, the proposal's new reporting requirements and penalties would be applicable.

### **Distributions by foreign trusts through nominees**

The proposal generally would treat any amount paid to a U.S. person, where the amount was derived (directly or indirectly) from a foreign trust, as if paid by the foreign trust directly to the U.S. person. This rule would disregard the role of an intermediary or nominee that may be interposed between a foreign trust and a U.S. beneficiary. Unlike present law, however, the rule would apply whether or not the trust was created by a U.S. person. The rule would not apply to a

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<sup>2</sup> The exception would not apply to the portion of any such trust attributable to any transfers made after September 19, 1995.

<sup>3</sup> For this purpose, a person generally would be treated as related to the beneficiary if the person is a brother, sister, spouse, ancestor or lineal descendant of the beneficiary.

withdrawal from a foreign trust by its grantor, with a subsequent gift or other payment to a U.S. person.

### **Effective date**

The proposal would be effective on the date of enactment.

### **b. Foreign trusts that are not grantor trusts**

### **Interest charge on accumulation distributions**

The proposal would change the interest rate applicable to accumulation distributions from foreign trusts from simple interest at a fixed rate of 6 percent to compound interest determined in the manner of the interest imposed on underpayments of tax under section 6621(a)(2). Simple interest would be accrued at the rate of 6 percent through 1995. Beginning on January 1, 1996, however, compound interest based on the underpayment rate would be imposed not only on tax amounts determined under the accumulation distribution rules but also on the total simple interest for pre-1996 periods, if any. For purposes of computing the interest charge, the accumulation distribution would be allocated proportionately to prior trust years in which the trust had undistributed net income (and the beneficiary receiving the distribution was a U.S. citizen or resident), rather than to the earliest of such years. An accumulation distribution would be treated as reducing proportionately the undistributed net income from prior years.

### **Loans to grantors or beneficiaries**

In the case of a loan of cash or marketable securities by the foreign trust to a U.S. grantor or a U.S. beneficiary (or a U.S. person related to such grantor or beneficiary<sup>4</sup>), except to the extent provided by Treasury regulations, the proposal would treat the full amount of the loan as distributed to the grantor or beneficiary. It is expected that the regulations would provide an exception from this treatment for loans with arm's-length terms. In applying this exception, it is further expected that consideration would be given as to whether there is a reasonable expectation that a loan will be repaid. In addition, any subsequent transaction between the trust and the original borrower regarding the principal of the loan (e.g., repayment) would be disregarded for all purposes of the Code. This proposal would not apply to loans made to persons exempt from U.S. tax.

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<sup>4</sup> For this purpose, a person generally would be treated as related to the grantor or beneficiary if the relationship between such person and the grantor or beneficiary would result in a disallowance of losses under section 267 or 707(b).



### **Effective date**

The proposal to modify the interest charge on accumulation distributions would apply to distributions after the date of enactment. The proposal with respect to loans to U.S. grantors or U.S. beneficiaries would apply to loans made after September 19, 1995.

### **c. Outbound foreign grantor trusts with U.S. grantors**

The proposal would make several modifications to the rules of section 679 under which foreign trusts with U.S. grantors and U.S. beneficiaries are treated as grantor trusts.

### **Sale or exchange at market value**

Present law contains an exception from grantor trust treatment for property transferred by a U.S. person to a foreign trust in the form of a sale or exchange at fair market value where gain is recognized to the transferor. In determining whether the trust paid fair market value to the transferor, the proposal generally would not, except as provided by regulations, take into account obligations issued by the trust, by any grantor or beneficiary of the trust, or by any person related to a grantor or beneficiary. In addition, to the extent provided by regulations, similar treatment would apply to obligations guaranteed by any such persons.

### **Other transfers**

Under the proposal, a transfer of property to certain charitable trusts would be exempt from the application of the rules treating foreign trusts with U.S. grantors and U.S. beneficiaries as grantor trusts.

### **Transferors or beneficiaries who become U.S. persons**

The proposal would apply the rules of section 679 to certain foreign persons who transfer property to a foreign trust and subsequently become U.S. persons. A nonresident alien individual who transfers property, directly or indirectly, to a foreign trust and then becomes a resident of the United States within 5 years after the transfer generally would be treated as making a transfer to the foreign trust at the time the individual becomes a U.S. resident. The amount of the deemed transfer would be the portion of the trust (including undistributed earnings) attributable to the property previously transferred. Consequently, the individual generally would be treated under the rules of section 679 as the owner of that portion of the trust in any taxable year in which the trust has U.S. beneficiaries. The proposal's new reporting requirements and penalties (discussed below) also would be applicable.

Under the proposal, a beneficiary would not be treated as a U.S. person for purposes of determining whether the transferor of property to a foreign trust would be taxed as a grantor with respect to any portion of a foreign trust if such beneficiary first became a U.S. resident more than 5 years after the transfer.

### **Outbound trust migrations**

The proposal would apply the rules of section 679 to a U.S. person that transferred property to a domestic trust if the trust subsequently became a foreign trust while the transferor was still alive. Such a person would be deemed to make a transfer to the foreign trust on the date of the migration. The amount of the deemed transfer would be the portion of the trust (including undistributed earnings) attributable to the property previously transferred. Consequently, the individual generally would be treated under the rules of section 679 as the owner of that portion of the trust in any taxable year in which the trust has U.S. beneficiaries. The proposal's reporting requirements and penalties (discussed below) also would be applicable.

### **Effective date**

The rules described in this part would apply to transfers of property after February 6, 1995.

#### **d. Anti-abuse regulatory authority**

### **In general**

The proposal would include an anti-abuse rule which authorizes the Secretary of the Treasury to issue regulations, on or after the date of enactment, that may be necessary or appropriate to carry out the purposes of the rules applicable to estates, trusts and beneficiaries, including regulations to prevent the avoidance of those purposes.

### **Effective date**

The proposal would be effective on the date of enactment.

#### **e. Residence of trusts**

### **Treatment as U.S. person**

The proposal would establish a two-part objective test for determining for tax purposes whether a trust is foreign or domestic. If both parts of the test are satisfied, the trust would be treated as domestic.

Under the first part of the proposed test, in order for a trust to be treated as domestic, a U.S. court (i.e., Federal, State, or local) must be able to exercise primary supervision over the administration of the trust. It is expected that this test would be satisfied by any trust instrument that specifies that it is to be governed by the laws of any State.

Under the second part of the proposed test, in order for a trust to be treated as domestic, one or more U.S. fiduciaries must have the authority to control all substantial decisions of the

trust. It is expected that this test would be satisfied in any case where fiduciaries that are U.S. persons hold a majority of the fiduciary power (whether by vote or otherwise), and where no foreign fiduciary, such as a "trust protector" or other trust advisor, has the power to veto important decisions of the U.S. fiduciaries. It is further expected that, in applying this test, a reasonable period of time would be allowed for a trust to replace a U.S. fiduciary that resigns or dies before the trust would be treated as foreign.

Under the proposal, a foreign trust would be defined as a trust other than a trust that is determined to be domestic under both the court-supervision test and the U.S. fiduciary test.

### **Outbound migration of domestic trusts**

Under the proposal, if a domestic trust changes its situs and becomes a foreign trust, the trust would be treated as having made a transfer of its assets to the foreign trust and would be subject to the 35-percent excise tax imposed by present-law section 1491 unless one of the exceptions to this excise tax is applicable. The U.S. grantor also would be required to report the transfer under the reporting requirements described below. Failure to report such a transfer would result in penalties (discussed below).

### **Effective date**

The proposal to modify the treatment of a trust as a U.S. person would apply to taxable years beginning after December 31, 1996. In addition, if the trustee of a trust so elects, the proposal would apply to taxable years ending after the date of enactment. The proposed amendment to section 1491 would be effective on the date of enactment.

### **f. Information reporting and penalties relating to foreign trusts**

The proposal would expand the reporting requirements with respect to foreign trusts if there is a U.S. grantor of the foreign trust or a distribution from the foreign trust to a U.S. person. The proposal would require the responsible parties to file the designated information reports with the Treasury Department upon the occurrence of certain events. A failure to comply with the reporting requirements would result in increased monetary penalties under the proposal.

### **Information reporting requirements**

First, the proposal would require the grantor, transferor or executor (i.e., the "responsible party") to notify the Treasury Department upon the occurrence of certain reportable events. The reportable events include direct and indirect transfers of property to a foreign trust, other than a nonexempt employees' trust described in section 402(b), and the death of a U.S. citizen or resident if any portion of a foreign trust was included in the gross estate of the decedent. The required notice would identify the money or other property transferred and report information regarding the trustee and beneficiaries of the foreign trust.

Second, a U.S. person that is treated as the owner of any portion of a foreign trust would be required to ensure that the trust files an annual report to provide full accounting of all the trust activities for the taxable year, the name of the U.S. agent for the trust, and other information as prescribed by the Secretary of the Treasury.<sup>5</sup> In addition, unless a U.S. person is authorized to accept service of process as the trust's limited agent with respect to any request by the Treasury Department to examine records or to take testimony and any summons for such records or testimony in connection with the tax treatment of any items related to the trust, the Treasury Secretary would be entitled to determine the amount to be taken into account under the grantor trust rules (secs. 671 through 679). This limited agency relationship would not constitute an agency relationship for any other purpose under Federal or State law.

Third, any U.S. person that receives (directly or indirectly) any distribution from a foreign trust would be required to file a notice to report the name of the trust, the aggregate amount of the distributions received, and other information that the Secretary of the Treasury may prescribe. In cases where adequate records are not provided to the Secretary of Treasury to determine that proper treatment of any distributions from a foreign trust, the distribution includible in the gross income of the U.S. distributee would be treated as an accumulation distribution from the middle year of a foreign trust (i.e., computed by taking the number of years that the trust has been in existence divided by 2) for purposes of computing the interest charge applicable to such distribution.

#### **Monetary penalties for failure to report**

Under the proposal, a person that fails to provide the required notice in cases involving the transfer of property to a new or existing foreign trust, or a distribution by a foreign trust to a U.S. person, would be subject to an initial penalty equal to 35 percent of the gross reportable amount. A failure to provide an annual reporting of trust activities would result in an initial penalty equal to 5 percent of the gross reportable amount. In cases involving a transfer of property to a foreign trust, the gross reportable amount would be the gross value of the property transferred. In cases involving the death of a U.S. citizen or resident whose estate includes any portion of a foreign trust, the gross amount would be the greater of: (a) the amount the decedent is treated as owning under the grantor trust rules or (b) the value of the property includible in the gross estate of the decedent. In cases where annual reporting of trust activities is required, the gross reportable amount would be the gross value of the portion of the foreign trust's assets treated as owned by the U.S. grantor at the close of the year, and in cases involving a distribution to a U.S. beneficiary of a foreign trust, the gross reportable amount would be the amount of the distribution to the beneficiary. An additional \$10,000 penalty would be imposed for continued failure for each 30-day period (or fraction thereof) beginning 90 days after the Treasury

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<sup>5</sup> It is intended that the regulations would require the trust to furnish information to U.S. grantors and beneficiaries concerning income reportable by such persons in a manner similar to that used to report the items on schedule K-1 of Form 1041.

Department notifies the responsible party of such failure. The same penalties would be applicable to a failure to report (as required by present law) certain transfers to other foreign entities. Such penalties would be subject to a reasonable cause exception. In no event would the total amount of penalties exceed the gross reportable amount.

### **Effective date**

The reporting requirements and applicable penalties generally would apply to reportable events occurring or distributions received after the date of enactment. The annual reporting requirement and penalties applicable to U.S. grantors would apply to taxable years of such persons beginning after December 31, 1995.

### **g. Reporting of foreign gifts**

The proposal generally would require any U.S. person (other than certain tax-exempt organizations) that receives purported gifts or bequests from foreign sources totaling more than \$10,000 during the taxable year to report them to the Treasury Department. The threshold for this reporting requirement would be indexed for inflation. The definition of a gift to a U.S. person for this purpose would exclude amounts that are qualified tuition or medical payments made on behalf of the U.S. person, as defined for gift tax purposes (sec. 2503(e)(2)), and amounts that are distributions to a U.S. beneficiary of a foreign trust if such amounts are properly disclosed under the reporting requirements of the proposal. If the U.S. person fails, without reasonable cause, to report foreign gifts as required, the Treasury Secretary would be authorized to determine the tax treatment of the unreported gifts. It is intended that the Treasury Secretary's exercise of its authority to make such a determination will be subject to judicial review under an arbitrary or capricious standard, which provides a high degree of deference to such determination. In addition, the U.S. person would be subject to a penalty equal to 5 percent of the amount of the gift for each month that the failure continues, with the total penalty not to exceed 25 percent of such amount.

### **Effective date**

The proposal would apply to amounts received after the date of enactment.

## **2. Repeal advance refunds of diesel fuel tax for diesel automobiles, vans, and light trucks**

### **Present Law**

Excise taxes are imposed on gasoline (14 cents per gallon) and diesel fuel (20 cents per gallon) to fund the Federal Highway Trust Fund. Before 1985, the gasoline and diesel fuel tax rates were the same. The predominate highway use of diesel fuel is by trucks. In 1984, the diesel fuel excise tax rate was increased above the gasoline tax rate as the revenue offset for a reduction in the annual heavy truck excise tax. Because automobiles, vans, and light trucks did not benefit from the use tax reduction, a provision was enacted allowing first purchasers of

model year 1979 and later diesel-powered automobiles, vans, and light trucks, an advance refund, or tax credit, to offset this increased diesel fuel tax. The credit is \$102 for automobiles, and \$198 for vans and light trucks.

### **Description of Proposal**

The tax credit for purchasers of diesel-fuel-powered automobiles, vans, and light trucks would be repealed.

### **Effective Date**

The proposal would be effective for vehicles purchased after the date of enactment.

## **3. Penalty for failure to file disclosure of exemption for shipping income of foreign persons**

### **Present Law**

The United States imposes a 4-percent tax on the U.S.-source gross transportation income of nonresident alien individuals and foreign corporations (sec. 887). This tax does not apply to income that is effectively connected with the foreign person's conduct of a U.S. trade or business. Nonresident alien individuals and foreign corporations are subject to U.S. tax at regular graduated rates on net income that is effectively connected with a U.S. trade or business (secs. 871(b) and 882). The U.S. taxation of a nonresident alien or foreign corporation may be altered by the provisions of an applicable tax treaty.

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)). In the case of transportation income attributable to transportation that begins in, and ends outside, the United States or that begins outside, and ends in, the United States, generally 50 percent is treated as U.S. source and 50 percent is treated as foreign source (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 from the international operation of a ship, provided that the foreign country in which such individual is resident grants an equivalent exemption to individual residents of the United States (sec. 872(b)(1)). A similar exemption from U.S. tax is provided for gross income derived by a foreign corporation from the international operation of a ship, provided that the foreign

country in which the corporation is organized grants an equivalent exemption to corporations organized in the United States (sec. 883(a)(1)).

Pursuant to guidance published by the Internal Revenue Service, a nonresident alien individual or foreign corporation 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).

At the time the 4-percent tax on U.S.-source gross transportation income was enacted, concern was expressed about whether compliance with the tax, which is collected by return, would be adequate. It was intended that the tax-writing committees of Congress and the Secretary of the Treasury would study the issue of compliance and that the Secretary would make recommendations if compliance did not prove adequate. Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986 (JCS-10-87), May 4, 1987, at 930.

#### **Description of Proposal**

Under the proposal, a nonresident alien individual or foreign corporation 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. In addition, under the proposal, if a nonresident alien individual or foreign corporation 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). The Secretary of the Treasury could waive all or part of these penalties upon a showing by the foreign person that there was reasonable cause for the failure and the person acted in good faith. 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 the later of the date the Shipbuilding Agreement takes effect or December 31, 1996.