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DESCRIPTION OF PROPOSALS

RELATING TO

THE TAXATION OF SHIPPING INCOME (H.R. 4769 AND RELATED PROPOSALS)

SCHEDULED FOR A HEARING

BEFORE THE

COMMITTEE ON WAYS AND MEANS

ON MARCH 19, 1980

PREPARED FOR THE USE OF THE

COMMITTEE ON WAYS AND MEANS

BY THE STAFF OF THE

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

The Committee on Ways and Means has scheduled public hearings on March 19, 1980, regarding the tax provisions of H.R. 4769: The Omnibus Maritime Regulatory Reform, Revitalization, and Reorganization Act and related legislative proposals. The staff of the Joint Committee on Taxation has prepared this pamphlet, providing a description of the tax provisions of the proposed legislation.

H.R. 4769 has been jointly referred to the Committees on Merchant Marine and Fisheries, Ways and Means, Government Operations, and the Judiciary. The Committee on Merchant Marine and Fisheries held a series of public hearings on the bill in 1979, and are in the process of revising provisions of the bill. Substantial revisions will be made to the tax provisions in the bill. The description in this pamphlet includes both a summary of the tax provsions in the original bill and a more detailed descrpition of the bill as redrafted. The public hearings scheduled by the Committee on Ways and Means will focus on the revised tax provisions of the bill. (See Ways and Means Committee press release No. 32, March 7, 1980.)

I. PRESENT LAW

A. Overview

In general, the United States taxes the worldwide income of any U.S. citizen, resident, or corporation whether the income is derived from sources within or without the United States. On the other hand, nonresident aliens and foreign corporations (even those which are subsidiaries of U.S. companies) generally are taxed by the United States only on their U.S. source income.

The U.S. tax laws contain a number of special rules which result in international shipping, both U.S. and foreign owned, being subject to very little U.S. tax. In addition, most other countries also impose little, if any, tax on international shipping.

B. Foreign Flag Shipping

In the case of foreign owned shipping, the principal special rule exempting it from U.S. tax on its U.S. income is the reciprocal exemption (secs. 872(b)(1) and 883(a)(1) of the Internal Revenue Code). Under the reciprocal exemption provisions, foreign owners are exempt from U.S. tax on U.S. source shipping income as long as the income is derived from the operation of a ship documented under the laws of a foreign country which grants an equivalent exemption for the shipping income of (or imposes no tax on the income of) citizens and corporations of the United States. The determination that a foreign country grants an equivalent exemption is usually made by an exchange of notes between the two countries.

In addition to the reciprocal exemption provided in the Internal Revenue Code, the United States has approximately 30 income tax treaties (covering approximately 50 countries) providing for a recipical exemption which would exempt shipping from taxation by either country even if there were no statutory exemption. (Although there is substantial overlap, the scope of the treaty reciprocal exemption is somewhat different than the statutory reciprocal exemption.) These treaties are in effect with virtually all of the developed countries and with most of the significant maritime countries of the world, including the United Kingdom, Germany, France, Japan, Norway, Greece, and the Soviet Union.

Even in those cases where a reciprocal exemption under the Code or a treaty is not in effect, relatively little tax is imposed on the international shipping profits of foreign corporations since the present source rules for shipping income (sec. 863) treat only a relatively small portion of the total international shipping income as from U.S. sources (i.e., that amount which the foreign corporation's costs incurred in the transportation business in the United States and a reasonable return on its assets used in the transportation business in

the United States bears to the entire costs incurred in the transportation business and a reasonable return on all of the assets used in the transportation business). A vessel generally is considered to be "within" the United States only when it is within U.S. territorial waters. Thus, most of the income earned by foreign flag shipping from operating in the international commerce of the United States is treated as earned in international waters "without" the United States and, consequently, not subject to U.S. tax.

C. U.S. Controlled Foreign Flag Shipping

Benefits from the Code reciprocal exemption and the treaty provisions are derived not only by strictly foreign operators, but also by U.S. citizens and corporations operating ships through foreign subsidiaries. Most international shipping businesses of U.S citizens and corporations are conducted through foreign subsidiaries and are most frequently registered in one of three countries: Liberia, the United Kingdom, or Panama.

Operators who incorporate abroad and who register their ships in a foreign country with no intention of operating the ships in the domestic or foreign commerce of that foreign country are often referred to as using "flags of convenience." As a general rule, most "flag of convenience" shipping companies, including those registered in Liberia and Panama, are able to obtain the reciprocal exemption provided in the Internal Revenue Code. On the other hand, ships registered in developed countries such as France, Germany, and Japan are generally used in the domestic and foreign commerce of the country of registry and thus are generally entitled to the reciprocal tax exemption provided in the applicable U.S. tax treaty as well as the reciprocal exemption provided by the Code.

Generally, the foreign source income of foreign corporations is not subject to U.S. tax. A U.S. shareholder of the corporation generally does not pay tax on the income unless and until it is distributed as a dividend. However, if a foreign corporation is controlled by U.S. shareholders, certain types of the corporation's foreign source income ("subpart F income") are treated as having been distributed to the shareholder immediately and are taxed accordingly. Subpart F income generally consists of passive and tax haven income.

Prior to the Tax Reduction Act of 1975, the law also contained an exception to subpart F which provided that the shipping income of foreign subsidiaries was not to be considered as tax haven income. That Act changed that rule to provide that shipping income is to be treated as subpart F income and taxed currently to the U.S. shareholders except to the extent that it is reinvested in shipping assets. A further modification to this rule was provided in the Tax Reform Act of 1976 to eliminate the reinvestment requirement for income earned in the country of incorporation of the foreign subsidiary if that is also the country in which the vessel is registered. Thus, under present law, tax deferral is only available on the shipping profits of foreign subsidiaries to the extent that they are (1) reinvested in the shipping business or (2) earned in the country of registry and incorporation.

D. U.S. Flag Shipping

1. Capital construction fund

Under the capital construction fund provisions of present law (sec. 607 of the Merchant Marine Act of 1936), any U.S. shipowner can defer the tax on income from the operation of "eligible vessels" if it deposits the shipping income into a tax-exempt capital construction fund established to accumulate funds for the acquisition (including construction and reconstruction) of "qualified vessels." The tax will continue to be deferred if the funds are withdrawn to acquire a qualified vessel. (The tax is payable, with interest, from the date of deposit if the funds are used for any other purpose.) When withdrawals from the fund are used to acquire a qualified vessel, the tax basis (for the purpose of determining the gain on the sale or depreciation) of the vessel is reduced to the extent the cost of acquisition is attributable to tax-deferred income or gains deposited in the fund or to the tax-exempt earnings of the fund. Thus, the deferred tax will in effect be recaptured by the Internal Revenue Service over the useful life of the acquired vessel as a result of its reduced basis for purposes of computing depreciation (unless, of course, those earnings are redeposited in the capital construction fund for the acquisition of other vessels). It is understood that, because of these long-term tax deferral benefits available under the capital construction fund provisions of present law, U.S. shipowners do not, in the aggregate, pay any U.S. tax on the income from eligible vessels.

To be an eligible vessel (the earnings of which may be tax-deferred under present law), a vessel (1) must have been constructed or reconstructed in the United States, (2) must be documented under U.S. law, and (3) must be operated in the foreign or domestic commerce or fisheries of the United States. Under present law, qualified vessels (those that can be acquired with amounts withdrawn from a capital construction fund) include vessels (1) constructed or reconstructed in the United States, (2) documented under U.S. law, and (3) operated in the foreign, Great Lakes, fisheries, or noncontiguous domestic trade (e.g., U.S. mainland to Hawaii or Alaska) of the United States.

2. Investment tax credit

Vessels documented under the laws of the United States, which are operated in the domestic or foreign commerce of the United States, are eligible for the investment tax credit. The credit allowable is generally 10 percent of the cost of the ship.

As discussed in section D.1. above, a U.S. owner or lessor of vessels may enter into an agreement with the Secretary of Commerce to establish a capital construction fund to accumulate funds for the acquisition or construction of vessels. Income tax is not imposed on the taxable income deposited in the fund or on the earnings of the fund. Further, income tax is not imposed when funds are withdrawn if they are used for the acquisition or construction of certain vessels. However, when withdrawals are made to acquire or construct a vessel, the basis of the vessel is reduced to the extent the withdrawal is attributable to tax-deferred income or gains.

The capital construction fund amendments were made at a time when the investment tax credit was not in force. When the credit was

restored, its relationship to the capital construction fund provisions was unclear. The Internal Revenue Service took the position that amounts withdrawn from the capital construction fund could not be counted as expenditures eligible for the investment tax credit. However, the IRS lost three Court of Claims cases on this point, in which the full credit was allowed. As part of the Tax Reform Act of 1976, Congress decided to allow one-half of the credit with respect to capital construction fund expenditures while making it clear that no inference was to be drawn from the legislation as to whether taxpayers would be entitled to the full investment tax credit under existing law.

3. Depreciation

Taxpayers are generally not allowed to deduct the cost of a capital asset immediately but must recover their investment by depreciating the asset over its useful life. A taxpayer may demonstrate the actual useful life of each asset or may elect to utilize the useful lives recognized by the IRS under the asset depreciation range ("ADR") system. Under ADR, the shortest allowable useful life of a vessel is 14.5 years.

Accelerated methods of depreciation may be used to utilize most of the depreciation deductions in the early years of the asset's useful life, but it still takes some time to realize the benefits.

II. PRIOR ACTION BY THE WAYS AND MEANS COMMITTEE

A. Tentative Decisions During Consideration of the Tax Reform Act of 1976

The Ways and Means Committee, during its consideration of the Tax Reform Act of 1976, had tentatively decided that, beginning in 1977, the reciprocal exemption for shipping income should be repealed. The source rules were also to be modified so that one-half of the taxable income from shipping into and out of the United States would be treated as U.S. source income. In cases where a foreign shipper was not willing to file a return of U.S. tax (and make his books available to the IRS), the IRS could assess a tax of 5 percent of the shipping charges on the cargo loaded or unloaded in the United States by the shipper. This provision would not have terminated provisions of existing tax treaties in 1977. Instead, the Treasury Department would have had an opportunity throughout 1977 to revise our treaties to make them consistent with the rules set out above. This proposal would have raised approximately $240 million a year if applied to ships of all flags, and $100 million if present treaty exemptions were maintained (and if no significant shift in ship registry to treaty countries occurred).

The primary criticism that was made of the committee's tentative decision with respect to the taxation of shipping income was that it failed to take into account the possibility of retaliation by foreign governments against U.S.-registered shipping. In order to permit a fuller consideration of the issues involved, the committee withdrew its tentative decisions and referred the questions involved to the task force on foreign source income.

B. Recommendations of Task Force on Foreign Source Income

The Ways and Means Committee, in the Tax Reform Act of 1976, agreed to a number of major changes which produced significant reform in the taxation of foreign source income. In addition, there were several other proposed changes in the taxation of foreign source income, including those involving international shipping income, which were considered by the committee but which the committee decided needed further study. Therefore, the committee established a task force to analyze the issues involved and to recommend to the full committee any appropriate legislative changes. The task force was comprised of 10 members of the Ways and Means Committee with Mr. Rostenkowski as chairman. It submitted its report on March 8, 1977.

The task force made the following recommendations with respect to the taxation of shipping profits from the operation or lease of foreign-registered ships in the United States:

(1) *Treaty country exemption.*—Shipping income which is exempt from U.S. tax under one of the various tax treaties that the United States has with other countries should continue to be exempt from U.S. tax.

(2) *Taxation of nontreaty country shipping.*—The present Internal Revenue Code provisions exempting income derived from the operation of ships registered in countries which do not tax income of U.S.-registered ships should be modified. Income would continue to be exempt under the Code from U.S. income tax only where the shipping either (a) is engaged in the foreign commerce of the country of registry, or (b) is owned and operated by residents of the country of registry.

(3) *U.S. source rules and alternative tax.*—The U.S. source rules would be modified so that one-half of the taxable income from shipping into and out of the United States would be treated as U.S. source income (although in many cases that income would still be exempt under the rules stated above). In cases where a foreign shipper was not willing to file a tax return to pay any U.S. tax due (and make his books available to the IRS), a tax equal to 5 percent of one-half of the shipping charges on the cargo loaded or unloaded in the United States would be imposed (where the exemptions stated above do not apply) on the shipper. In either case, the tax would be imposed with respect to the aggregate taxable income derived from, or the aggregate shipping charges for, the shipment of the cargo from the U.S. port to the ultimate country of destination or to the United States from the country of origin, whether or not the cargo is off-loaded in an intermediate foreign port and switched to a different ship or mode of transportation for the remainder of the trip.

(4) *Treaty negotiations.*—The Treasury Department would be instructed to initiate discussions with countries with which the United States has tax treaties exempting shipping profits, with a view to modifying these tax treaties to provide rules similar to those recommended for nontreaty country shipping.

III. ISSUES

A. In general

1. The largest merchant marine fleets in the world are generally registered in those countries that impose the lowest tax obligations. Should the U.S. taxation of shipping income be revised to provide additional tax incentives to encourage the construction and operation of U.S. vessels?

B. Specific issues raised by the revised bill

2. The current definition of an "eligible vessel," the income from which may be deferred by deposit in a capital construction fund, requires that the vessel be constructed in the United States, documented under the laws of the United States, and operated in the domestic or foreign commerce of the United States. Should the definition of eligible vessel be expanded to allow the deferral of income for vessels constructed in foreign countries and/or documented under the laws of a foreign country and which do not operate in United States commerce?

3. Currently, the tax-deferred income in the capital construction fund is allowed to be reinvested tax-free in qualified vessels which, among other things, must be operated in the foreign, Great Lakes, or noncontiguous domestic trade of the United States. Should the definition of qualified vessels be expanded to include vessels which do not operate in the commerce of the United States and vessels which operate in the coastal trade of the United States?

4. Presently, the use of the capital construction fund is limited to citizens of the United States owning or leasing eligible vessels. Should United States shareholders of foreign subsidiaries be allowed to use the capital construction fund where the foreign subsidiary owns or leases an eligible vessel?

5. The Code explicitly provides that a withdrawal of funds from a capital construction fund for the acquisition or construction of a qualified vessel is eligible for a 5-percent investment tax credit. It is not clear whether such investments are eligible for the remaining 5 percent. Should the Code be amended to provide that investments in qualified vessels from capital construction funds be eligible for the full 10-percent investment tax credit?

6. Under present law vessels may be depreciated over their useful life or a generally shorter period of 14.5 years if the taxpayer uses the ADR method of depreciation. Should the taxpayer be allowed to depreciate U.S. constructed vessels over a 5 year period, and foreign constructed vessels over a 10 year period?

7. Currently, a full 10 percent investment tax credit is allowed only for property with a useful life of 7 years or more. Property with a useful life of 5–7 years is eligible for a 6⅔ percent credit while property with a useful life between 3–5 years is entitled to a 3⅓ percent credit. Should vessels depreciated over a 5-year useful life under the provisions of the bill be allowed a full 10-percent investment credit rather than the 6⅔ percent credit?

IV. THE OMNIBUS MARITIME BILLS

A. Tax Provisions of Original Bill (H.R. 4769)

The basic thrust of the tax provisions of the original bill was to provide tax incentives for the construction and operation of U.S. flag ships and tax disincentives for the operation of foreign flag ships by U.S. taxpayers. The disincentives involved the elimination of tax exemptions for foreign flag ships engaged in U.S. operations and the elimination of tax-deferral for foreign flag ships owned by U.S. shareholders. The incentive provisions involved increased investment tax credits and accelerated depreciation deductions for U.S. flag ships and an expansion of the capital construction fund provisions.

The original bill generally adopted the Ways and Means Task Force's recommendations for changing the taxation of foreign flag shipping. The original bill would terminate the statutory reciprocal exemption where the shippers are not citizens of the foreign country in which the vessel is registered or the vessels are not engaged in foreign commerce in that country (reciprocal exemptions provided by treaty would not be affected by the bill).

The bill would treat one-half of all income earned on shipping to or from U.S. ports as subject to U.S. taxation. H.R. 4769 also provided for the flat rate alternative tax and the enforcement provisions recommended by the task force.

A disincentive contained in the original bill for U.S. controlled foreign flag shipping was that referral on foreign shipping income would generally be eliminated. This would be accomplished by terminating the present rules allowing the deferral of profits reinvested in foreign flag shipping.

Under current law, ships documented under the laws of the United States and acquired with income in a capital construction fund are entitled to one-half (and possibly the full amount) of the normal investment tax credit of 10 percent of the cost of the ship. The bill would make it clear that a full 10-percent investment tax credit is allowed on the vessel.

Under the current ADR Guideline Lives, a ship can be depreciated over a useful life of 14.5 years. The original bill would allow U.S. flag ships and U.S. shipyards to be written off immediately rather than capitalized and depreciated as under present law.

Finally, the tax deferral provisions of the capital construction fund would be expanded. Deferral is currently allowed only for income from certain eligible vessels constructed in the United States and operated in the domestic or foreign commerce of the United States. This requirement would be eliminated under the bill and replaced with a requirement that the ship need only be documented in the United States to be eligible for deferral.

Similarly, the income in the capital construction fund may currently be used only for reinvestment in certain qualified vessels. These qualified vessels must be constructed in the United States and can only engage in the foreign commerce and limited domestic commerce of the United States. The original bill would eliminate the U.S. construction requirement and the restrictions on the usage of the vessels, and would require only that the vessels be documented in the United States.

B. Tax Provisions of Revised Bill

Explanation of provisions

The House Merchant Marine and Fisheries Committee recently announced that H.R. 4769 had been substantially redrafted, particularly with regard to the tax provisions contained in the bill. The provisions relating to the tax treatment of foreign shipping income were removed from the revised bill. The tax provisions in the redrafted bill are (1) an expansion of the capital construction fund provisions, (2) the specific allowance of a full 10-percent investment tax credit with respect to vessels acquired with amounts withdrawn from a capital construction fund, and (3) the allowance of depreciation on foreign-built vessels based upon a 10-year useful life and on U.S.-built vessels based on a 5-year useful life.

1. Capital Construction Fund

While the bill generally does not alter the manner in which the capital construction fund provisions presently operate, it does expand both the category of eligible vessels and qualified vessels. It also permits U.S. shareholders to establish capital construction funds with respect to the shipping income of their foreign subsidiaries.

To be an eligible vessel (the earnings of which may be tax-deferred under present law), a vessel (1) must have been constructed or reconstructed in the United States, (2) must be documented under U.S. law, and (3) must be operated in the foreign or domestic commerce or fisheries of the United States. The bill would eliminate the requirements that the vessel be built and documented in the United States and would extend the category to cover vessels operated in international commerce—essentially, the bill would permit any U.S. owner to use a capital construction fund to defer its tax on the operation of any vessel.

The bill would similarly expand the category of qualified vessels—those that may be acquired with amounts in a capital construction fund. Under present law, qualified vessels include vessels (1) constructed or reconstructed in the United States, (2) documented under U.S. law, and (3) operated in the foreign, Great Lakes, fisheries, or noncontiguous domestic trade of the United States. The bill would permit qualified vessels to be used in international trade and in all aspects of U.S. domestic and foreign commerce (except domestic trade in any inland or intracoastal waterway of the United States).

2. Investment credit

Under present law, ships documented under the laws of the United States and acquired with amounts withdrawn from a capital construction fund are entitled to one-half (and possibly the full amount) of the normal investment tax credit of 10 percent of the cost of the ship. The bill would make it clear that a full 10-percent investment tax credit is allowed on the vessel. In addition, the bill makes it clear that vessels

depreciated under the 5-year useful life election provided in the bill qualify for the full investment credit even though the normal 7-year useful life requirement is not satisfied.

3. *Depreciation*

Under the current ADR Guideline Lives, a ship can be depreciated over a useful life of 14.5 years. This bill allows the taxpayer to elect a 5 year useful life for either a U.S. constructed vessel placed in service after the date of enactment of this bill or a foreign constructed vessel subject to a written contract before the date of enactment of this bill which is placed in service before December 31, 1981. For a foreign constructed vessel placed in service after the date of enactment of this bill and which is not eligible for a 5 year useful life, the taxpayer may elect a 10 year useful life.

Effective date

The amendments made by the revised bill, including the amendments relating to the tax laws, are effective January 1, 1981. However, the depreciation amondments regarding 5-year and 10-year useful lives generally only apply to vessels placed in service after the date of enactment of this bill.

Revenue effect

According to preliminary estimates, the tax provisions allowing 5-year depreciation and 10-percent investment credit are estimated to reduce budget receipts by $67 million in fiscal year 1981, $250 million in 1982, and by $579 million in fiscal year 1985. Because of lack of data, no estimates of revenue effects have been made for the provision allowing 10-year depreciation on the amendments to the capital construction fund.

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