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A Perfect Experiment: 'Deferral' And the U.S. Shipping Industry

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"So let us do what we can to ensure that American businesses continue to find profit in trade upon the waters."

— Senate Finance Committee Chair Max Baucus, D-Mont.

A great body of academic and think-tank literature has discussed the impact on the domestic economy of our tax law's general rule of "deferral," that is, the principle under which U.S. multinational corporations are not taxed on overseas profits until those amounts are brought back to the United States. This work is marked primarily by abstract economic theories and references to byzantine concepts such as "capital export neutrality." Almost no one wants to read this stuff.

Now, as a result of an important change made by the American Jobs Creation Act of 2004, we can take a break from the economic treatises and simply open our eyes to a real-world demonstration unfolding before us. The 2004 act restored the general rule of deferral for the U.S.-based international shipping industry, a rule that had been repealed by the Tax Reform Act of 1986. We are left with something quite rare in the tax world: a controlled experiment. We can contrast an industry operating with deferral before 1986, without deferral from 1986 to 2004, and then again with deferral in 2005 and afterward.

These perfect tax-law extremes produced extreme results. The industry began a long decline following the 1986 act, with U.S. companies losing significant market share and many becoming foreign-owned. Today, just over two years into the industry's reentry into the deferral world, we already see dramatic reinvigoration of U.S. shipping and the creation of domestic jobs, all attributable to the 2004 act change.

In this article, I explore industry's experience with deferral and current taxation under subpart F over the past quarter century and examine the reasons cited by policymakers for the 1986 and 2004 act changes. There are lessons to be learned, lessons about unintended consequences that are directly relevant to the policy debate unfolding today in the international tax arena.

The 1986 Act

Up until the 1986 act, foreign shipping income earned by U.S. controlled foreign corporations was eligible for deferral treatment, although the history is a bit tortured.

In 1962 Congress enacted the subpart F regime, which taxes currently the U.S. parent on some types of income earned by a CFC, regardless of whether the income is brought back to the United States, or repatriated, in the form of a dividend. When enacted, the subpart F regime specifically excluded foreign shipping income from its operation. Accordingly, deferral remained the general rule for U.S.-based global shipping companies.

In the Tax Reduction Act of 1975, Congress designated foreign shipping income of a CFC as subpart F income, but provided that such income would not be subject to the subpart F current taxation rule to the extent the income was reinvested by the CFC in its foreign shipping operations. To preserve deferral following the 1975 act, most U.S.-based shipping companies took great pains to meet the reinvestment requirements.

In the 1986 act, Congress repealed the reinvestment exception. Thus, Congress eliminated any ability to defer tax on foreign shipping income.

The stated rationale for the 1986 act change was remarkable. The Joint Committee on Taxation staff explained, as a reason for eliminating deferral, that "shipping income is seldom taxed by foreign countries."[1] It is true that other countries, as a general rule, do not tax the international shipping income earned by their home companies. Indeed, the 1986 act change made the United States the *only* country to tax that income. I suppose the thinking was that all income should be taxed currently by someone and it does not particularly matter by whom. Completely absent was any attention to a more important question: Can a U.S.-based multinational company survive in a global market when it is subject to tax on its income and its competitors are not? That question was answered — with a vengeance — in the years following the 1986 act.

An Industry In Extremis

U.S. shippers feared they would be increasingly unable to compete following the 1986 act. International bulk shipping markets are served primarily by foreign-flagged tankers, container ships, and other vessels. Competition in these markets is fierce, and a shipper's ability to offer

[1]*General Explanation of the Tax Reform Act of 1986* (JCS-10-87), at 970.

competitive charter rates is dependent on its operational costs. U.S.-based shipping companies feared that the increase in operational costs resulting from subpart F taxation — a burden not borne by their competitors — would be devastating and that they would soon lose market share in the global trades.

Those fears were fully realized. The results of the 1986 act ''experiment'' were dramatic. In 1986 there were 429 U.S.-owned, foreign-flag ships serving international bulk shipping markets.[2] By 2000 that fleet had shrunk to 273 ships. The decline was particularly pronounced in the tanker market. From 1988 to 2000, the number of U.S.-owned, foreign-flag tankers fell by nearly 50 percent, from 246 ships to only 126 ships. Overall, from 1988 to 1999, the number of U.S.-owned, foreign-flag ships as a percentage of the world merchant fleet dropped from 5.6 percent to 2.9 percent.

Much of the decline was attributable to the acquisition of U.S.-based shipping companies by foreign competitors not subject to tax on their shipping income. For example, Singapore-based Neptune Orient Lines in 1997 acquired U.S.-based American President Lines, then the largest U.S. shipper. In 1999 Denmark-based A.P. Moller Group acquired the international liner business of Sea-Land Services Inc., a subsidiary of CSX Corp. and previously the largest U.S. shipper of containers. By becoming foreign-owned, these shipping businesses were able to shed themselves of crippling subpart F taxation and compete again in the global markets. Of course, the movement of these businesses overseas meant the loss of headquarter jobs and related employment in the United States.

Fewer U.S.-based shipping companies also meant fewer potential investors in the U.S.-flag ''Jones Act'' domestic trade, which is limited to U.S.-owned enterprises. Thus, one should not have been surprised that the number of U.S.-flag ships also declined following the 1986 act change. Over the 1985-2004 period, the U.S.-flag fleet declined from 737 to 412 vessels, causing U.S.-flag shipping capacity, measured in deadweight tonnage, to drop by more than 50 percent.[3]

The losses had implications not only for U.S. shipping companies and U.S. shipbuilders but also for America's security interests. In times of emergency, the U.S. military relies on the ability to requisition U.S.-owned tankers, bulk carriers, and other vessels to carry oil, gasoline, and other materials in defense of U.S. interests overseas. The military turns first to U.S.-flag ships and then to U.S.-owned foreign-flagged ships that comprise the Effective United States Control (EUSC) fleet. A 2002 Massachusetts Institute of Technology study[4] expressed concern that the EUSC fleet, eviscerated following the 1986 act changes, was not large enough to satisfy U.S. strategic needs.

The 2002 MIT study pointed directly at the loss of deferral as the culprit:

> The combination of U.S. tax laws passed in 1975 and 1986 resulted in a business environment where EUSC shipowners could no longer avoid paying tax on current income. This change put them at a major disadvantage to their foreign competitors who often paid little or no income tax. . . . Consequently, EUSC shipowners have greatly reduced their investment in EUSC ships since the Tax Reform Act of 1986.[5]

At the time the MIT study was being completed, the few remaining U.S.-based shipping companies mounted an effort to reverse the 1986 act provision. The timing was fortuitous.

The Restoration

In January 2002 the World Trade Organization Appellate Body held that U.S. extraterritorial income tax benefits — like their predecessor foreign sales corporation rules — constituted prohibited export subsidies under international trade agreements. Congress embarked on legislation to phase out ETI benefits and soften the impact in part by reforming U.S. international tax rules to make U.S.-based companies more competitive in world markets.

Meanwhile, concerns were being expressed about ''inversion'' transactions in which U.S. businesses had become redomiciled outside the United States. Some in Congress pushed for legislation to disregard corporate inversion transactions and continue taxing the new foreign-headquartered entity as a domestic company. Others argued for a review of subpart F and other anticompetitive aspects of U.S. tax law that had motivated these transactions.

The 1986 act shipping changes became a poster child for reform. The Treasury Department, in its May 2002 report on corporate inversion transactions, used the shipping rules as a stark example of anticompetitive U.S. tax law:

> No country has rules for the immediate taxation of foreign-source income that are comparable to the U.S. rules in terms of breadth and complexity. For example, the U.S. tax system imposes current tax on the income earned by a U.S.-owned foreign subsidiary from its shipping operations, while that company's foreign-owned competitors are not subject to tax on their shipping income. Consequently, the U.S.-based company's margin on such operations is reduced by the amount of the tax, putting it at a disadvantage relative to the foreign competitor that does not bear such a tax. The U.S.-based company

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[2] Sources for data include Henry Marcus et al., ''U.S. Owned Merchant Fleet: The Last Wake-Up Call?'' Massachusetts Institute of Technology, 1991; Warren L. Dean and Michael G. Roberts, ''Shipping Income Reform Act of 1999: Background Materials Regarding Proposal to Revitalize the U.S. Controlled Fleet Through Increased Investment in International Shipping,'' Thomas Coburn LLP, 1999; U.S. Maritime Administration; *Fearnleys World Bulk Fleet*, July 1998, July 1993, July 1999; *Fearnleys Review*, 1993, 1998, 1999; *Fearnleys Oil & Tanker Market Quarterly*, No. 1, 2000; *Fearnleys Dry Bulk Market Quarterly*, No. 2, 2000.

[3] U.S. Department of Transportation, Maritime Administration, ''World Merchant Fleet 2005,'' July 2006.

[4] ''Increasing the Size of the Effective United States Control Fleet,'' Henry Marcus et al., MIT, Aug. 2002.

[5] *Id.* at iii.

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> has less income to reinvest in its business, which can mean less growth and reduced future opportunities for that company.[6]

What was left of the U.S. shipping industry also was speaking out. The Overseas Shipholding Group (OSG), a New York-headquartered international shipping company, testified before the House Ways and Means Select Revenue Measures Subcommittee in a June 2002 hearing on ways to promote U.S. international competitiveness following the WTO's ETI ruling. OSG urged lawmakers to enact legislation[7] introduced by Ways and Means Committee member Jerry Weller, R-Ill., and cosponsored by current Chair Charles B. Rangel, D-N.Y., to restore the rule of deferral for U.S. shipping companies. In his testimony before the subcommittee, Robert Cowen, then OSG's chief operating officer, succinctly explained the real-world economic impact of the 1986 act change:

> Because of the 1986 Act change, U.S. investors in international shipping effectively now pay a "premium" because their investments must be made with after-tax dollars, while most foreign-controlled competitors invest with pre-tax dollars. Over time, these premiums on U.S. investments require U.S.-owned vessels to command higher charter rates than their competition in order to maintain overall rates of return that are comparable to those earned by their foreign-based competitors. To the extent such comparatively higher charter income cannot be obtained — and it is clearly not possible to do so — the overall economic picture of U.S.-owned shipping will continue to be eroded.[8]

Leading members of the taxwriting committee were persuaded, and Congress responded. On October 22, 2004, President Bush signed into law the Jobs Act, which restored deferral for shipping income while making other international tax reforms. The JCT staff explained Congress's rationale for revisiting the 1986 act shipping changes:

> In general, other countries do not tax foreign shipping income, whereas the United States imposed immediate U.S. tax on such income. The Congress believed that the uncompetitive U.S. taxation of shipping income caused a steady and substantial decline of the U.S. shipping industry. The Congress further believed that the provision provides U.S. shippers the opportunity to be competitive with their tax-advantaged foreign competitors.[9]

The shipping provision generally took effect for tax years beginning after 2004. With deferral switched back "on," the next phase of Congress's shipping industry tax experiment began. Fortunately, the results of the 2004 act have been just as dramatic as the consequences of the 1986 act.

The Industry Today

The impact of the deferral's restoration on OSG, the leader in urging the 2004 legislation, was nearly immediate. In 2005 OSG posted exceptional financial results, earning $465 million in net income, a company record attributed in large part to the 2004 legislation.[10] OSG had gained the confidence needed to take investment risks and again become a growing enterprise.

In January 2005, just three months after enactment of the 2004 legislation, OSG acquired Stelmar Shipping, an Athens-based international shipper of crude and petroleum products, thereby reversing the trend of foreign takeovers of U.S. shipping companies. The acquisition of Stelmar increased the size of OSG's foreign-flag fleet by 80 percent, from 50 to 90 vessels.

OSG also began committing itself to a major expansion of its U.S.-flag fleet. Before enactment of the 2004 act, OSG's U.S. fleet had been declining in size. In 1996 OSG's U.S.-flag fleet consisted of just 16 operating vessels, and by 2004, the fleet had shrunk to just 10 operating vessels. In June 2005 OSG ordered 10 new Jones Act tankers to be built at the Aker Philadelphia shipyard, today an employer of approximately 1,300. And in February and March 2007, OSG announced plans to commission six new U.S-flag vessels to be built at the Aker Philadelphia shipyard and Alabama's Bender shipyard.

PricewaterhouseCoopers has concluded that this investment will yield substantial economic benefits. A new PwC study[11] found that the 10-ship Aker shipbuilding project announced in June 2005 would increase Philadelphia's gross economic output by $1.29 billion, labor compensation by $490 million, and average annual employment by 1,217 over the 2005-2010 period, with substantial gains also rippling through the national economy as a result.

PwC also asked OSG President and CEO Morten Arntzen about the relationship between this investment and enactment of the 2004 act provision. Here is what he said:

> The restoration of deferral dramatically improved OSG's financial position, strengthening our balance sheet, increasing our profitability, and making us confident about our ability to compete going forward in the global shipping marketplace. The financial assurance we gained from this enhanced financial position has allowed us to take investment risks, associated with our expansion in the U.S. domestic portion of our business, that we never would have contemplated while weakened financially by current taxation under subpart F. Our commitment to finance the construction of ships at Aker without securing employment of the ships

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[6]Office of Tax Policy, "Corporate Inversion Transactions: Tax Policy Implications," Treasury Department, May 2002, at 28.

[7]The Restore Access to Foreign Trade Act (H.R. 3312, 107th Congress).

[8]*See* http://waysandmeans.house.gov/legacy.asp?file=legacy/srm/107cong/6-13-02/6-13cowe.htm.

[9]*General Explanation of Tax Legislation Enacted in the 108th Congress* (JCS-5-05), Joint Committee on Taxation, May 2005, at 296.

[10]*See* OSG 2005 Annual Report at 4.

[11]"Economic Impact of OSG's U.S. Flag Fleet Expansion," PricewaterhouseCoopers, Sept. 4, 2007.

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> ahead of time was a direct manifestation of this confidence in our future performance.[12]

Lessons Learned

This story's happy ending is accompanied by twin morals for lawmakers wrestling with international tax issues. One lesson learned from the shipping industry's experience is that U.S. businesses will surely be lapped in global markets when subject to taxes not borne by their competitors. No one will disagree that the U.S. shipping industry was decimated in the years following 1986. And while it may have teetered on the verge of becoming foreign-owned in 2004, OSG was able to grow in global markets when again placed by Congress on a level playing field. OSG's Arntzen also attributed OSG's ability to acquire Stelmar to the 2004 changes:

> Without the 2004 Act changes, OSG would not have been successful with respect to this acquisition because we were competing against a foreign bidder which could assume income from Stelmar would be subject to no tax.[13]

Another lesson is that deferral, rather than being an incentive for "runaway jobs," can surely operate to promote investment here at home. If one is not persuaded by the PwC study, one can simply go to the Aker shipyards and ask the workers there what OSG's 2005 investment has meant to them. And one should understand that the same principles apply in other industries. Just as employment in the Philadelphia shipyards has depended on OSG's profitability in global markets, a multitude of U.S. jobs in other industries likewise are dependent on U.S. business growth abroad.

As the 110th Congress examines proposals to reshape our international tax laws, it would do well to remember the perfect experiment that it created for the shipping industry between 1986 and 2004, and the clear-cut results.

[12]*Id.* at 10.

[13]*Id.* at 9.

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