Business Roundtable[SM]

Case Study: Elimination of Deferral Sank American Shipping Industry

In a rare "controlled" experiment involving U.S. tax policy, the elimination of deferral for the American shipping industry provides clear evidence of the harm that can occur when globally engaged American companies do not benefit from deferral. Fortunately, the recent reversal of the 1986 decision to eliminate deferral has initiated a rejuvenation of the American shipping industry and an increase in American shipping jobs.

1975 and 1986 legislation eliminated deferral for U.S. foreign shipping income

- Prior to 1975, shipping income of U.S.-owned foreign subsidiaries was eligible for deferral, like most other active foreign business income. In 1975, deferral for shipping income was restricted to income reinvested in qualified shipping assets of the foreign subsidiary. In 1986, deferral was eliminated entirely for foreign shipping income.
- These cutbacks in deferral led to a substantial contraction of the U.S. shipping industry, fewer jobs, and *reduced* U.S. income tax revenue on shipping income. The contraction in American shipping occurred at the same time that foreign carriers were growing substantially. Fortunately, legislation enacted in 2004 has restored deferral for shipping income. The U.S. shipping industry is again on the rebound.
- The evidence is clear – deferral matters for the competitiveness of U.S. companies, for American jobs, and for the overall health of our economy.

What lessons can we learn from the taxation of foreign shipping income?

- In a competitive industry, taxing U.S.-owned operations at non-competitive international tax rates simply diminishes U.S. activity and advantages our foreign competitors.
- Reduced U.S. operations result in reduced employment and lower wages for American workers.
- Non-competitive international taxation of U.S. businesses leads to a lower standard of living for American workers.

The American shipping industry contracted as foreign competitors expanded

- In an industry that requires substantial investments to modernize and expand capacity, the increase in the cost of making shipping investments put the U.S. industry at a significant disadvantage to foreign competitors.
- The decline in the U.S. shipping industry that occurred as a result of this legislation has been well documented.
    - In 1975, U.S.-parent companies owned or controlled 25.7% of the foreign-flag ships serving international shipping markets. By 1986 this share had fallen to 13.2%, and by 1996 this share had fallen to just 5%.
    - Measured by gross tons, the U.S.-controlled foreign merchant fleet fell in size from 21.8 million gross tons in 1975 to 10.8 million gross tons in 1996, a 50% decline. At the same time, the

    capacity of the foreign-controlled merchant fleet expanded from 63.2 million gross tons in 1975 to 204.3 million gross tons in 1996, a 323% increase over this period.
  - U.S.-flag ships, including ships for use solely in domestic trade, also declined over the period, from 737 vessels in 1985 to 423 vessels in 2004. The freight capacity of U.S.-flag shipping declined by more than 40% over the period.
  - U.S.-flag and U.S.-owned foreign-flag shipping declined over this period through an increase in the use of foreign-owned vessels, reduced investment in U.S. shipping, and from the acquisition of U.S. shipping operations by foreign competitors.
  - The decline in U.S.-controlled foreign shipping cannot be attributed to weakness in the worldwide shipping industry given the substantial increases by foreign competitors at the same time.

The decline in foreign shipping income reduced U.S. tax revenue

- In addition to reductions in U.S. shipping operations and related U.S. employment, it is estimated that by 1992 corporate tax collections on shipping income declined to one-fifth of the level of tax paid prior to the 1975 and 1986 legislation.
- Dividends paid and taxable to U.S.-parent companies from foreign shipping income prior to the 1975 and 1986 legislation exceeded all foreign shipping income of U.S. parents by 1992, adjusted for inflation.

Legislation in 2004 restoring deferral brought back the American shipping industry

- Recent analyses indicate that the 2004 legislation restoring deferral for foreign shipping income is reversing the decline in the U.S. shipping industry.
- An acquisition of a foreign shipping company by a major U.S. shipper has expanded the size of its foreign-flag fleet by 80 percent, from 50 to 90 vessels.
- Additionally, the U.S. company has placed orders for the construction of new domestic vessels to substantially expand its U.S. fleet. This ship building is estimated to provide substantial employment gains and increases in labor compensation.
- The capacity of the U.S.-controlled open registry merchant fleet has increased each year since the 2004 Act, rising 21 percent to 14.3 million gross tons in 2010, the highest level since deferral was repealed in 1986.

For a list of source documents and additional research, please see the Business Roundtable fact sheet, "Further Reading on International Tax Issues."

Let's maintain the foundation for sustained economic growth.
Business tax policy must promote U.S. international competitiveness.

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