The Alternative Tonnage Tax

by Brett M. Esber and Joseph T. Gulant

The American Jobs Creation Act of 2004, signed into law by President Bush in November 2004, includes two significant changes to the tax laws applicable to shipping income. As an initial matter, the reader should be informed that these new tax laws apply only to income from the operation of vessels in international trade. They do not apply to income generated from the operation of vessels in the domestic, or Jones Act, trades. However, U.S. companies that currently operate, or might be interested in operating, vessels in international trade (U.S./foreign or foreign/foreign), should be aware of these new tax laws and the significant opportunities they create for more competitive and profitable operation of vessels in international trade.

The two changes included in the Jobs Creation Act are (i) the creation of an "alternative tonnage tax" for income from the operation of certain U.S.-flag vessels in the international trades, and (ii) the removal of "foreign base company shipping income" from subpart F of the Internal Revenue Code. The size of this article does not permit discussion of both changes to the tax laws. For that reason, it will focus on the first change—the introduction of a new alternative tonnage tax. Readers who are also interested in the second change—the change to subpart F—are directed to the article that appeared in the October 2005 issue of Marine News (which will be updated to reflect recent developments).

What is the alternative tonnage tax?

The alternative tonnage tax is essentially a flat tax based on vessel tonnage and the number of days the vessel was operated in the international trades. If elected, the alternative tonnage tax is imposed in lieu of the normal corporate income tax with respect to the operation of the taxpayer's "qualifying vessels."

The U.S. Congress enacted the alternative tonnage tax regime as a mechanism to "level the playing field" for U.S.-flag vessel operators. Several European countries have traditionally allowed their resident entities to pay tax based on alternative tonnage tax regimes—which often produce significantly lower effective income tax rates for those entities as compared to paying income tax. The absence of a tonnage tax regime in the U.S. under prior law was considered to be a competitive disadvantage for U.S.-flag vessel operators.

The alternative tonnage tax is imposed at the highest corporate income tax rate (currently 35 percent) on the daily "notional shipping income" of each qualifying vessel. For tonnage tax purposes, daily notional shipping income is based on the net tonnage of the qualifying vessel and is equal to 40 cents for each 100 net tons up to 25,000 net tons, and 20 cents for each 100 net tons in excess of 25,000 net tons. For example, the daily notional shipping income of a qualifying vessel of 45,000 net tons would be $140, and the daily tonnage tax on the vessel would be $49, or $17,885 for the entire year.

If the alternative tonnage tax is elected with respect to the taxpayer's qualifying vessels, it is imposed in lieu of the normal corporate income tax. Therefore, all items of income, deduction (with limited exceptions), loss or credit associated with the taxpayer's qualifying vessels are excluded from the taxpayer's normal corporate income tax return and are entirely replaced by the relatively simple tonnage tax.

Who can elect the alternative tonnage tax?

In general (non-tax-speak terms), the alternative tonnage tax may be elected by companies operating U.S.-flag vessels of 6,000 deadweight tons or more in international trades. For this purpose, trades between the U.S. and its possessions, such as Puerto Rico and Guam, are considered international trade, and vessels operating in these trades qualify of the alternative tonnage tax.

To be more specific, the tonnage tax regime may be elected by a "qualifying vessel operator" with respect to its "qualifying vessels." A qualifying vessel is any self-propelled (or combination of a self-propelled and non-self-propelled) U.S.-flag vessel of 6,000 deadweight tons or more that is used exclusively (with limited exceptions) in international trades during the period the tonnage tax election is in effect. Temporary use of an otherwise qualifying vessel in the U.S. domestic trades is permitted if the taxpayer timely notifies the IRS of such domestic use, and such use does not exceed 30 days during the taxable year. To be timely, notice must be given not later than the due date (including extensions) for the taxpayer's tax return for the taxable year in which the domestic use occurred.

A "qualifying vessel operator" is a corporation (or an entity that elects to be taxed as a corporation) who (i) operates one or more qualifying vessels, and (ii) meets the "shipping activity requirements." A taxpayer will be treated as "operating" a qualifying vessel if the vessel is owned by or chartered (including on a time charter basis) to the taxpayer. The shipping activity requirements are met if, during the taxable year and each of the two preceding taxable years, on average, at least 25 percent of the aggregate tonnage of qualifying vessels used by the taxpayer were owned or bareboat chartered by the taxpayer. A special rule is applied for the first year that the tonnage tax is elected. In that case, the "look back" is limited to the preceding taxable year only. An election by a member of a controlled group will apply to all qualifying vessel operators that are members of the controlled group. It should also be noted that all members of a controlled group will be treated as one person for tonnage tax purposes and application of the shipping activity requirement. As a result, the taxpayer and its controlled group members may not elect to apply the tonnage tax regime on a vessel-by-vessel basis with respect to the vessels owned by the group; the tonnage tax election, if made, applies to all qualifying vessels within the group.

A taxpayer that charters-out a qualifying vessel on a bareboat basis will generally not be considered to be operating that vessel unless (i) the vessel is temporarily surplus to the taxpayer's requirements and the term of the bareboat charter does not exceed three years, or (ii) the vessel is bareboat chartered to a member of the owner's controlled group or to an unrelated person who sub-bareboat charters or time charters the vessel back to the owner or a member of the owner's controlled group. These provisions tend to prevent election of the tonnage tax by passive investors such as finance companies that own an otherwise qualifying vessel and bareboat charter the vessel to an operator who uses the vessel exclusively in the international trades.

Scope, Timing and Duration of the Election

If the tonnage tax is elected, it replaces the standard corporate income tax with respect to income derived by the taxpayer from its "qualifying shipping activities." In other words, if the tonnage tax is elected, any income earned by the taxpayer from qualifying shipping activities is excluded from the taxpayer's gross income otherwise subject to the standard corporate income tax. Income from activities other than qualifying shipping activities (*e.g.*, income from the operation of vessels in the domestic trades), remains subject to the standard corporate income tax. Complications may arise, however, with respect to the proper allocation of deductible overhead expenses to the portion of business not subject to the tonnage tax regime. For these purposes, tax deductions otherwise allowable that are attributable to qualifying vessels subject to the tonnage tax are effectively ignored.

The definition of "qualifying shipping activities" encompasses more than just freight earned from the carriage of cargo in international trades. It is therefore important to carefully identify all income derived from qualifying shipping activities in order to obtain the greatest benefit from electing the alternative tonnage tax.

"Qualifying shipping activities" are divided into three groups: (i) core qualifying activities, (ii) qualifying secondary activities, and (iii) qualifying incidental activities. Core qualifying activities involve the operation of qualifying vessels in international trades. Qualifying secondary activities include (among other things) managing and operating nonqualifying vessels in international trades, providing vessel, container and cargo-related services, and other activities of the taxpayer that are an integral part of its business of operating qualifying vessels in the international trades. It should be noted that gross income from qualifying secondary activities may be excluded from gross income otherwise subject to the standard corporate income tax only to the extent that gross income from qualifying secondary activities does not exceed 20 percent of gross income from core qualifying activities. Income from qualifying incidental activities (defined generally as activities that are incidental to the taxpayer's core qualifying activities but do not qualify as secondary qualifying activities) may also be excluded from gross income otherwise subject to the standard corporate income tax, but only to the extent that gross income from such activities does not exceed 0.1 percent of the taxpayer's gross income from its core qualifying activities.

The election of the tonnage tax in lieu of the regular corporate income tax can be made with respect to a taxable year at any time before the due date (including extensions) for filing the tax return for that year. The election remains effective until revoked or until the taxpayer ceases to be a qualifying vessel operator, in which case revocation is automatic as of such date. In the later case (lapse of qualification), income of the electing taxpayer will be annualized using a method prescribed by the Secretary of the Treasury.

The tonnage tax election may be revoked at any time. If the revocation is made before the 15th day of the third month of the tax year, it will be effective as of the first day of that tax year. Otherwise, the revocation will be effective as of the first day of the next tax year. It is also possible to specify a later revocation date, in which case the revocation will be effective for tax years beginning on or after the specified date. Once revoked, the tonnage tax may not be re-elected for a period of five years.

Sale or Disposition of Qualifying Vessel/ Availability of Tax Deferred "Like-Kind" Exchanges

In general, the sale or other disposition of a qualifying vessel remains a taxable event. An important exception applies, however, if a replacement vessel is purchased in a timely manner. In general, no gain is recognized on the sale or other disposition of a qualifying vessel if a replacement qualifying vessel is acquired during the period beginning one year prior to the disposition and ending three years after the close of the first taxable year in which the gain is realized. The basis of the new vessel is its cost minus the amount of gain not recognized on the disposition of the old vessel. For these purposes, a taxpayer that has elected the tonnage tax must still account for depreciation of its qualifying vessels on a straight-line basis.

Deciding Whether to Elect the Alternative Tonnage Tax

Deciding whether to elect the tonnage tax is a two-step process. The first step is determining whether the taxpayer qualifies for the tonnage tax. A taxpayer is likely to qualify for the tonnage tax if the following two statements are accurate with respect to the taxpayer:

- The taxpayer operates one or more vessels of at least 6,000 dwt exclusively in the international trades (each such vessel, a "Qualifying Vessel").
- During the tax year in question and each of the preceding two tax years, on average, the taxpayer owned or bareboat chartered Qualifying Vessels having an aggregate tonnage equal to at least 25 percent of the aggregate tonnage of all Qualifying Vessels used by the taxpayer during the period in question.

If the above two statements are accurate with respect to the taxpayer, then the taxpayer is likely to qualify for the alternative tonnage tax. At that point, the decision whether to elect the tonnage tax is strictly a mathematical exercise involving a comparison of total federal income tax using the standard corporate income tax rules and the alternative tonnage tax rules. To accurately calculate the full benefit of electing the alternative tonnage tax regime, the taxpayer must identify all income to be excluded from the regular corporate income tax, including income from core qualifying activities, secondary qualifying activities and incidental qualifying activities.

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