

COMMENTS

Taxation of Marine Shipping Income: A Critique of U.S. Tax Laws in the Energy Transport Industry

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I. INTRODUCTION

As a converted World War II Liberty freighter, the METHANE PIONEER, with her balsa wood supports and plywood insulation, made a courageous transatlantic voyage in 1959 from Lake Charles, Louisiana, to Canvey Island, United Kingdom, to deliver the world’s first shipment of liquefied natural gas (LNG).¹ This successful crossing helped the maritime practice strengthen its image in the oil and natural gas industry and reassured the global marketplace that LNG tankers would play a vital role in the commodity’s international transportation. Fifty years later, innovative natural gas extraction methods in the U.S. Barnett, Eagle Ford, and Marcellus shale fields have revolutionized the production process and created an oversupply of the commodity.

This U.S. natural gas surplus has sparked the interest of energy-hungry countries in the Asia-Pacific that depend on the relatively cheap, clean-burning fossil fuel to power their growing economies and conform to tightening environmental regulations. As a result, the energy industry’s focus has shifted to LNG marine transportation. However, only 379 LNG vessels currently operate throughout the world.² In response to this shortage, the vessel construction industry has recently experienced a massive demand for LNG tanker orders.³

1. David Gardner, *LNG Shipping, in LIQUEFIED NATURAL GAS: THE LAW AND BUSINESS OF LNG* 65 (Paul Griffin et al. eds., 2d ed. 2012).

2. 2012 Annual Report Form 20-F, GOLAR LNG 28-29 (Apr. 30, 2013), http://www.golarlng.com/media/20-F_2013-05-01.pdf.

3. Costas Paris, *Energy Boom Drives Demand for Tankers: Rising North American Energy Exports Lead to Shipbuilding Frenzy*, WALL ST. J. (Oct. 31, 2013, 9:00 PM ET), <http://online.wsj.com/news/articles/SB10001424052702304069604579153452290231762>.

This development is exciting news for the maritime industry, natural gas producers, and developing countries that need low-priced, efficient energy. Surprisingly, however, in contrast to producers who stand to profit significantly from the boom, the U.S. maritime industry may not accrue much economic benefit. Outdated U.S. maritime and tax laws prevent U.S.-owned, U.S.-flagged vessels from obtaining lucrative international shipping contracts. Federal maritime statutes, coupled with federal income tax regulations, have crippled the U.S. maritime industry and pushed capital investment into foreign vessel construction and trade. Over time, these puzzling anticompetitive policies have aggressively tipped the scales significantly in favor of foreign-flagged vessels.

This Comment will analyze the reasons for this imbalance and will use a tax-focused lens to provide explanations that will examine the ultimate damaging effects these policies have had on the U.S. maritime industry. While these antiquated tax policies may have previously bolstered foreign imports and provided inexpensive goods for the American consumer, the current tax laws on marine shipping income disrupt growth opportunities for a U.S. maritime industry that could benefit from the U.S. LNG export boom.

Part I of this Comment will provide an introduction to the recent surge in U.S. natural gas production, describe U.S. lawmakers' efforts to export the commodity internationally, and explore the associated international marine transportation chartering opportunities. The Comment then comprehensively discusses the current U.S. federal income tax regime for maritime shipping income and includes an example in the LNG marine transportation industry to contrast the U.S. tax consequences between a U.S.- and foreign-flagged vessel. Next, the Comment will advance statistical data that illustrates the harmful consequences of outdated tax laws on U.S.-flagged vessel chartering operations. Finally, Parts VIII-X will conclude with a discussion of the resurgence of the U.S. maritime industry within the natural gas markets and recommend various tax reform policies that could incentivize and strengthen U.S. LNG marine transportation. In sum, the objective of this Comment is to inform the reader about influential U.S. federal income tax policies that have, over time, impaired the U.S. maritime industry.

II. NATURAL GAS AND LNG MARINE TRANSPORTATION

A. *Growth of the Natural Gas Industry*

Industry analysts project that the increased development of shale gas extraction through hydraulic fracturing and horizontal drilling will

increase U.S. LNG exports by 17.7% from 2020 to 2040.⁴ Further, by the end of 2014, the United States will surpass Russia as the world's biggest natural gas producer.⁵ This recent oversupply of natural gas has prompted President Obama and U.S. legislators to pursue increased exports to energy-hungry Asian countries such as Japan, South Korea, and Taiwan through the Trans-Pacific Partnership (TPP).⁶ While the TPP is still being negotiated, the United States Department of Energy has conditionally approved export applications to non-FTA countries for U.S. Gulf Coast LNG refineries Cheniere Sabine Pass and Freeport LNG Expansion.⁷ Because only twenty-five LNG-importing countries exist in the world, numerous developing countries in Europe, Central America, and South America are considering plans to construct new LNG terminals and enter the global LNG trade.⁸ With recent natural gas prices in Asian countries reaching approximately \$18 per million British thermal unit (mBtu) compared with \$5 per mBtu in the United States, the LNG marine transportation industry can capitalize on this severe price discrepancy by obtaining attractive chartering agreements with various types of LNG vessels, including LNG tankers, floating storage and regasification units (FSRUs), and floating liquefied natural gas (FLNG) facilities.⁹

B. Marine Transportation of LNG

Natural gas in its organic form is an odorless, yet highly flammable, fossil fuel.¹⁰ Accordingly, to reduce the inherent dangers of transporting an unstable and dangerous cargo, onshore LNG liquefaction facilities

4. *Annual Energy Outlook 2013 with Projections to 2040*, U.S. ENERGY INFO. ADMIN. (Apr. 2013), [http://www.eia.gov/forecasts/aeo/pdf/0383\(2013\).pdf](http://www.eia.gov/forecasts/aeo/pdf/0383(2013).pdf).

5. Michael Crittenden & Amy Harder, *U.S. Faces Pressure on Its Gas Exports: Lawmakers Urge Administration To Ease Barriers to Sales that Could Weaken Russia's Grip on Ukraine*, WALL ST. J., <http://online.wsj.com/news/articles/SB30001424052702303369904579421623403071720> (last updated Mar. 6, 2014, 5:27 PM).

6. *Oil & Gas Update: US LNG Exports Driven by Demand*, ERNST & YOUNG (June 2013), [http://www.ey.com/Publication/vwLUAssets/EY_-_US_LNG_exports_driven_by_demand/\\$FILE/EY_Hot_Topic_US_LNG_exports_DW0275.pdf](http://www.ey.com/Publication/vwLUAssets/EY_-_US_LNG_exports_driven_by_demand/$FILE/EY_Hot_Topic_US_LNG_exports_DW0275.pdf).

7. *Global LNG: Will New Demand and New Supply Mean New Pricing?*, ERNST & YOUNG 9, [http://www.ey.com/Publication/vwLUAssets/Global_LNG_New_pricing_ahead/\\$FILE/Global_LNG_New_pricing_ahead_DW0240.pdf](http://www.ey.com/Publication/vwLUAssets/Global_LNG_New_pricing_ahead/$FILE/Global_LNG_New_pricing_ahead_DW0240.pdf) (last visited Nov. 24, 2014).

8. *Sabine Pass Liquefaction Project*, CHENIERE, http://www.cheniere.com/lng_industry/sabine_pass_liquefaction.shtml (last visited Nov. 24, 2014).

9. Eric Yep, *Surge in U.S. Natural Gas Prices Deflates Hopes in Asia*, WALL ST. J. (Feb. 27, 2014, 4:07 AM ET), <http://online.wsj.com/news/articles/SB10001424052702304709904579408400351274242>.

10. *Natural Gas*, U.S. EPA, <http://www.epa.gov/cleanenergy/energy-and-you/affect/natural-gas.html> (last updated Sept. 25, 2013).

cool the gas to negative 260 degrees Fahrenheit to convert it into a nonflammable liquid that is approximately 1/600 of its original size. This transformation is equivalent to shrinking a volleyball to the size of a ping pong ball.¹¹ Once the gas becomes a harmless liquid, specially built double-hulled vessels that use either a Membrane insulation or spherical Moss containment system safely transport the product across the waterways to an onshore import facility.¹² When the vessels are moored to the facility's subsea LNG pipelines, the liquefied gas is transferred to regasification facilities or an offshore FSRU. There, the liquid is vaporized into its gaseous form and stored for end-use markets via pipelines.¹³

III. BASIC U.S. TAX REGIME FOR MARINE TRANSPORTATION INCOME

A. *General Rules for Effectively Connected U.S. Trade or Business Income*

U.S. federal income taxes impose liability through the source of earnings and the taxpayer's residency status.¹⁴ The general rule is that a U.S. taxpayer's income effectively connected with a U.S. trade or business will be subject to ordinary income tax rates.¹⁵ For a U.S. citizen's or resident's foreign trade or business income that is not connected with the United States, the Internal Revenue Code (I.R.C.) provides a foreign tax credit "for the amount of any income, war profits, and excess profits taxes paid . . . to any foreign country" to offset double taxation by the foreign country of source.¹⁶ This so-called "worldwide tax regime" attempts to tax U.S. individuals and corporations on all U.S. earned income.¹⁷ Thus, the tax laws for foreign persons and corporations that earn income from a U.S. trade or business are markedly different than the tax regime for U.S. citizens.

11. *Facts About LNG*, AUSTL. PAC. LNG, <http://www.aplng.com.au/pdf/factsheets/FactsaboutLNG.pdf> (last visited Nov. 24, 2014).

12. Annual Report Form 20-F, *supra* note 2, at 29 (describing the systems that transport LNG).

13. *Id.*

14. See Cynthia Blum, *U.S. Taxation of Shipping: Anchored to a Flawed Policy*, 33 J. MAR. L. & COM. 461, 462 (2002) (discussing the methods through which the United States imposes income tax).

15. I.R.C. § 861(a)(3) (2012) (noting that compensation for personal services, including marine LNG transportation, is considered gross income from sources within the United States and is subject to income tax liability).

16. *Id.* § 901(b)(1).

17. See Peter A. Glicklich & Michael J. Miller, *U.S. Taxation of International Shipping and Air Transport Activities*, 945 Tax Mgmt. (BNA) Foreign Income Portfolios, at A-3 (2005).

The general rule provides that all income earned by a foreign citizen or corporation not conducting a U.S. trade or business is not subject to U.S. tax.¹⁸ However, if a nonresident alien or foreign corporation earns income from U.S. sources that are effectively connected with a U.S. trade or business, then all of the U.S. source income will be subject to U.S. taxation at ordinary rates.¹⁹ Unfortunately, these basic source rules do not apply to vessel transportation income under I.R.C. § 863(c).²⁰

B. Exception to the Rule—Vessel Transportation Income

The I.R.C. defines “transportation income” as “any income derived from, or in connection with—(A) the use (or hiring or leasing for use) of a vessel” and exempts this type of income from the general sourcing rules for U.S. and foreign entities discussed *supra*.²¹ In place of the general tax regime, the I.R.C. provides two simple solutions to the sourcing and taxation of vessel transportation income. First, if the transportation begins and ends in the United States (think Jones Act vessels), then under the Code, all transportation income is derived from U.S. sources and is fully taxable.²² The second exception states that if the voyage begins or ends in the United States, then the I.R.C. treats 50% as originating from sources within the United States, and earnings will be subject to tax on half of the charterer’s net income.²³ These two exceptions to the I.R.C.’s general sourcing rules under § 871(b) and § 882 serve as the foundation for the U.S. taxation of marine transportation income, barring “reciprocal exemptions” or exclusions by a U.S. income tax treaty.

IV. COMPETING TAX REGIMES BETWEEN U.S. AND FOREIGN VESSELS

A. Reciprocal Exemptions

In 2003, the United States Congress enacted finalized regulations that skirted the § 863(c) exception for sourcing vessel transportation income by codifying § 883, which excluded a foreign “qualified corporation’s” U.S. source income from taxation, pending certain requirements.²⁴ Under the I.R.C., a “qualified corporation” could

18. *Id.*

19. I.R.C. §§ 871(b), 882.

20. *Id.* § 863(c).

21. *Id.* § 863(c)(3)(A).

22. *Id.* § 863(c)(1).

23. *Id.* § 863(c)(2)(A)(ii).

24. *Id.* § 883(a)(1); *see also* Treas. Reg. § 1.883-1 (2012).

exclude U.S. source income through the reciprocal exemption if it were “derived from the international operation of ships” and if the foreign country granted an equivalent exemption to corporations organized in the United States.²⁵ In addition, the qualified corporation had to meet one of three stock ownership tests and satisfy certain U.S. reporting requirements.²⁶ Thus, if the foreign shipowner met the reciprocal exemption requirements, it could circumvent the 50% U.S. source rules imposed under § 863(c)(2)(A) and effectively exclude all income earned by carrying cargo to or from the United States from U.S. taxation.²⁷

The policy-based rationale for promulgating the reciprocal exemptions under § 883 stemmed from decades of congressional concern over the double taxation of shipping income and the inherent administrative burden of allocating income tax liability between U.S. and foreign jurisdictions.²⁸ The original form of the exemption, included in the Revenue Act of 1921, “intended to encourage the international adoption of uniform tax laws affecting shipping companies, for the purpose of eliminating double taxation.”²⁹ Although the current language of the exemption under § 883 differs from its original 1921 form, the operational mechanics of the statute continue to allow foreign-owned, “qualified corporation” vessels to escape U.S. federal income tax liability.

B. *Elective Tonnage Tax*

To offset the favorable U.S. income tax treatment foreign vessels can enjoy under § 883, in 2004, Congress enacted an elective “tonnage tax” regime for qualifying U.S. vessels that would otherwise be subject to the 50% income tax sourcing rules under § 863(c).³⁰ Under this alternative flat tax, any self-propelled, U.S.-flagged vessels of not less than 10,000 deadweight tons, used for “U.S. foreign trade,”³¹ could choose to pay a lowered U.S. income tax determined by the vessel’s

25. Treas. Reg. § 1.883-1(b).

26. *Id.* § 1.883-1(c)(2)-(3) (stating that stock ownership tests include the publicly traded test, *id.* § 1.883-2(a), the controlled foreign corporation stock ownership test, *id.* § 1.883-3(a), or the qualified shareholder stock ownership test, *id.* § 1.883-4(a)).

27. *Id.* § 1.883-1(f)(1).

28. Glicklich & Miller, *supra* note 17, at A-6.

29. *Id.* (quoting S. REP. NO. 275 (1921) (internal quotation marks omitted)).

30. See Paul Riermaier, *United States Tonnage Taxation in the Wake of Polar Tankers, Inc. v. City of Valdez, Alaska: Lessons from the European Union*, 36 TUL. MAR. L.J. 257, 278 (2011) (discussing the mechanics of the U.S. tonnage tax election).

31. “‘United States foreign trade’ means the transportation of goods or passengers between a place in the United States and a foreign place or between foreign places.” I.R.C. § 1355(a)(7) (2012).

“notional shipping income.”³² Set by a formula,³³ the notional shipping income attempts to tax the U.S. vessel on the size of the ship and the amount of time it spends outside of U.S. waters.³⁴ Although the tax still implements the 35% corporate tax rate, the elective tonnage tax provides a corporate tax break for operators of U.S.-flagged vessels who cannot use the reciprocal exemption to eliminate U.S. income tax liability.³⁵

C. *U.S.- and Foreign-Country Income Tax Treaties*

Distinct from the reciprocal exemption or the elective tonnage tax, the United States also attempts to promote income tax neutrality through tax treaties with foreign member states.³⁶ Income tax treaties operate through the source country (i.e., where the money was earned), effectively “rolling over” and allowing the residence country or place of incorporation to impose income tax.³⁷ Specific provisions in the U.S. Model Income Tax Convention³⁸ apply to the marine shipping transport industry. Under article eight of the Convention, profits from the “operation of ships . . . in international traffic” are taxable only in the shipowner’s residence country.³⁹ With “international traffic” defined as “any transport . . . except . . . solely between places [in the residence] [s]tate,” the United States provides shipowners broad discretion to avoid the double taxation of shipping income for foreign-owned vessels and thereby exclude effectively connected income from taxation.⁴⁰

V. PRACTICAL TAX IMPLICATIONS

A. *U.S. Tax Consequences for U.S.-Owned, U.S.-Flagged Vessels*

For the few marine transportation companies currently incorporated in the United States, all shipping income from international operations are subject to U.S. income tax.⁴¹ Historically, U.S. corporations that

32. Glicklich & Miller, *supra* note 17, at A-64.

33. The daily notional shipping income of a qualifying vessel weighing 45,000 net tons would be \$140, with the daily tonnage tax on the vessel of \$49 (\$140 multiplied by the 35% tax rate) and the total tax liability for the vessel’s operating year being approximately \$18,000.

34. Glicklich & Miller, *supra* note 17, at A-64.

35. See I.R.C. §§ 1357(a), 1352.

36. Glicklich & Miller, *supra* note 17, at A-47.

37. *Id.*

38. *United States Model Technical Explanation Accompanying the United States Model Income Tax Convention of November 15, 2006*, U.S. TREAS., <http://www.treasury.gov/press-center/press-releases/Documents/hp16802.pdf> (last visited Nov. 24, 2014).

39. *Id.* at 27.

40. *Id.* at 10.

41. I.R.C. § 861(3) (2012).

registered under flags of “open registry” foreign countries have exploited this worldwide tax regime. Open registry allowed vessels to fly the flags of foreign countries, even if foreign individuals or corporations owned the vessels.⁴² Therefore, to avoid U.S. income tax from shipping operations, many U.S. corporations simply established wholly owned subsidiary corporations in open registry countries such as Liberia or Malta and allowed these foreign subsidiaries to “own” and operate the internationally flagged vessel.⁴³ However, the United States Department of the Treasury quickly learned of this aggressive tax avoidance scheme, and in 1962, Congress enacted Subpart F of the I.R.C., requiring a U.S. shareholder (the U.S. parent shipping company) to include in gross income all “foreign base company shipping income” from a controlled foreign corporation (CFC).⁴⁴ Until 2004, this general rule⁴⁵ applied to all U.S.-owned foreign subsidiaries flying foreign flags.

However, under section 415 of the American Jobs Creation Act of 2004, for taxable years beginning after December 31, 2004, the U.S. government no longer required U.S. shipping corporations to include undistributed foreign shipping income earned by a controlled foreign corporation in their taxable income under Subpart F.⁴⁶ The repeal of Subpart F in 2004 was an obvious relief to U.S. shipping corporations because it allowed U.S.-based parent corporations to compete on an equitable basis for international trade routes with their foreign-flagged competitors. However, the downside to the repeal of Subpart F was that U.S.-owned, foreign-flagged vessels could defer income tax liability only until the income was repatriated from the foreign subsidiaries back to the U.S. parent corporations through dividends.⁴⁷ Thus, while U.S. corporations could enjoy the tax deferral,⁴⁸ the I.R.C. required that all earnings must be reinvested in the CFC to avoid tax liability.⁴⁹ Therefore, this regime still differed considerably from the full tax exemption that

42. Blum, *supra* note 14, at 473-74.

43. *See id.* at 474 (discussing subpart F of the U.S. income tax rules).

44. Treas. Reg. § 1.954-1(a)(2)(iv) (2012). “Foreign base company shipping income” is defined as income derived from (1) the use of a vessel in commerce; (2) the performance of services from a vessel; or (3) the sale of any vessel. Blum, *supra* note 14, at 474 n.69.

45. *See* Blum, *supra* note 14, at 474 (discussing subpart F of the U.S. income tax rules).

46. American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 415, 118 Stat. 1418, 1511 (2004) (codified as amended at I.R.C. § 954).

47. Glicklich & Miller, *supra* note 17, at A-62.

48. *See The Deferral of Income Earned Through U.S. Controlled Foreign Corporations: A Policy Study*, U.S. TREAS. (Dec. 2000), <http://www.treasury.gov/resource-center/tax-policy/Documents/subpartf.pdf> (defining “deferral” as “the postponement of current taxation on the net income or gain economically accrued by a taxpayer”).

49. Glicklich & Miller, *supra* note 17, at A-61.

low tax jurisdictions exercise over foreign shipping companies. In fact, the regime encourages U.S. shipping corporations to postpone recognition of the deferred income indefinitely and invest all undistributed earnings into the foreign countries.⁵⁰

B. U.S. Tax Consequences for Foreign-Owned, Foreign-Flagged Vessels

If a foreign-flagged vessel's shipping income is connected with the United States, then U.S. tax law imposes income tax liability on all effectively connected income from U.S. operations.⁵¹ However, when the vessel operates under a foreign country that has an income tax exemption, the United States will exempt the foreign vessel's shipping income.⁵² Thus, under the current U.S. tax regime, if the foreign corporation is incorporated in the Bahamas (a non-U.S. resident and § 883 reciprocal exemption country), the income earned from shipping LNG from Houston to Japan is excluded from U.S. source or residency tax. Instead, the United States, through a reciprocal tax exemption, will allow the foreign country of incorporation to tax these earnings. However, foreign tax jurisdictions where shipping companies incorporate usually impose little or no income tax.⁵³ Thus, the shipping corporation will effectively avoid paying U.S. or foreign income taxes on the shipment of LNG from a U.S. port to a foreign port.

The contrast in U.S. income tax liability between U.S.-flagged vessels and foreign-flagged vessels is alarming for the U.S. maritime industry, considering the imbalance in competition and subsequent disincentive for owners to invest in U.S. vessels.

VI. A CURRENT PERSPECTIVE ON THE U.S. MARITIME INDUSTRY

A. Jones Act Vessels for LNG Marine Transportation

The Merchant Marine Act of 1920, more commonly referred to as the Jones Act, has sought to shield domestic shipbuilding and U.S.

50. See 2011 Annual Report, OVERSEAS SHIPPING GROUP 20 (Apr. 27, 2012), <http://ir.osg.com/phoenix.zhtml?c=82053&p=irol-reportsAnnual> (follow "2011 Annual Report" hyperlink).

51. See I.R.C. § 863(b) (describing income that is partly from within and partly from without the United States as taxable to the extent it is attributable to sources within the United States).

52. See *id.* § 883(a) (stating that income of foreign corporations from the international operation of ships is not included in the gross income calculation if the foreign country grants an equivalent exemption to corporations organized in the United States).

53. See Blum, *supra* note 14, at 479-80 (discussing foreign tax jurisdiction that offers beneficial income tax rates).

coastwise trade from international competition.⁵⁴ However, for natural gas transportation, vast transmission pipelines⁵⁵ and railways that crisscross the United States provide more flexible and cost-efficient methods of moving the product from coast to coast compared with LNG marine transportation.⁵⁶ Thus, U.S.-flagged Jones Act vessels can expect to accrue little economic benefit from transporting LNG because most charterparties for carriage between Louisiana or Texas and China, Japan, or other Pacific-Rim countries will be too costly to operate compared to foreign-flagged vessels.⁵⁷ Therefore, from a tax-focused perspective, foreign-flagged, foreign-owned vessels appear to have a competitive advantage over U.S.-owned, U.S.-flagged vessels.

B. The Current Condition of the U.S. Maritime Industry

Since 1951, the U.S. oceangoing merchant marine fleet has declined by 82%.⁵⁸ According to the United States Department of Transportation Maritime Administration's (MARAD) latest reports on popular flags of registry for privately owned, oceangoing, self-propelled, cargo-carrying vessels of 1,000 gross tons or more, 48 U.S.-flagged tankers currently operate in the world.⁵⁹ However, the 1,331, 910, and 852 tankers currently registered in Panama, Liberia, and Singapore, respectively, dwarf this figure.⁶⁰ By comparison, more than 540 U.S.-owned vessels are registered in 31 foreign countries, with the Marshall Islands, Singapore, and Liberia accounting for 31%, 11%, and 10% of those vessels, respectively.⁶¹ To further illustrate the decline in U.S.-flagged tankers, according to MARAD statistics, U.S.-flagged tankers peaked in

54. Han Deng, "Built" or "Rebuilt"? *That Is the Question: Risk of Losing the Coastwise Privilege After Vessel Modification Projects Outside the United States*, 35 TUL. MAR. L.J. 241, 242 (2010).

55. See *Natural Gas: About U.S. Natural Gas Pipelines*, U.S. ENERGY INFO. ADMIN., http://www.eia.gov/pub/oil_gas/natural_gas/analysis_publications/ngpipeline/index.html (last visited Nov. 24, 2014) (stating that the U.S. natural gas infrastructure includes 305,000 miles of interstate and intrastate transmission pipelines).

56. Javier E. David, *In Moving US Oil, 'Flexible' Rail Bests Pipelines*, CNBC (June 24, 2013, 10:40 AM ET), <http://www.cnbc.com/id/100831924>.

57. See Paris, *supra* note 3.

58. *Comparison of U.S. and Foreign-Flag Operating Costs*, U.S. DEP'T TRANSP. MAR. ADMIN. 7 (Sept. 2011), http://www.marad.dot.gov/documents/Comparison_of_US_and_Foreign_Flag_Operating_Costs.pdf.

59. *1946-2014 U.S.-Flag Privately-Owned Fleet*, U.S. DEP'T TRANSP. MAR. ADMIN. (Jan. 7, 2014), http://www.marad.dot.gov/library_landing_page/data_and_statistics/Data_and_Statistics.htm (follow "1946-2014 U.S.-Flag Privately-Owned Fleet" hyperlink).

60. *Top 25 Flag of Registry*, U.S. DEP'T TRANSP. MAR. ADMIN. (Sept. 27, 2013), http://www.marad.dot.gov/library_landing_page/data_and_statistics/Data_and_Statistics.htm (follow "Top 25 Flag of Registry" hyperlink).

61. *Comparison of U.S. and Foreign-Flag Operating Costs*, *supra* note 58, at 1.

1951 at approximately 452 vessels and have experienced a downward spiral ever since.⁶² This trend away from operating U.S.-flagged vessels will most likely continue.⁶³

C. *Vessel Construction*

Presumably, because of this decline in U.S.-flagged vessels since 1951, the United States has also suffered a concomitant decrease in vessel construction projects. Beginning in the early 1990s, South Korea's emergence as a global trading partner, coupled with the significant decline in the value of the South Korean Won and availability of cheap labor, provided the Asian country with a boom era for new vessel building projects.⁶⁴ South Korean shipbuilders, including Hyundai Heavy Industries, Daewoo Shipbuilding, and Samsung Heavy Industries, quickly became the leading developers for newbuild projects for LNG tankers by reducing construction costs from approximately \$250 million to \$160 million per vessel.⁶⁵ As a result, the United States currently has very little involvement in constructing these LNG vessels given that "[o]f the 134 LNG tankers built since 2009, 100 were made by South Korean companies, 20 by Chinese companies and 13 by Japanese yards."⁶⁶ The explanation for this decline in the U.S. maritime industry arises, in part, from antiquated U.S. income tax policies, but is also the result of the protectionist policies of the Jones Act.

VII. CULPABILITY FOR THE DECLINE

A. *The Jones Act*

The Jones Act supports isolationist policies that protect the nation's shipping industry from foreign competition and ensure that U.S.

62. 1946-2014 U.S.-Flag Privately-Owned Fleet, *supra* note 59.

63. See, e.g., *Marshall Islands Registry Hits 100 Million Gross Ton*, MAR. EXECUTIVE (Jan. 23, 2014), <http://www.maritime-executive.com/pressrelease/Marshall-Islands-Registry-Hits-100-Million-Gross-Ton-2014-01-23/>; *Malta Registrations Jump Six Million Tons*, MAR. EXECUTIVE (Jan. 21, 2014), <http://www.maritime-executive.com/article/Malta-Registrations-Jump-Six-Million-Tons-2014-01-21/>.

64. See *Special Report: Boom Times for Korean Shipbuilding*, MAR. REP. & ENGINEERING NEWS 30 (May 1992), <http://www.digitalwavepublishing.com/pubs/NWM/maritime-reporter/199205/?pigno=32>.

65. Gardner, *supra* note 1, at 65-66.

65. Annual Report Form 20-F, *supra* note 2, at 29.

66. Simon Hall, *Asian LNG Tanker Builders Vie for Market Share: Chinese and Japanese Shipyards Are Set To Challenge South Korea's Market Dominance*, WALL ST. J. (Dec. 20, 2013, 12:39 AM ET), <http://online.wsj.com/news/articles/SB10001424052702304866904579269290895618508>.

waterways stay in the hands of Americans.⁶⁷ The driving force behind implementing the Jones Act was to prevent foreign-flagged vessels from transporting cargo between U.S. domestic ports and stealing profitable U.S. chartering contracts.⁶⁸ However, this lack of competition from foreign companies resulted in U.S. shipbuilders becoming less efficient and technologically savvy compared to other shipbuilders around the world.⁶⁹ Ironically, through a lack of continual development in maritime investment, coupled with a rising U.S. standard of living, the Jones Act has priced U.S.-flagged vessels out of profitable overseas chartering opportunities and contributed to higher fuel costs in the United States.⁷⁰ With only thirty-two tankers and forty-two barges eligible under the Jones Act to haul fuel along the Gulf and East coasts, as of 2014, shipping a gallon of oil from Houston to New York with a U.S.-owned, U.S.-flagged vessel is more expensive than shipping the oil from Houston to London with a foreign-owned, foreign-flagged vessel.⁷¹

Several factors contribute to this disparity. Some factors include greater insurance costs, higher repair costs, more compliance costs for environmental regulations, and as discussed *supra*, increased U.S. income tax rates for U.S.-owned, U.S.-flagged vessels. Therefore, the benefits of foreign-flagged vessels potentially include zero federal income tax liability, limited manning requirements, flexibility where vessels can be built or repaired, and lack of government vessel safety inspections. However, a 2014 MARAD report indicated that crew labor costs are the greatest differentiating factor between flying a U.S. or foreign flag, primarily because under the Jones Act, U.S.-flagged vessels can only employ U.S. citizens as crew. These citizen crew requirements result in higher manning requirements, higher wages, and thus greater operating expense compared to those of foreign-flagged vessels.⁷² In addition, the income tax considerations for the crewmembers play a significant role in whether the vessel owner decides to fly a foreign or U.S. flag.

67. Deng, *supra* note 54, at 242.

68. See 46 U.S.C. § 50101(a) (2012) (“It is necessary for the . . . development of . . . domestic and foreign commerce . . . that the United States have a merchant marine . . .”).

69. Jackie Northam, *A Boom in Oil Is a Boon for U.S. Shipbuilding Industry*, NPR (Mar. 14, 2014, 3:25 AM ET), <http://www.npr.org/2014/03/14/289849961/a-boom-in-oil-is-a-boon-for-u-s-shipbuilding-industry>.

70. Matthew Phillips, *U.S. Law Restricting Foreign Ships Leads to Higher Gas Prices*, BLOOMBERG BUSINESSWEEK (Dec. 12, 2013), <http://www.businessweek.com/articles/2013-12-12/u-dot-s-dot-law-restricting-foreign-ships-leads-to-higher-gas-prices>.

71. *Id.*

72. *Id.* at 5-6.

B. U.S.- and Foreign-Flagged Vessel Crew Income Taxes

In addition to the vessel owner/operator planning for its tax liability on shipping income, the company must also consider income tax withholding requirements for its crewmember-employees. The general rule under U.S. tax law is that income from performing services is sourced to the location where the services are performed.⁷³ Under this general rule, a foreign crewmember who stops and unloads cargo in a U.S. territory would be subject to U.S. tax on a portion of the income attributable from his or her brief layover in the United States. However, federal law provides income tax exemptions for foreign crewmembers. Under I.R.C. § 861(a)(3), compensation for labor performed by a nonresident alien crewmember on a foreign vessel that is engaged in transportation between the U.S. and a foreign country will be excluded from U.S. sources.⁷⁴ Thus, similar to foreign shipholding companies under § 883, foreign crewmembers have an equivalent exemption from U.S. taxation under § 861.

Coupled with U.S. federal statutes that exempt foreign crewmembers from income tax, the U.S. Model Convention provisions also exempt foreign crewmembers from filing U.S. income tax returns.⁷⁵ This exemption extends to the vessel's captain, engineers, and additional navigators onboard.⁷⁶ Further, to the extent that a nonresident alien earns compensation for services performed outside of the United States, no U.S. taxation will apply. Thus, in effect, if the crewmembers and captain reside in, or are citizens of, a low-income tax jurisdiction, they may effectively escape income tax by using a foreign-flagged vessel.

By comparison, U.S. tax laws impose a worldwide tax regime on all U.S. citizens and residents, regardless of the sourcing of the income. Accordingly, the payee will include income for performing services within the United States by a U.S. citizen or resident as taxable gross income.⁷⁷ To the extent the U.S. crewmember earns income outside of the United States for manning the vessel, the income is taxable both in

73. See I.R.C. §§ 861(a)(3), 862(a)(3) (2012) (listing the source rules for income of sources within and without the United States).

74. *Id.* § 861(a)(3).

75. See *United States Model Income Tax Convention of November 15, 2006*, IRS art. 14(3) (Nov. 15, 2006), <http://www.irs.gov/pub/irs-trty/model006.pdf> (“[R]emuneration . . . derived by a resident of a Contracting State in respect of an employment as a member of the regular complement of a ship . . . operated in international traffic shall be taxable only in that [individual's state of residency].”).

76. *United States Model Technical Explanation Accompanying the United States Model Income Tax Convention of November 15, 2006*, *supra* note 38, at 28.

77. I.R.C. § 861(a)(3).

the United States and by the foreign sourcing jurisdiction.⁷⁸ However, to avoid imposing double taxation, the United States provides a dollar-for-dollar foreign tax credit to the extent of the foreign income tax liability.⁷⁹ Therefore, in the net, the vessel crewmember should only pay U.S. income tax to the extent the crewmember receives U.S. source compensation. While this provision helps to lessen the economic burden on crewmembers, the requirement that vessel operators withhold income tax payments on behalf of their workforces provides another reason why vessels choose to fly foreign flags.

VIII. NEW OPPORTUNITIES FOR THE MARITIME INDUSTRY

When the ramp-up of new natural gas liquefaction facilities begins in late 2014 and early 2015,⁸⁰ the United States Department of Energy will likely grant additional non-FTA export licenses to export facilities in the Gulf South. Further, with new supply areas developing in East Africa and Western Canada, annual LNG supply could increase from 230 million tons in 2013 to over 400 million tons in 2020, with over 30% of this increase coming from the United States.⁸¹ The combination of these developments has sparked a resurgence in the marine construction industry for unique alternative extraction and storage vessels.

A. *Floating Liquid Natural Gas Facilities (FLNGs)*

FLNGs represent a new type of vessel that will extract natural gas trapped in offshore gas fields beneath the ocean's seabed.⁸² These vessels will be moored directly above the source of gas and will extract, process, and liquefy the natural gas for eventual transportation by an LNG vessel to the onshore marketplace.⁸³ The ability of FLNGs to extract and liquefy the gas offshore will eliminate the need for costly pipelines to ship the product to land. FLNGs will also decrease the need for capital-intensive onshore liquefaction facilities that can have a full project

78. See *id.* § 862(b) (allowing the taxing of income from services performed outside the United States).

79. See *id.* § 901 (providing an allowance of credit for taxes of foreign countries and of possessions of the United States).

80. *Global LNG: Will New Demand and New Supply Mean New Pricing?*, *supra* note 7, at 8.

81. *Preliminary Fourth Quarter and Financial Year 2013 Results*, Golar LNG (Mar. 3, 2014), <http://hugin.info/133076/R/1765599/599451.pdf>.

82. Gardner, *supra* note 1, at 68.

83. *Id.*

development time frame of five to seven years.⁸⁴ In addition to corporations that will own FLNGs, environmentalists welcome this development because FLNGs will eliminate expensive dredging and jetty construction projects that ultimately leave damaging environmental footprints throughout marine and coastal locations.

The first example of an FLNG is the 1,600-foot hull of the SHELL PRELUDE that stretches approximately four soccer fields from bow to stern and will be the world's largest vessel ever sent to sea.⁸⁵ With an estimated construction cost of \$10 billion, the PRELUDE will drop anchor 100 miles off the Australian coast and anticipates extracting the equivalent of 110,000 barrels of oil per day in natural gas, which it will then cool and liquefy for transport and sale in Asia.⁸⁶ Further, three 6,700-horsepower thrusters sitting in the rear of the vessel will enable her to correct her position out of the wind and, theoretically, remain moored to the natural gas field during category five hurricanes.⁸⁷

B. *Floating Storage and Regasification Units (FSRUs)*

FSRUs first emerged as a solution to the protracted process of obtaining permits for shore-based LNG reception facilities, especially along the U.S. coasts; these units will be vital to developing the LNG marine transportation industry.⁸⁸ FSRUs have onboard regasification facilities that can be moored to turret-loading buoys. Then the units can discharge raw natural gas into subsea pipelines for eventual storage and consumption.⁸⁹ This new marine technology will create import-based opportunities for growing economies in Asia, the Middle East, and Central/South America, which are currently without the regasification infrastructure necessary to import and convert liquefied gas.⁹⁰ The addition of FSRUs and FLNGs to the current maritime landscape,

84. John White, *Floating LNG—Developing and Implementing Floating Regasification and Liquefaction Projects*, GAS TECH. INST. 2, http://www.gastechnology.org/Training/Documents/LNG17-proceedings/17-2-John_White.pdf (last visited Nov. 24, 2014).

85. *Shell's Massive Prelude Hull World's Biggest-Ever Floating Vessel and First Ocean-Based LNG Plant*, FIN. POST, http://business.financialpost.com/2013/12/03/record-breaking-lng-ship-launched-bigger-one-planned/?_lsa=0e42-7434 (last updated Dec. 3, 2013, 6:16 PM ET).

86. *Id.*; Justin Scheck, *Shell Plans Boat To Tap Gas Fields: Billion-Dollar Vessel Would Chill Gas and Pump It into Tankers*, WALL ST. J. (Jan. 28, 2014, 11:16 PM ET), <http://online.wsj.com/news/articles/SB1000142405270230327770457934833445778984>.

87. *A Revolution in Natural Gas Production*, SHELL GLOBAL, <http://www.shell.com/global/aboutshell/major-projects-2/prelude-flng/revolution-natural-gas-production.html> (last visited Nov. 24, 2014).

88. *Id.*

89. Gardner, *supra* note 1, at 68.

90. *Preliminary Fourth Quarter and Financial Year 2013 Results*, *supra* note 81.

coupled with the newbuild orders for LNG tankers, illustrate the growing demand and promising areas of opportunity for the U.S. maritime industry. However, the government must implement structural tax reform to encourage charterers and shipowners to use American crews and U.S.-flagged vessels to produce and transport LNG.

IX. PROPOSAL OF U.S. TAX REFORMS TO REINSTITUTE GROWTH

U.S. lawmakers originally developed the U.S. income taxation of international shipping income for a different economic and political context than the current U.S. marketplace. Now, as America emerges as a net exporter in the oil and gas industry, officials should amend these antiquated policies to strengthen the U.S. Merchant Marine, reduce reliance on foreign energy imports, and create additional jobs for the U.S. economy. The following reforms to institute this growth focus exclusively on the tax policy tools traditionally exercised by U.S. lawmakers.

A. *Prescription for Reform*

From a tax perspective, the fundamental obstacle blocking the reemergence of the U.S. maritime industry is the unequal advantage foreign-owned, foreign-flagged vessels have through reciprocal exemption that exempts U.S. source shipping income from U.S. tax liability.⁹¹ For example, of the five most popular “open registry” jurisdictions (Hong Kong, Liberia, Marshall Islands, Panama, and Singapore), all have full exemptions for international shipping income tax and pay minimal tax rates for chartering operations solely within the country’s waters.⁹² To boot, these foreign jurisdictions have the added advantages of no capital gains tax or withholding tax, which eventually raises a corporation’s cost of doing business.⁹³ Ultimately, these policies provide many foreign corporations with zero U.S. income tax liability for international shipping income.

This result, as discussed *supra*, contrasts greatly with the U.S.-flagged elective tonnage tax regime⁹⁴ or the general 50% U.S. sourcing rules for worldwide shipping income.⁹⁵ However, before U.S. shipyards

91. See I.R.C. § 883(a) (2012).

92. Blum, *supra* note 14, at 479-80.

93. Robert Carroll & Gerald Prante, Ernst & Young LLP, *Corporate Dividend and Capital Gains Taxation: A Comparison of the United States to Other Developed Nations*, POLITICO (Feb. 2012), http://images.politico.com/global/2012/02/120208_asidividend.pdf.

94. I.R.C. § 1355(a)(4).

95. *Id.* § 863(c).

begin ramping up production of LNG vessels, tax reform must first be instituted to lure financially attractive international chartering contracts to U.S.-owned, U.S.-flagged ships. Some measures to institute this reform include the following initiatives: (1) repealing the § 883 reciprocal exemption for foreign-flagged vessels, (2) instituting a similar income tax credit for U.S.-flagged vessels, or (3) broadening the current elective tonnage tax regime to include Jones Act vessels.

Repealing the § 883 reciprocal exemption or renouncing income tax treaties with foreign jurisdictions are the most dramatic tax proposals and, thus, the least likely to gain U.S. congressional approval. While repealing the exemption would “level the playing field” for U.S. vessels that compete with foreign-flagged vessels, this repeal would stymie international trade and erode political relationships with friendly U.S. commercial partners. A more realistic solution is to provide a dollar-for-dollar nonrefundable U.S. income tax credit that will reduce or eliminate the tax liability owed for “qualifying shipping activities.”⁹⁶

B. A U.S.-Owned, U.S.-Flagged Vessel Income Tax Credit

The U.S. tax credit is a prevalent public policy tool lawmakers use to equalize the tax burden for struggling families through the earned income tax credit and also to incentivize consumers to invest in environmentally friendly technologies through investment tax credits.⁹⁷ The U.S. tax credit for a “qualifying vessel operator”⁹⁸ would work in a similar fashion by eliminating the tax liability for U.S.-owned, U.S.-flagged vessels that fell under the § 863 sourcing rules or the tonnage tax election. Essentially, for every dollar of U.S. income tax liability the vessel operators owes, the operator would receive a tax credit to offset liability limited to the taxpayer’s taxable income from U.S. sources.⁹⁹ This tax reform proposal will efficiently provide significant capital investment incentives for U.S.-flagged, U.S.-owned vessels and will avoid rupturing the beneficial tax agreements the U.S. currently has with “reciprocal exemption” countries that depend on foreign trade as major sources of their gross domestic product. The greatest opposition to this proposal would stem from the U.S. federal government’s short-term

96. *Id.* § 1355(c).

97. *Id.* §§ 32, 48.

98. *Id.* § 1355(a).

99. This mechanism is similar to the current foreign tax credit available under § 901(a) and the associated limitation of the credit under § 904 to the extent of the amount of tax liability due from sources within the United States.

economic losses that are a result of its inability to collect tax revenue from U.S.-flagged, foreign-trade shipping activities.

Arguably, however, the potential for vessel owners and operators to incorporate within the United States, enjoy the country's legal protections, benefit from the high standard of living, and maintain confidence that shipping activities beginning or ending in the United States will be exempt from U.S. income tax liability will ameliorate the federal government's short-sighted loss in tax revenues. Furthermore, this shift to U.S.-owned, U.S.-flagged vessels would encourage additional investment in oil and gas transportation technologies and stimulate U.S. vessel construction projects for FSRUs and FLNGs, ultimately strengthening the U.S. maritime industry.

C. *Amending the Tonnage Tax Base*

A third proposal to incentivize U.S. vessel construction projects is to expand the elective tonnage tax regime to include Jones Act vessels that charter domestically within the United States. Amending § 1353(b)(1)(B) from “the number of days . . . operated . . . as a qualifying vessel in United States foreign trade”¹⁰⁰ to “the number of days the vessel operated in U.S. trade” would achieve this goal. Thus, assuming the U.S.-flagged vessel operates at less than 100% utilization, the product of the notional shipping income and the vessel's number of days chartered in the United States should amount to a lower tax liability than the current corporate net income tax liability on domestic shipping operations.¹⁰¹

Narrowing the taxable income base would tweak the elective tonnage tax to benefit the U.S. maritime industry. This proposal is a moderate approach to reform because it maintains the existing tax infrastructure, but creates carve-outs for specific goods that stand to benefit the most from U.S. marine exports. Similar to state sales tax exemptions for items like food and medicine, the U.S. Treasury Department could promulgate exceptions for LNG marine transportation income from qualifying as “vessel transportation income” under § 863(c) or “notional shipping income” under § 1353(c). Ideally, carve-out provisions specifically tailored to LNG transportation income would help decrease the cost of extraction, push the U.S. Department of Energy to

100. I.R.C. § 1353(b)(1)(B).

101. *See id.* § 11 (imposing a 35% corporate income tax on net income greater than \$10,000,000).

grant additional export licenses, and spark a surge in U.S. vessel construction and U.S. chartering operations.

X. CONCLUSION

The U.S. natural gas industry is currently experiencing a boom in production and a commensurate push from U.S. lawmakers to export the excess supply to energy hungry countries in the Asian-Pacific. This prospect for overseas transportation of natural gas presents tremendous growth opportunities in the U.S. maritime industry for LNG shipping and constructing FLNG and FSRU vessels. However, to reinstitute growth, lawmakers must reform antiquated tax policies, including the § 883 reciprocal exemption, to rebalance the cutthroat chartering industry that currently prevents U.S.-owned, U.S.-flagged vessels from competitively bidding against foreign-owned, foreign-flagged vessels for profitable international LNG shipping contracts. With sound tax reform policies that extend tax credits to U.S. vessel transportation income or narrow the tax base for LNG marine transportation income, lawmakers could catalyze lucrative chartering opportunities for U.S.-owned, U.S.-flagged vessels and revitalize the U.S. maritime industry in the process.