
SENATE COMMITTEE ON REVENUE AND TAXATION

Senator Jerry McNerney, Chair
2025 - 2026 Regular

Bill No:	SB 1113	Hearing Date:	5/6/26
Author:	Valladares	Tax Levy:	Yes
Version:	3/23/26 Amended	Fiscal:	Yes
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CORPORATE TAX: EXCLUSIONS: QUALIFYING SHIPPING ACTIVITIES

Excludes amounts received from qualifying shipping activities from gross income subject to the Corporation Tax when a federal tonnage tax election is in effect.

Background

Until 2017, the United States employed a “worldwide” tax system, under which *domestic* corporations generally are taxed on all income, including income from shipping operations, whether in the United States or abroad. Federal law allowed a foreign tax credit for income taxes paid to foreign countries to avoid double taxation, subject to certain limitations. In 2017, the Tax Cuts and Jobs Act (TCJA) discarded the worldwide system in favor of a territorial one, where income derived from foreign subsidiaries of U.S. corporations is more lightly taxed, if at all.

Generally, the United States taxes *foreign* corporations only on income that is “effectively connected” to the United States. Largely untouched by TCJA, federal law taxes such “effectively connected income” at the same graduated rates that apply to U.S. corporations.

Taxation of international shipping. Federal tax law divides shipping income into two distinct categories: domestic and international. Domestic shipping income generally is income earned from the carriage of passengers or goods between two points in the United States. International shipping income is income earned from the carriage of passengers or goods between a point in the United States and a point in a foreign country and is subject to different tax rules. For U.S. corporations, federal law allocates half of international shipping income to the U.S. for tax purposes, and the other half to foreign countries. U.S. corporations can then claim a foreign tax credit for taxes paid to other countries on half of the income.

Foreign corporations are treated differently. Federal law imposes a 4% tax on the amount of a foreign corporation’s U.S. gross transportation income, which includes income from the use of a vessel and income from services directly related to the use of a vessel. However, this tax has three carve outs, specifically:

- The foreign corporation can elect to treat domestic transportation income subject to the 4% tax as “effectively connected” and subject to the general corporation tax rate if it has a fixed place of business here, and substantially all the income is attributable to regularly scheduled transportation.
- The tax is limited by an applicable U.S. income tax treaty.
- The tax does not apply when a foreign country grants an equivalent exemption to U.S. corporations.

Additionally, federal law excludes a foreign corporation's income from the international operation of its ships, if such foreign country grants an equivalent exemption to corporations organized in the United States under Internal Revenue Code §883.

Tonnage taxes. International shipping significantly differs from other kinds of trades and businesses. Shipping is capital-intensive, costing millions to build a ship, which can then stay in operation for decades. A rapidly changing global economy and foreign conflicts lead to volatile pricing, which makes business planning difficult. Shipping companies compete internationally, and a nation's commercial shipping fleet and shipbuilding capability are intertwined with its industrial capacity and national security.

The United States' shipbuilding, as well as its fleet registered with the United States Coast Guard (U.S.-flag vessels), has been in decline in recent decades. According to the Brookings Institution, American commercial shipbuilding was a vibrant industry, equal in economic size to military shipbuilding in the mid-1970s, and employed 180,000 workers in 1980.¹ After that, President Ronald Reagan cut subsidies to U.S. commercial shipbuilding, and the industry significantly reduced; today America produces less than one half of one percent (0.5%) of the world's commercial ships. The Cato Institute blames U.S. "cabotage" laws that seek to ensure that only U.S. persons operate U.S.-built and U.S.-documented vessels with respect to domestic shipping activities.²

Since the 1950s, countries have developed "tonnage tax" regimes as alternatives to taxing the income derived from companies owning vessels flagged by that country. In 2004, Congress changed federal law to include the U.S. as one of these countries as part of the American Jobs Creation Act, which enacted a new Subchapter R of Chapter One of Subtitle A of the Internal Revenue Code. According to the Congressional Joint Committee on Taxation, Congress believed at the time that operators of U.S.-flag vessels in international trade were subject to higher taxes than their foreign-based competition, causing a substantial decline in the U.S. shipping industry. The federal tonnage tax allows an election for corporations to measure its tax on international shipping based on the tonnage of a vessel used in international shipping and the number of days in operation, instead of profit and loss like general corporation taxes.

Specifically, the tonnage tax is equal to the maximum federal corporate income tax rate (currently 21%) multiplied by its "notional shipping income," which is based on the net tonnage of each of the corporation's qualifying vessels and the number of days in the taxable year that each vessel operates. Qualifying vessels are generally U.S.-flagged vessels that operate exclusively in U.S. foreign trade, which is the "transportation of goods or passengers between a place in the United States and a foreign place or between foreign places." The daily notional shipping income is equal to 40 cents for each 100 tons of net tonnage up to 25,000 net tons, and 20 cents for each 100 tons above 25,000 net tons. That amount is multiplied by the number of days during the taxable year that the electing corporation operated such vessel as a qualifying vessel in United States foreign trade. The resulting amount is then multiplied by the federal corporate tax rate to determine tonnage tax due; gains and losses from vessels electing tonnage tax are then not subject to the general corporation tax.

¹ Aaron Klein and Bruce Jones, "Why maritime infrastructure is about more than the United States Navy," Brookings Institution, May 21, 2021.

² Colin Grabow, "U.S. Maritime Policy Needs an Overhaul," Cato Institute (Sept. 6, 2024).

For example, a 150,000-ton vessel operating 360 days in a taxable year would have \$126,000 in notional shipping income for that year, with \$350 in notional daily income [calculated as follows: $\$0.40 \times (25,000 \text{ net tons} \div 100)$, which equals \$100; plus $(\$0.20 \times ((150,000 \text{ net tons} - 25,000 \text{ net tons}) \div 100))$, which equals \$250; giving notional daily income of \$350. When multiplied by the 360 operating days, this results in \$126,000 worth of notional shipping income for that year]. The corporation owning the vessel would pay \$26,460 (21% times \$126,000) in annual federal tonnage tax, but would not include any profit or loss on the federal corporation tax return from vessels where they paid tonnage tax. However, most U.S.-flagged vessels are much smaller than 150,000 tons.

Any income that does not qualify for the tonnage tax is subject to the regular corporate income tax rules. Losses, deductions, and credits are disallowed against tonnage tax, except for interest expense, which is disallowed according to the ratio that the fair market value of such corporation's qualifying vessels bears to the fair market value of its total assets. Additionally, straight line depreciation must be applied to the basis for any vessel for purposes of determining gain or loss. Vessel owners can defer gain from a vessel subject to tonnage tax when acquiring a replacement vessel, except to the extent the amount from the sale exceeds replacement cost.

Conformity. State law does not automatically conform to changes in federal tax law, except for specific retirement provisions. Instead, the Legislature must affirmatively conform to federal changes, which it can do in two different ways. First, the Legislature can pass an individual tax bill that conforms to a specific federal provision, such as the Regulated Investment Company Modernization Act (AB 1423, Perea, 2011). Second, the Legislature can enact one omnibus bill to provide that state law conforms to federal law as of a specified date. Currently, state law generally conforms to federal tax law as of January 1, 2025 (SB 711, McNerney, 2025).

California Corporation Tax. As a starting point, California measures a corporation's tax by its income derived from, or attributable to, sources in California. However, few large businesses consist of just one entity; instead, they are a collection of subsidiaries and affiliates. Like other states, California applies the unitary business principle, a subsidiary or affiliate is considered part of a unitary business group when there is unity of ownership; unity of operation (via central purchasing, advertising, accounting, and management); and unity of use in its centralized executive force and general operations. Two or more corporations conducting a unitary business within and outside of California must use the combined reporting approach to determine California source income. However, all states with a corporate income tax, including California, generally allow multinational corporations to exclude the income of foreign subsidiaries from their combined groups through a "water's edge election."

California specifically conforms to IRC §883, which excludes a foreign corporation's income from foreign shipping for state tax purposes. As a result, foreign shipping income derived from a foreign subsidiary of a U.S. Corporation would not be included for California purposes, even if the corporation made the water's edge election.

California never conformed to the federal tonnage tax. As a result, any U.S. corporation taxable in California with gain or loss from international shipping must include it for state tax purposes, despite it being subject to the tonnage tax for federal purposes. The author wants to exclude income subject to the federal tonnage tax for state tax purposes.

Proposed Law

Senate Bill 1113 excludes amounts received from qualifying shipping activities by a corporation, or electing corporation, from gross income subject to California's Corporation Tax when a federal tonnage tax election is in effect. The measure also affords similar treatment as federal law by disallowing losses, deductions, or credits, except for interest expense, using the same limitation in federal law. The bill also conforms to the same treatment in federal law to allow electing corporations to defer gain from a vessel subject to tonnage tax when acquiring a replacement vessel, except to the extent the amount from the sale exceeds replacement cost.

SB 1113 defines several terms by reference to the Internal Revenue Code and takes effect commencing in the 2026 taxable year.

State Revenue Impact

According to the Franchise Tax Board (FTB), "To determine the magnitude of the revenue impact, the number of entities that file in California for which an election is in effect under Subchapter R of Chapter 1 of Subtitle A of the Internal Revenue Code the value of qualified shipping activities, and the apportionment factors for each of these taxpayers would need to be known. Because it is difficult to predict these factors, the revenue impact is unknown. However, it is assumed that for every \$1 billion in net income excluded from qualified shipping activities, the estimated impact to the General Fund could be a loss of up to \$50 million annually."

Comments

1. Purpose of the bill. According to the author, "California currently taxes profits that are exempt under the federal tonnage tax system — even when vessels never call at a California port. This lack of conformity penalizes U.S.-flag international shipping companies that operate under federal law. The current system increases operating costs, undermines American competitiveness in global shipping markets, discourages investment in U.S.-flag vessels and shipbuilding, conflicts with bipartisan federal efforts to rebuild the U.S. maritime fleet, and weakens national security by limiting the availability of U.S. commercial vessels in emergencies. Senate Bill 1113 conforms California tax law to the federal tonnage tax regime under Internal Revenue Code Subchapter R. The measure allows qualifying U.S.-flag international shipping companies operating under the federal tonnage tax system to receive consistent treatment under California tax law. This narrow, technical conformity update modernizes state tax policy and ensures that California supports — rather than undermines — national maritime strategy."

2. Come sail away. Any objective metric indicates that the U.S. shipbuilding industry has declined significantly from its post-World War II peak, with implications for the nation's economy and naval security. Congress enacted the tonnage tax regime in 2004 in the hopes of equalizing the tax burden between U.S.-flagged vessels and its foreign competitors; however, it does not appear to have much effect revitalizing the industry.³ Congress is currently considering the SHIPS for America Act of 2025 (S. 1541), which would enact a number of changes to federal law in the hopes of arresting and reversing this decline, including modifications to the tonnage tax. SB 1113 would exclude income subject to the federal tonnage tax from income under California's corporation tax, which would make California's treatment more consistent with other coastal states. The bill also provides parity between U.S. Corporations and foreign ones,

³ Guy Bracuti, "Two if by Sea: The Role of Tax in the U.S. Shipping Revolution." Tax Notes Federal. July 7, 2025.

whose income from foreign shipping generally isn't taxed by either California or the federal government. However, while the bill equalizes the state's tax treatment of U.S. Corporations engaged in international shipping, it is hard to find evidence that it will make a significant enough difference to arrest the decline of the shipbuilding industry.

3. Choppy waters. Countries often impose duties and tariffs on imported products, a power the United States Constitution grants to Congress (Article One, Section Eight). While countries may tax the income of shipping companies situated in their countries, most countries do not apply income taxes on foreign shipping companies, either by law, reciprocal exemption, or international tax treaty. No states impose tonnage taxes, and any state attempting to do so would face difficulties. When taxing the income of multistate or multinational corporations, states must adhere to limits set by federal courts, which state that states cannot tax value earned outside its borders. Taxing income derived from international shipping may stretch this authority. Additionally, tax agencies would have to verify the tonnage of vessels that could be located and operating far away.

4. The loneliest number. United States Department of Transportation reports identify around ten firms owning U.S.-flagged vessels.⁴ IRS data show 11 taxpayers filing the federal tonnage tax form in 2020. Unless one of these firms other than Saltchuk does business in California, it's unlikely that this measure impacts any other firm.

Support and Opposition (5/1/26)

Support: California Society of Enrolled Agents
Pacific Merchant Shipping Association
Saltchuk

Opposition: None received.

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⁴ https://www.maritime.dot.gov/sites/marad.dot.gov/files/2025-06/DS_USFlag-Fleet_2025_JAN.pdf