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# SENATE COMMITTEE ON APPROPRIATIONS

Senator Sabrina Cervantes, Chair  
2025 - 2026 Regular Session

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## SB 1113 (Valladares) - Corporate tax: exclusions: qualifying shipping activities

**Version:** March 23, 2026

**Urgency:** No

**Hearing Date:** May 11, 2026

**Policy Vote:** REV. & TAX. 5 - 0

**Mandate:** No

**Consultant:** Robert Ingenito

**Bill Summary:** SB 1113 would exclude amounts received from qualifying shipping activities from gross income subject to the Corporation Tax when a federal tonnage tax election is in effect.

### Fiscal Impact:

- The Franchise Tax Board (FTB) estimates that for every \$1 billion in net income excluded from qualified shipping activities, the impact to the General Fund could be a loss of up to \$50 million annually (see Staff Comments).
- FTB estimates that for every \$200 million in unrecognized gains from the disposition of a qualifying vessel, the impact to the General Fund could be a loss of up to \$10 million annually (see Staff Comments).
- FTB's administrative costs have yet to be identified.

**Background:** Until 2017, the United States generally operated under a worldwide taxation system, under which U.S. corporations were taxed on their global income, including income from shipping activities earned both domestically and abroad. To mitigate double taxation, taxpayers could claim a foreign tax credit for income taxes paid to other countries, subject to statutory limitations. The Tax Cuts and Jobs Act of 2017 significantly restructured this framework by shifting toward a more territorial system, under which income earned by foreign subsidiaries of U.S. corporations is generally exempt or subject to reduced U.S. taxation.

In contrast, foreign corporations remain primarily taxed only on income that is effectively connected with a U.S. trade or business, and such income is subject to the same graduated corporate tax rates applicable to domestic corporations.

International shipping income is treated under a specialized regime. Federal law distinguishes between domestic shipping income (transportation between U.S. points) and international shipping income (transportation between the United States and foreign locations). For U.S. corporations, international shipping income is typically apportioned, with half treated as U.S.-sourced income and half as foreign-sourced, allowing for foreign tax credits on the latter portion.

Foreign corporations are subject to a separate gross-basis tax on U.S.-related shipping activity, generally imposed at a rate of 4 percent on U.S. gross transportation income. This regime includes several key exceptions and elections, including the ability to treat certain income as effectively connected with a U.S. trade or business (and thereby

subject to regular corporate tax rates), limitations under applicable tax treaties, and reciprocal exemptions where foreign jurisdictions provide equivalent relief to U.S. operators. Additional statutory provisions, including IRC §883, may exempt qualifying foreign shipping income when reciprocal treatment is available.

More broadly, the shipping industry is recognized as structurally distinct from most other sectors due to its capital intensity, long asset lifecycles, and exposure to volatile global market and geopolitical conditions. These characteristics, combined with international competition, have made national shipping capacity closely tied to industrial policy and national security considerations. The U.S. commercial shipbuilding and U.S.-flag fleet have declined significantly since the late 20th century, a trend generally attributed to reductions in subsidies, global competition, and domestic regulatory constraints.

To address perceived competitive disadvantages, many countries developed “tonnage tax” systems beginning in the mid-20th century. These regimes replace traditional profit-based taxation with a simplified formula based on vessel capacity and operating days. The United States adopted a similar elective system in 2004 through Subchapter R of the Internal Revenue Code, allowing qualifying shipping companies to compute tax liability based on notional shipping income rather than actual profits.

Under the U.S. tonnage tax regime, tax is calculated by applying the corporate tax rate to a deemed income figure derived from vessel tonnage and days in service. This system generally applies to qualifying U.S.-flag vessels engaged in foreign trade, and electing taxpayers are excluded from ordinary corporate taxation on income attributable to those vessels. Certain deductions, credits, and loss offsets are restricted, and specialized rules govern depreciation, interest expense allocation, and deferral of gain on vessel replacement.

Income not subject to the tonnage tax remains taxable under standard corporate rules. For example, a large vessel operating full-time would generate a fixed amount of notional income based on statutory formulas, which is then taxed at the corporate rate, regardless of actual profitability.

At the state level, tax conformity with federal law is not automatic. States must affirmatively adopt federal tax changes, either selectively or through conformity legislation tied to a specific federal date. California generally conforms to the Internal Revenue Code on a rolling basis but retains discretion over specific provisions. Currently, state law generally conforms to federal tax law as of January 1, 2025.

California’s corporate tax system applies a unitary business principle, requiring combined reporting for integrated business groups with sufficient operational unity. However, multinational corporations may often exclude foreign subsidiaries through a “water’s edge” election. California also conforms to IRC §883, excluding certain foreign shipping income from state taxation.

California has not adopted the federal tonnage tax regime. Consequently, income or gains related to international shipping that are excluded or specially computed for federal purposes may still be subject to California’s standard corporate tax rules.

**Proposed Law:** This bill, among other things, would do the following beginning in taxable year 2026:

- Exclude 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.
- Afford 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 would conform 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.

**Staff Comments:** This bill contains two provisions that would have uncertain but potentially significant revenue effects.

**Provision #1 - Qualified Shipping Activities: Gross Income Exclusion and Disallowance of Losses, Deductions, and Credits**

FTB indicates that the revenue impact of excluding gross income from qualified shipping activities, along with the corresponding disallowance of related losses, deductions, and credits, cannot be precisely estimated at this time. The magnitude of any fiscal effect depends on several unknown variables, including (1) the number of California taxpayers making an election under Subchapter R of the Internal Revenue Code, (2) the total value of qualifying shipping activity income, and (3) the apportionment factors applicable to each taxpayer. Because these inputs are not readily predictable, FTB indicates that the overall revenue impact is indeterminate. However, as a general benchmark, FTB estimates that for every \$1 billion in net income excluded under the qualified shipping activity provisions, the General Fund revenue loss could reach \$50 million annually.

**Provision #2 - Election to Defer Recognition of Gain from Disposition of a Qualifying Vessel with Replacement Acquisition**

FTB indicates that the revenue impact associated with the deferral of gain on the disposition of a qualifying vessel (where an electing corporation subsequently acquires a replacement qualifying vessel) also cannot be precisely determined. Estimating the fiscal effect would require detailed information that is not currently available, including (1) the number of California taxpayers making an election under Subchapter R of the Internal Revenue Code, (2) the value of qualifying vessels sold and replaced, and (3) the apportionment factors applicable to each affected taxpayer. Again, because these variables are not reasonably predictable, FTB notes that the overall revenue impact is uncertain. However, FTB estimates that for every \$200 million in unrecognized gains from qualifying vessel dispositions, the General Fund could experience a revenue reduction of up to \$10 million annually.

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