PROPOSED MASSACHUSETTS TAX EXPENDITURES
EVALUATION SUMMARY

EVALUATION YEAR: 2021

TAX EXPENDITURE TITLE	Deferral of Tax on Certain Shipping Companies
TAX EXPENDITURE NUMBER	2.101
TAX EXPENDITURE CATEGORY	Deferrals of Gross Income
TAX TYPE	Corporate & Business Excise Tax
LEGAL REFERENCE	IRC § 7518(c), (g)(5); M.G.L. c. 63, § 30.3, 30.4
YEAR ENACTED	Effective January 1, 1987
REPEAL/EXPIRATION DATE	None
ANNUAL REVENUE IMPACT	$0.8 million per year during FY19-FY23
NUMBER OF TAXPAYERS	Not available
AVERAGE TAXPAYER BENEFIT	Not available

Description of the Tax Expenditure: Under Internal Revenue Code ("IRC" or the "Code") § 7518, certain companies with merchant marine capital construction funds receive a deferral of tax on certain amounts set aside for acquisition, construction, modernization, and major repair of ships.	**Is the purpose defined in the statute?** The statute does not explicitly state the purpose of this tax expenditure. We inferred that the purpose is to encourage the acquisition, construction, modernization, and repair of ships. Note that this is a federal expenditure to which Massachusetts conforms by virtue of its conformity with the Code.
What are the policy goals of the expenditure? To encourage acquisition, construction, modernization, and repair of certain ships by allowing a deferral of tax for income set aside to fund such activities.	**Are there other states with a similar Tax Expenditure?** States that use federal taxable income as the basis for their calculation of taxable income will allow the deduction, unless they specifically decouple from IRC § 7518. States that allow the deduction on that basis include New York, California, Connecticut, Maine, Rhode Island, and Vermont. No state has affirmatively decoupled from the federal expenditure.

INTRODUCTION

Federal law provides for the creation of special funds ("merchant marine capital construction funds" or "CCFs") by taxpayers who own eligible vessels. Taxpayers can use CCFs to set aside funds for the acquisition, construction, modernization, and major repair of ships that are constructed or reconstructed in the U.S., registered in the U.S., and used in trade or fishing activity. A deduction is allowed under the Code for amounts properly deposited into a CCF. Tax on income earned on amounts in the fund is deferred. Amounts placed in the CCF must be used for an eligible purpose within 25 years of being contributed or they will be taxed. Massachusetts conforms to the federal tax treatment of the contributions by virtue of its conformity with the Code.

Amounts withdrawn from a CCF are characterized as either qualified withdrawals or nonqualified withdrawals. Qualified withdrawals are those made for the purpose of either the acquisition, construction, or repair of qualified vessels, or making principal payments on the mortgage of a qualified vessel. Qualified withdrawals are excluded from a taxpayer's taxable income. Instead, taxpayers must reduce the depreciable basis of the vessel by the amount of the qualified withdrawal. Nonqualified withdrawals, which are any withdrawals that are not qualified withdrawals, are taxable. Nonqualified withdrawals include amounts used to make principal payments on the mortgage of a vessel if the basis of that vessel has already been reduced to zero.

Amounts that remain in a CCF after the termination of the agreement with the U.S. Secretary of Commerce or the U.S. Department of Transportation (see the next paragraph) are taxable. In addition, any amount left in the account for more than 25 years after being contributed must be recaptured through the inclusion of twenty percent of such amount in income in each of the next five years.

The Department of Transportation's Maritime Administration (MARAD)[1] and the Department of Commerce's National Oceanic and Atmospheric Administration (NOAA)[2] are responsible for administering the CCF program, with MARAD handing commercial vessels, and NOAA handling those in the fishing industry.

The deferral of the tax is essentially an interest-free loan from the government.

POLICY GOALS

[1] https://maritime.dot.gov/grants/capital-construction-fund
[2] https://www.fisheries.noaa.gov/national/funding-and-financial-services/capital-construction-fund-program

DOR surmises that the deferral of tax on income deposited into a CCF is designed to encourage the acquisition, construction, modernization, and repair of ships by allowing a deferral of tax for amounts set aside to fund such activities.

DIRECT COSTS

The revenue loss resulting from this tax expenditure is estimated to be about $0.8 million per year during FY19-FY23.[3] See Table 1.

Table 1. Tax Revenue Loss Estimates for Deferral of Tax on Certain Shipping Companies

Fiscal Year	2019	2020	2021	2022	2023
Estimated Revenue Loss ($Million)	$0.8	$0.8	$0.8	$0.8	$0.8

DIRECT BENEFITS

MARAD gives examples of eligible businesses/vessels that include a broad cross section of the U.S. maritime industry, such as:

- Liner companies that operate containerships and other specialized vessels from the west coast of the United States to points in the Far East and Hawaii and from Gulf of Mexico and east coast ports to Europe, South America, and Africa;
- Tanker operators delivering crude oil from the North Slope of Alaska to the U.S. mainland;
- Bulk vessel operators moving ore, and operators providing ferry and passenger service on the Great Lakes;
- Companies specialized in offshore towing and supply operations that serve oil drilling and production rigs off U.S. coasts and in foreign waters;
- Operators serving Caribbean and Central American ports;
- Tug and barge operators providing service between Pacific Coast ports and points in Alaska, on the river system in Alaska, and in the Gulf of Alaska;

[3] The revenue loss resulting from this tax expenditure is estimated based on federal estimates contained in the most recent tax expenditure report prepared by the Joint Committee on Taxation (JCT), Congress of the United States. To convert the federal estimates into Massachusetts estimates, adjustments are made to take into account, among other factors, the difference between the federal fiscal year and Massachusetts fiscal years, and the difference between the Massachusetts effective corporate tax rate and federal effective corporate tax rate.

- Cruise vessels and tug-barge operators providing inter-island service in the Hawaiian Islands; and
- Operators moving containers and Roll-on/Roll-off cargo in short-sea Shipping trades; and

For fishing vessels, a taxpayer must enter into a CCF agreement with the Secretary of Commerce through NOAA/National Marine Fisheries Service (NMFS). For other vessels, CCF agreements are administered by MARAD.

The list of CCF fundholders with agreements with MARAD as of April 19, 2021 can be found on MARAD's website: Capital Construction Fund (CCF) Fundholders 2021.pdf (dot.gov). It seems that there is no similar list publicly available for fundholders with CCF agreements administered by NMFS.

CCF fundholders that file a Massachusetts state tax return are the direct beneficiaries of this tax expenditure.

EVALUATION: COMPARING COSTS AND BENEFITS

In the previous sections, we report the direct costs (to the Commonwealth, or to the residents and businesses who ultimately bear the costs when the Commonwealth cuts government spending or increases taxes to finance the deferral of tax on certain shipping companies) and direct benefits (to CCF fundholders) of this tax expenditure. In this instance, the direct costs to the Commonwealth, namely the corporate tax that would have been collected from the income deposited into the CCF, are equal to the direct benefits afforded by the tax expenditure to the relevant businesses, which is the corporate tax they would have had to pay to the Commonwealth.

Besides the direct costs and benefits, there are indirect and induced costs and benefits associated with this tax expenditure. The indirect impact (cost or benefit) is felt by the chain of businesses that provide intermediate products and services to the directly impacted businesses. The induced impact (cost or benefit) occurs when a directly or indirectly impacted business passes on the costs or benefits to households, such as those of its employees, in the form of lower or higher income, such as wages and salaries, who then in turn reduce or increase purchases of goods and services from other businesses. The total costs or benefits to the whole economy are larger than the initial direct impacts. This phenomenon is called the "Multiplier Effect".[4]

[4] For an illustration of "Multiplier Effect", see Slide 4 of: https://www.ilw.com/seminars/JohnNeillCitation.pdf

To measure these indirect and induced costs and benefits, economists often need to utilize complicated models, such as REMI (Regional Economic Models, Inc.) or IMPLAN (Impact Analysis for Planning) models. DOR did not attempt to use such models given their complexity and the data limitations present in this instance.

One industry in particular benefits significantly but indirectly from this tax expenditure: the ship and boat building industry in Massachusetts. Businesses in this industry likely benefit from this tax expenditure due to both increased demand and higher prices for their products and services.[5]

According to the U.S. Census Bureau, in 2017, Massachusetts had 11 firms in the industry of ship building and repairing. These firms employed 381 people generating $22.8 million in annual payroll and $76.9 million in annual sales. In the same year, Massachusetts had 25 firms in the industry of boat building, employing 240 people and generating $12.6 million in annual payroll and $60.9 million in annual sales. See Table 2.

Table 2. Annual Payroll, Sales, and Employment of the Industry of Ship and Boat Building in Massachusetts

2017 NAICS Code	Meaning of NAICS Code	Number of Firms	Number of Establishments	Sales, Value of Shipments, or Revenue ($Millions)	Annual Payroll ($Millions)	Number of Employees
33661	Ship and boat building	36	36	$137.8	$35.4	621
336611	Ship building and repairing	11	11	$76.9	$22.8	381
336612	Boat building	25	25	$60.9	$12.6	240

Source: The U.S. Census Bureau, 2017 Economic Census, which is the most recent version of Economic Census. The next version will be 2022 Economic Census.

Besides the economic costs and benefits discussed so far, there are also externalities to consider. A negative externality occurs when the production and/or consumption of a good or service exerts a negative effect on a third party independent of the transaction. For example, a shipyard involved in the building or repairing of vessels may cause noise and air pollution during the building/repairing process. By encouraging this activity, this tax expenditure may aggravate these negative externalities if there are no offsetting policies to dampen the impact.

[5] In turn, the growth of the "ship and boat building" industry due to this tax expenditure will spur growth in other industries (further indirect impact and induced impact), as shown in a report prepared by MARAD: https://www.maritime.dot.gov/sites/marad.dot.gov/files/docs/resources/3641/maradeconstudyfinalreport2015.pdf

Similar Tax Expenditures Offered by Other States

States that use federal taxable income as the basis for their calculation of taxable income will allow the deduction for CCF contributions unless they specifically disallow the deduction. States that follow the deduction include New York, California, Connecticut, Maine, Rhode Island, and Vermont. No state has affirmatively decoupled from the federal expenditure.