The 2007 Act: "Highways to Waterways"

By H. Clayton Cook


Cook

The Energy Independence and Security Act of 2007 (the 2007 Act) authorized a Short Sea Transportation (SST) program. As passed by the House, the legislation would have authorized $2 billion for the Maritime Administration (MARAD) Title XI program and have extended the Capital Construction Fund Program (CCF or Program) to shipyards and operators building and operating vessels in SST services nationwide. Mr. Oberstar and his Congressional co-sponsors were confident that with their proposals in place, the much-discussed use of U.S. waterways for the transportation of freight and passengers by water ("From Highways to Waterways") would be underway. While retaining the SST terminology for MARAD CFR regulations, MARAD now more generally refers to the SST program as the "America's Marine Highway (AMH)" program.

The 2007 Act gave MARAD the authority to add U.S. citizen shipyards and operators in the SST/AMH coastal and inland waterways trades as CCF Program "qualified vessel" participants. In the decade that has followed, not a single U.S. citizen shipyard, and only one U.S. citizen operator has sought to access this CCF Program opportunity. Why?

MARAD CCF Program

The CCF Program authorized by Merchant Marine Act of 1970 (1970 Act) enables a U.S. shipyard, or ship owner or operator, to defer the payment of federal (and in most instances state) income taxes on the profits from U.S. vessel construction, vessel operations and sales, and vessel leasing, and on investment income on its Program deposits. The Program provides what is in effect an interest free loan (from the federal and state taxing jurisdictions) of the money that would otherwise be paid to settle federal and state taxes, in exchange for the taxpayer's promise to use that money for the construction of vessels for operation in "qualifying trades."

As defined in the 1970 Act these "qualifying trades" were the U.S. foreign and Great Lakes trades, and U.S. domestic non-contiguous (Alaska, Hawaii and Puerto Rico) trades. No other domestic trades were included. The 2007 Act expanded the domestic qualifying trades to include the carriage of "cargoes contained in intermodal cargo containers loaded on the vessel by crane" and "cargoes loaded on the vessel by means of wheeled technology" in all coastwise and inland river services nation-wide.

Now, more than 46 years since its 1970 Act passage, the Program has been highly successful. All U.S. citizen owners of significant Jones Act qualifying trades fleets are enrolled. At 2015 year-end deposits totaled approximately $2.2 billion from 147 Program participants. Particular advantages include:

- ***Deferring tax:***

The CCF Program allows a Participant to defer tax by depositing earnings with a MARAD approved financial institution Depository. The Participant commits to a program of vessel construction and MARAD commits the United States to defer tax on monies deposited to finance these projects. Unlike federal income tax benefits under the Internal Revenue Code, the Program tax benefits are contractual, as agreed by MARAD and the Participant. MARAD administers the Program under regulations that provide the rules for participation, the sources and measures for deposits, the timing and accounting for withdrawals, and other Agreement matters. The Internal Revenue Service's role is detailed in the MARAD/IRS Joint Regulations that govern a limited number of filing and accounting issues.

A shipyard may make deposits representing shipbuilding profits, and a vessel owner or operator may make deposits representing chartering and operating income. The Participant's taxable income is reduced by the amount

The 2007 Act gave MARAD the authority to add U.S. citizen shipyards and operators in the SST/AMH coastal and inland waterways trades as CCF Program "qualified vessel" participants. In the decade that has followed, not a single U.S. citizen shipyard, and only one U.S. citizen operator has sought to access this CCF Program opportunity. Why?

placed in the CCF account. The Participant remains the owner of the deposited funds and manages their investment itself or with an investment advisor. The Participant then later withdraws funds from its CCF account to construct or acquire or reconstruct a qualified vessel. These withdrawals are not subject to income tax liability, but there is a downward adjustment in the tax basis of the vessel for which the monies are used.

The tax benefit begins when the taxpayer's deposit is made, and ends when the money is withdrawn in a "qualified withdrawal" to finance the purchase or construction of a "qualified vessel." Because a vessel owner's cost basis will have been reduced by the measure of these Program withdrawals, the owners will begin to "repay" the deferred tax when the vessel is placed in service. The Program basis reduction will result in reduced depreciation deductions during its years in service, and a lower cost basis when it is sold. On a vessel-by-vessel basis, the taxpayer's deferrals are recaptured in this fashion. However, in a typical vessel fleet context, income from vessel sales will often be deposited and taxes will be further deferred, and vessel basis reductions will be on a fleet basis. In a fleet expansion context, the CCF Program tax deferrals can be both substantial and ongoing.

Shipyards using Program monies for working capital in the construction of qualified vessels will have a corresponding lower basis at vessel deliveries, and will pay more tax than would otherwise be due, or will deposit their proceeds of sale adding them to their Program working capital accounts and continuing their Program deferrals.

- ***Accelerating Depreciation:***

The CCF Program also allows the vessel owner to retire qualified vessel indebtedness with before-tax monies, by first depositing the required measure of vessel income, then making qualified withdrawals to retire the debt, and then making an accompanying offsetting reduction on the cost basis of its qualified vessel. Once the cost basis of this vessel has been exhausted, the taxpayer makes vessel-by-vessel reductions in the cost basis of its entire vessel fleet. This allows a vessel owner to access and use the depreciation deductions of its entire fleet on a current basis. A taxpayer employing this methodology can often materially enhance its current cash and liquidity positions.

- ***Coastal Inland Trades Opportunities:***

U.S. coastal and inland waterways services can only be undertaken by U.S. citizens, operating U.S. built vessels that are owned by U.S. citizens. Any owner or operator engaged in these services, and that has a plan for the purchase of one or more "qualified vessels", may be able to achieve Program deferrals. These deferrals would be available for the taxes on the income from "eligible vessel" operations in all coastwise and inland waterways trades.

The 2007 Act change was made so that these deferred tax accumulations could be used for the purchase or construction, or the paydown of existing debt, of this entire new class of SST/AMH "qualified vessels." So, since 2007 an existing inland waterways owner or operator has been able defer the tax on income from its "eligible vessel" operations, by agreeing with MARAD that the funds being deposited will be used for the purchase or construction of new qualified vessels.

- ***Inland Shipyard Opportunities:***

MARAD opened the CCF Program to shipyard participation in 1988 with the contract award to National Steel & Shipbuilding Company (NASSCO), which remains a Program participant today. NASSCO is said to have a Program working capital fund in excess of $500 million that it employs in financing transactions. There are no references to shipyard Program participation on the MARAD website or in the 46 CFR Part 390 regulations. The rules of MARAD Program administration are generally similar to those for vessel owners. However, the informality involved with a case-by-case administration without formal CFR regulations has discouraged shipyard participation.

The Program should allow an inland waterways shipyard to defer the payment of the taxes on shipyard profits from its vessel sales, and vessel leasing, and associated investment income. The alternatives for inland shipyard uses in the financing of new "qualified" vessel and tug and barge designs, and in leasing transactions appear significant. Any U.S. shipyard that meets MARAD U.S. citizenship standards, that owns or leases at least one U.S. built vessel engaged in U.S. domestic or foreign commerce, and has a plan for the construction of qualified vessels should contact MARAD to discuss participation in the CCF Program.

THE WAY FORWARD

MARAD regulations require that a vessel that has been the subject of Program withdrawals must be operated in "qualifying trades" for the vessel's useful life, and will otherwise incur "liquidated damages." The rules "attach to the vessel (even if ownership changes) for 20 years after construction or acquisition of a new vessel." MARAD imposes the liquidated damages provisions on subsequent purchasers even though the original owner has repaid its Program tax benefits to the U.S. Treasury in a taxable sale. MARAD justifies these "attached to vessel" penalties as if the original deferral benefit has in some way been passed on to the subsequent purchasers. This benefit has not been passed on in fair market value transactions.

The owner of a Program vessel is benefitted by the deferral of the payment of taxes that would otherwise have been due on monies that are deposited. When monies are withdrawn to finance the vessel purchase, or retire vessel debt, the deferral ends. The Program vessel cost basis is reduced by the measure of the earlier tax benefit which is then recaptured through reductions in the Program vessel depreciation, and a larger taxable gain on the occasion of its sale (and the gain attributed to the Program basis reductions will be taxed at ordinary income rates). The combination of the reduced depreciation deductions and the taxation of the additional gain will recoup the original tax advantage received by the seller. No tax benefit is passed on to the purchaser.

When an owner wishes to sell a Program vessel, the vessel is less marketable because of these trading restrictions that remain "attached." The owner may not be able to sell the vessel at what would otherwise be its "fair market value," or the owner may not be able to sell the vessel at all. Where would a shipyard or a vessel owner find a purchaser for a vessel so limited in its employment? If you were an operator that had made such a shipyard purchase, or had entered the CCF program and used CCF monies to pay down vessel debt, to whom would you later sell the vessel?

If a shipyard enrolls in the Program and uses its deposits as working capital to finance customer vessel construction, the customer must restrict the vessel to qualifying trades for 20 years. If the vessel to be purchased might be used in any service other than qualifying services, the shipyard cannot use Program monies in the construction.

The 2007 Act was intended to open the Program to SST/AMH qualified vessel construction. MARAD has received only one application for Program participation under this 2007 enlargement. Asked why there have not been more Program applicants, MARAD staff has responded that the SST/AMH sectors "have been depressed." When I have inquired of MARAD staff about the advice that I have received from U.S. Gulf Coast shipyards and operators that the liquidated damages regulations have discouraged and prevented Program participation, the staff have responded that the regulations "are required" by the 1970 Act and cannot be modified.

The liquidated damages regulations are not required by the 1970 Act in situations in which the Program vessel is the subject of a taxable sale or exchange. It remains uncertain as to whether MARAD will amend these regulations to make the Program useful to the U.S. shipyards and vessel owners that were the intended beneficiaries of the 2007 Act.

__H. Clayton Cook__ was the MARAD General Counsel who was responsible for the 1970 Act CCF Program implementation. He completed 10 years as U.S. flag counsel for Seward & Kissel LLP in December 2014, and now continues his U.S. flag practice from new quarters in McLean, VA. Contact him at:
cook@CookMaritimeFinance.com