The big sticking point in CCF is the liquidated damages provision

Making Financing More Flexible

Removing provision from CCF would make program more flexible for offshore support vessel construction

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"Each agreement . . . shall contain a liquidated damages provision for the purpose of placing the party in its prefund position for each day a qualified agreement vessel is operated in violation of the geographic trading restrictions . . . The liquidated damages provision requires that the party repay the time value of the deferral of Federal Income Tax which the party has received."

46 CFR § 390.12 (a)(1)

In recent talks with Gulf Coast shipbuilders, a colleague and I asked why more of them weren't using the U.S. Maritime Administration (MARAD) Capital Construction Fund program (CCF) to build Offshore Support Vessels (OSVs). They pointed to the liquidated damages provision as a stumbling block.

While CCF has been available to a shipyard building vessels for the "qualified" domestic non-continuous trades, the MARAD 46 CFR § 390.12 "liquidated damages" rules have prevented Gulf Coast shipyards from using it to build OSVs that might be used in section 390.5 "non-qualified" international services.

Section 390.12 requires that each agreement "contain a liquidated damages provision for the purpose of placing the party in its prefund position for each day a qualified agreement vessel is operated in violation of the geographic trading restrictions" and that a CCF Program seller must require that "the transferee agree with the Maritime Administrator to comply with the geographic trading restrictions and to pay liquidated damages for any breach of such agreement that occurs after the transfer."

We explained that we believed that this language simply required that: (i) the Agreement fundholder remained liable (after Agreement termination) for section 390.5 violations in the employment of the qualified agreement vessel that had occurred during the period the selling (transferor) fundholder was party to an Agreement (prior to the transfer); and (ii) the purchasing (transferee) new vessel owner (whether or not a new fundholder party) would be liable for section 390.5 violations after that date.

We saw no requirement that the selling transferor fundholder would have any liability for violations after the sale of the qualified agreement vessel. And we suggested that the purchaser (transferee) new vessel owner should only be subject to section 390.5 restrictions at that time it was itself a CCF Program Agreement participant and the vessel was a "qualified agreement vessel" under that Agreement.

However, the shipbuilders said that we were mistaken, and gave the following two examples of MARAD application of section 390.5 "non-qualified operations" and section 390.12 "liquidated damages" provisions to the situation of a hypothetical Shipyard Alpha CCF Program participant, and an OSV Vessel purchaser owner Delta (not a CCF program participant).

Example No. 1: Shipyard Alpha uses the CCF Program to finance construction of an OSV that is sold to Purchaser Delta (not a CCF participant). In year 5, Delta operates the OSV in a service that is a non-qualified service under section 390.5. Alpha and Delta are each liable to MARAD under section 390.12 damages for these 5 years after delivery section 390.5 non-qualified OSV operations.

Example No. 2: The facts are the same as in Example 1 except that Delta does not operate the OSV in a non-qualified service, but in year 5 sells the OSV to Purchaser Gamma (not a CCF participant), and in year 7 of Gamma ownership, Gamma operates the OSV in a service that is a non-qualified service under section 390.5. Alpha, Delta and Gamma are each liable to MARAD for 390.12 damages for this 17 years after delivery OSV non-qualified operation.

As the shipyards explained, any owners use of the OSV that provided services to platforms in international non-U.S. locations services would require that payment of liquidated damages under 390.12 for which the shipyard and every other owner in the CCF Program funded vessel chain of title would be liable. The Gulf Coast shipyards asserted they could not assume this burden, and urged that MARAD should not be asking the shipyards to assume it.

These changes would enable U.S. shipyards to use the CCF Program to finance OSV building for U.S. flag OSV owner-operators free of any limitations on international trade employments.

U.S.-based OSV owner-operators provide services in the Gulf of Mexico and at locations around the world. When Shell contacts an owner to request OSV services for a project in Indonesia, the OSV owner delivers—if it wishes to remain a Shell "preferred provider." But if the OSV has been financed with shipyard CCF monies, the owner will be subjected to MARAD liquidated damages unless prior approvals are obtained. MARAD has no published regulations explaining the standards that it will apply. So, the OSV owners will forgo CCF program use, and will avoid purchases of vessels with CCF restrictions, in order to maintain needed business flexibility.

When the CCF Program is employed, the program participant gains the tax advantage of the deferral of tax on the amounts deposited under the program. These taxes are later recaptured by the Treasury, for a shipyard at vessel delivery, and for an owner-operator over the vessel's life or at its sale. If a CCF Program participant operates a CCF financed vessel in a non-qualified trade, the value of that deferral is repaid to the Treasury in the form of the "liquidated damages" under section 390.12.

Under current MARAD interpretations these liquidated damages provisions are being treated as being "attached" to the vessel, both to the original program participant and all subsequent purchasers. This philosophy implies that the original CCF tax deferral benefit in some way flows through to the subsequent purchaser. But this is not the case.

When a CCF Program participant sells

a qualified agreement vessel in a taxable transaction, tax is computed on the excess of the selling price over the adjusted basis of the vessel. Because the qualified withdrawals that have been made for the vessel will have lowered its adjusted basis, the gain attributable to the CCF reduction will be taxed at ordinary income rates. The taxation of the gain attributable to the CCF basis reduction recoups the original tax deferment, and no tax advantage is passed on to the purchaser. Of course the CCF Program participant has benefitted from the time value of the deferral of the tax over some period. However, during this period that money has been used for MARAD approved qualified CCF Program objectives. The sale of a qualified vessel should not be an occasion for MARAD's recapture of the timing benefit that was used to accomplish MARAD approved Schedule B objectives.

These changes would enhance the value of the program and result in more widespread CCF Program use. They would allow the employment of OSVs in worldwide service competition, enable fair market value sales of vessels with clean titles, free of CCF Program restrictions and the need for MARAD negotiations. And with these changes in place, MARAD staff would no longer be required to devote time to the grant of 390.5 waivers or to monitoring the operation of formerly CCF Program qualified agreement vessels that have been sold to other than Program participants so that liquidated damages can be assessed under section 390.12.

These changes would enable U.S. shipyards to use the CCF Program to finance OSV building for U.S. flag OSV owner-operators free of any limitations on international trade employments. The CCF provisions of the 1970 Act were intended to "level the tax playing field" for our U.S. citizen vessel operators. Certainly no one who was involved with the 1970 Act passage or implementation would have imagined that MARAD would later block this intended tax result and erect a barrier to competition with foreign flag operators in its CCF Program regulations.

MARAD should act to remove these barriers to U.S. shipyard CCF Program participation. ■

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