

FINANCING WITH THE MARITIME ADMINISTRATION'S CAPITAL CONSTRUCTION FUND

By H. Clayton Cook, Seward & Kissel

BACKGROUND

In Europe and the United States the past half dozen years have born increasing witness to highway traffic congestion concerns and to the use of water transportation as a possible supplement and alternative. The U.S. Maritime Administrator speaks of the need to access "America's Marine Highways." However, the means for financing the vessels necessary to access this alternative have remained uncertain. Congress is now moving to make the existing Maritime Administration ("MARAD") financing guarantee and tax deferral programs available for these America's Marine Highways vessel financings.

Neither MARAD program has enjoyed significant use during the current decade. While the Title XI financing guarantee program is well known, the Administration has opposed its use and the enabling Congressional authorizations as unnecessary in the existing credit environment. While the less well known Title VI capital construction fund tax deferral

program has been available for the domestic Great Lakes and non-contiguous trades since 1970, the Bush Administration has opposed all efforts to extend this program's use to vessels in the domestic coastwise ocean trades as an unjustified tax expenditure.

Congress has now proposed authorization for \$2 billion of new Title XI financing guarantee authority for Short Sea Transportation project use, and the extension of the Title VI capital construction fund program to container and roll-on/roll-off ("ro/ro") coastwise ocean services and inland waterways nationwide. Perhaps it is time to look briefly at both of these programs, and then to examine in some detail the potential financing opportunities that the capital construction fund program may offer?

THE U.S. SHIP FINANCING SCENE

The Jones Act and the Passenger Vessel Services Act reserve the carriage of cargo and passengers between United

States ports to vessels built in the United States, operated under U.S. registry and owned and operated by U.S. citizens.¹ While these Acts protect U.S. shipbuilders from competition by foreign shipyards and assure relatively stable values for U.S. flag vessel assets, with the exception of vessels for the petroleum sector, commercial asset-based financing for U.S. flag vessels has seldom if ever been particularly forthcoming.

This situation is true for U.S. vessel owners today. Commercial asset-based vessel financing will generally be limited to 80 percent of vessel cost, with a term of no more than 10 to 12 years, or less than one-half the life of the vessel asset. Financing on this basis, as compared with financing over 20 or 25-year periods, will almost double annual debt service requirements in the early transaction years. This will increase the cost for the transportation service being provided --- be it the charges for a 53-foot trailer on an East Coast ro/ro service, or a ferry fare for a work-bound New York commuter --- by the

same multiple.

As originally enacted in the Merchant Marine Act, 1936 (the "1936 Act"), and revised under the Merchant Marine Act of 1970 (the "1970 Act"), and the Federal Ship Financing Act of 1972, the MARAD capital construction fund tax deferral program (the "CCF Program" or simply the "Program"), and the MARAD federal financing guarantee program (the "Title XI Program") enable qualified U.S. citizen operators: (1) to accumulate the equity for fleet replacement over a period of up to 25 years, under U.S. government CCF Program tax deferral agreements; and (2) to access private sector commercial vessel financing with terms of up to 25 years matched to vessel service lives, by means of a U.S. government Title XI Program of financing guarantees.

Where the Title XI Program is available, the interest rates will almost always compare favorably (after including MARAD fees and transaction costs) with the rates that can be otherwise

achieved. In this context, the 25-year maturities and Treasury related rates under the Title XI Program are the most exact financing fit for long-lived U.S. flag vessel assets. Where the CCF Program is available, its use can materially shorten the time required for the accumulation of the equity funds necessary for a new vessel purchase and materially lessen the cash flow requirements for servicing vessel debt.²

All vessels built in U.S. shipyards for U.S. citizen owners are qualified for the Title XI Program without regard to their trades. Qualification for the CCF Program vessel construction or renewal is limited to vessels that are to be employed in the foreign or domestic non-contiguous or Great Lakes trades, or in certain Gulf of Mexico and other offshore operations. In August of this year, the House of Representatives passed H.R. 3221, which authorized the extension of the CCF program to container and ro/ro services in all U.S. domestic trades.

MARAD'S CAPITAL CONSTRUCTION FUND PROGRAM

1. History & Current Participants

MARAD's CCF Program history begins with the Revenue Act of 1920. The 1936 Act contained a tax reserve program for vessels operating in the United States essential foreign trades. When this program was revised in 1970, it was extended to include domestic services in the Great Lakes and non-

contiguous trades. The Program's Congressional sponsors believed it to be the most important part of the President's 1970 Act fleet and shipyard revitalization program. Today, in H.R. 3221, Congress would extend the Program's application to container and ro/ro services in U.S. domestic coastwise and inland waterways trades. While the CCF Program does not have significant name recognition, the names of CCF Program participants do. BP Oil Shipping Co., Exxon Corporation, Crowley Maritime, General Electric Credit & Leasing, Matson Navigation Company and National Steel & Shipbuilding Co. are all CCF Program participants.

2. Summary & Program Agreements

The CCF Program provides for the accumulation of capital necessary for the acquisition, construction or reconstruction of U.S. built vessels over a period not in excess of 25 years on a before-tax basis. This is accomplished through the deferral of federal (and in most instances state) income taxes on income from the operations and sales of designated agreement vessels, when deposited (and income on such deposits) under the terms of a CCF Program agreement (the "Agreement") between MARAD and an eligible U.S. citizen participant (the "Participant").

In these Agreements the Participant commits to a scheduled program of vessel construction and reconstruction projects that

will advance the MARAD Program objectives. In exchange for this Participant undertaking, MARAD commits the United States government to the deferral of tax on monies the Participant will deposit to finance these projects. Unlike other federal income tax benefits governed by the Internal Revenue Code of 1986, the Participant's tax benefits are contractual, as negotiated and agreed by MARAD and the Participant under the terms of the Agreement.

MARAD sets the terms and conditions of each Participant's scheduled program in the course of the negotiation of the individual Agreement. MARAD governs the Program's administration overall on the basis of regulations describing the eligibility for Program participation, the sources and measures of deposits, the use and timing of withdrawals, and related matters, which are published 46 CFR Part 390. MARAD has also negotiated and published joint regulations with the Internal Revenue Service that govern a limited number of issues that are the subject of joint MARAD and IRS jurisdiction. These are published in identical texts at 46 CFR Part 391 for MARAD, and 26 CFR Part 3 for the IRS.

3. Participant Qualifications

Any U.S. citizen who owns or leases at least one U.S. flag, U.S. built vessel operated in the U.S. foreign or domestic commerce, an "eligible vessel," is eligible to participate in the CCF Program, and to include

selected eligible vessels, that will be the source its deposit ceilings, in its Agreement "Schedule A." The Participant's uses for its deposits, its Program objectives, are detailed in a "Schedule B", which lists the "qualified vessels" — U.S. flag, U.S. built vessels that will be operated in the U.S. foreign, and domestic Great Lakes and non-contiguous trades — that will be purchased, or constructed or reconstructed, together with an estimate of the costs that will be involved.³ The "eligible vessels" and "qualified vessels" that are selected for inclusion in the project are termed "Agreement Vessels."

4. Benefits, Deposit Ceilings & Qualified Withdrawals

The tax benefits — deferral of tax on deposits — begin when a deposit authorized under the Agreement is made under an ordinary income or capital gain deposit ceiling into an ordinary income or capital gain account held by an approved Agreement depository (the "Depository"). The tax deferral ends when the Participant withdraws money from an ordinary income or capital gain account in a "qualified withdrawal" to finance a vessel purchase, or construction or reconstruction. The Participant begins to repay the deferred tax during the first year in which the new or reconstructed vessel, which has been financed with such a qualified withdrawal, is placed in or returned to service.

Agreement deposits may be made subject to four deposit ceilings. For a given year, the

Participant's deposits may not exceed the measure of its: (1) depreciation deductions for Agreement Vessels; (2) net proceeds from the sale or other disposition (or from insurance or indemnity proceeds) for Agreement Vessels; (3) operating income for Agreement Vessels; and (4) receipts from the investment or reinvestment of amounts held by the Agreement Depository. Deposits are assigned to three Agreement accounts, on the basis of source, a "capital account," a "capital gain account" and an "ordinary income account."

The federal income tax cost basis of a CCF qualified Agreement vessel is reduced by the measure of ordinary income or capital gains monies used in the CCF financing. This basis reduction results in reduced yearly depreciation deductions during the years in which the vessel is in service and a lower cost basis when it is sold. As a result, on a vessel-by-vessel basis, the government can expect to capture the measure of tax deferred through increased tax collections during the vessel service life and upon its eventual disposal. In a vessel fleet context, vessel basis reductions are on a fleet basis and vessel sale proceeds can and generally will be deposited so as to shelter the gain on vessel sales. In a fleet expansion situation, the tax deferral may well be continued over an extended period.

5. Non-Qualified Withdrawals

The Participant's tax deferral may also be terminated as the

result of a "non-qualified withdrawal;" one that is not for a CCF Program specified "qualified" purpose. Such withdrawals can be made with MARAD permission in the event the Participant wishes to terminate its U.S. vessel ownership or otherwise abandon its Agreement scheduled projects. MARAD also retains the right to treat monies on deposit as withdrawn in a non-qualified withdrawal, after prior notice and an administrative hearing, in situations where MARAD determines that: (1) the Participant has monies on deposit in excess what would be required for the completion of its Agreement scheduled projects; or (2) the Participant has failed to fulfill a substantial obligation under its Agreement.

Deemed non-qualified withdrawals are required by statute for Agreement monies that remain on deposit for more than 25 years from their original date of deposit. When a non-qualified withdrawal is made, or deemed to have been made, the Participant becomes liable in that year for the entire measure of the deferred tax at the taxpayer's current highest statutory tax rate, with simple interest on the measure of tax due computed from the dates of the original deposits to the date of the withdrawal on a first-in/first-out basis.

ALPHA CORP.: TWO CCF PROGRAM APPLICATIONS

We began this article's CCF Program discussion by summa-

rizing a vessel owner Participant's most basic Program applications -- employing the Program to "materially shorten the time required for the accumulation of the equity funds necessary for a new vessel purchase, and materially lessen the cash flow requirements for servicing vessel debt." And, so while there are a variety of CCF Program applications that would deserve one's attention in more complex lease financing and shipyards settings, it seems appropriate to take the space here to provide detailed illustrations of these two applications.

Perhaps these Program applications can be best understood in the context of two hypothetical examples using Alpha Corp, an existing U.S. citizen operator that currently employs five U.S. built, U.S. flag, integrated tug and barge units ("ITBs") in a highly successful ro/ro service in a U.S. domestic Gulf of Mexico trade.

Alpha wishes to expand its operations to include U.S. to Mexico and U.S. to other Caribbean location trades. Alpha's business plan for this expansion calls for the execution of shipyard construction contracts for three to five new, somewhat larger ITBs no later than December 31, 2011. Alpha believes that the shipyard price for these ITBs will be approximately \$30 million each, for a total cost of \$90 million for three to \$150 million for five ITBs. Alpha expects MARAD Title XI debt financing for 80 percent of the ITBs' cost. However, Alpha will

still need \$18 million to \$30 million of equity depending upon the number of ITBs to be purchased.

How can Alpha accumulate the equity that it will need?

Alpha's projections suggest that it can set aside \$3 million of before tax earnings each year from existing ITB operations for this purpose. On this basis, Alpha will be able to accumulate only \$10.76 million during this period -- only enough for the purchase of one new ITB.

Let's examine Alpha's possible use of the CCF Program for this purpose -- first showing how Alpha can meet a portion of its new ITB equity needs by making Program deposits to defer tax on Alpha's current ITB earnings.

1. Alpha Program Application No. 1: Deferring Tax on Current Earnings

As noted above, if Alpha simply set aside \$3 million of before tax earnings each year for the next five years it would have a total of \$10.76 million. Making use of the CCF Program, Alpha would deposit the \$3 million of its current ITB vessel earnings into its CCF Program account with its Depository, in each of the next five years (2007 to 2011).

Alpha would thereby defer the otherwise due tax on these earnings (and on all of the investment income on its deposits). At the end of year five, this \$15 million in vessel earnings, together with the

Accumulating Capital without CCF – One ITB

Year	Taxable Income ^a	Non CCF Account Deposits (Jan 1) ^b	Tax Payable ^c	Income on Non CCF Account Balance (Dec 31) ^d	Tax Payable on Non CCF Account Income	Non CCF Account Balance (Dec 31)
1	\$3,000,000	\$3,000,000	\$1,200,000	\$ 180,000	\$ 72,000	\$ 1,908,000
2	\$3,000,000	\$3,000,000	\$1,200,000	\$ 370,800	\$ 148,320	\$ 3,930,480
3	\$3,000,000	\$3,000,000	\$1,200,000	\$ 573,048	\$ 229,219	\$ 6,074,309
4	\$3,000,000	\$3,000,000	\$1,200,000	\$ 787,431	\$ 314,972	\$ 8,346,767
5	\$3,000,000	\$3,000,000	\$1,200,000	\$1,014,677	\$ 405,871	\$10,755,573
Additional funds available for fleet expansion: \$10,755,573 – One ITB						

^a Taxable income from prior tax year.

^b Taxable income remains taxable in the absence of CCF account deposits.

^c Assuming a federal tax at Alpha's highest marginal rate, and a combined federal and state tax rate of 40 percent.

^d Assuming a 10.0% rate of return on deposited funds.

FIGURE 1

\$5.15 million of investment income, would provide a total of \$20.15 million for use as Alpha's ITB vessel equity. This would be \$9.39 million more than the \$10.76 that Alpha would have accumulated without the Program, which would only have been enough for the purchase of one ITB.

Alpha's situation may be easier to understand if presented in a

tabular format as in Figures 1 and 2.

Alpha can also accumulate additional equity by retiring Alpha's exiting ITB vessel debt with before-tax dollars.

2. Alpha Program Application No. 2: Retiring Existing Vessel Debt with Before-Tax Dollars

Alpha's five existing ITBs have

been financed, on a vessel-by-vessel basis, with long-term vessel associated debt. While Alpha's annual debt service requirements are substantial, its earnings are such that maintaining this debt service is not seriously burdensome. (Moreover, with respect to some of the Alpha fleet, vessel depreciation deductions allow a portion of these debt service payments to be made with before-tax

dollars.)

Rather than continuing to make debt service payments from general funds, Alpha will now deposit its ITB operating income under its CCF Program (under the vessel operating income sub-ceiling) in the amount necessary to make its debt service payments (that are not already made with monies that are depreciation tax sheltered).

Accumulating Capital with CCF – Three ITBs

Year	Taxable Income ^a	CCF Account Deposits (Jan 1)	Tax Payable	Income on CCF Account Balance (Dec 31) ^b	Tax Payable on CCF Account Income	CCF Account Balance (Dec 31)
1	\$3,000,000	\$3,000,000	-0-	\$ 300,000	-0-	\$ 3,300,000
2	\$3,000,000	\$3,000,000	-0-	\$ 630,000	-0-	\$ 6,930,480
3	\$3,000,000	\$3,000,000	-0-	\$ 993,000	-0-	\$10,923,309
4	\$3,000,000	\$3,000,000	-0-	\$1,392,300	-0-	\$15,315,300
5	\$3,000,000	\$3,000,000	-0-	\$1,831,530	-0-	\$20,146,830
Additional funds available for fleet expansion: \$20,146,830 – Three ITBs						

^a Taxable income from prior tax year.

^b Assuming a 10.0% rate of return on deposited funds.

FIGURE 2

Retiring Debt without CCF – Zero ITBs

Year	Taxable Income ^a	Non CCF Account Deposits (Jan 1) ^b	Tax Payable ^c	Debt Payments (Jan 1)	Non CCF Account Balance (Jan 1)	Income on Non CCF Account Balance (Dec 31)	Non CCF Account Balance (Dec 31)
1	\$5,000,000	-0-	\$2,000,000	\$3,000,000	-0-	-0-	-0-
2	\$5,000,000	-0-	\$2,000,000	\$3,000,000	-0-	-0-	-0-
3	\$5,000,000	-0-	\$2,000,000	\$3,000,000	-0-	-0-	-0-
4	\$5,000,000	-0-	\$2,000,000	\$3,000,000	-0-	-0-	-0-
5	\$5,000,000	-0-	\$2,000,000	\$3,000,000	-0-	-0-	-0-

Additional funds available for fleet expansion: \$0 – Zero ITBs

^a Taxable income from prior tax year.

^b Taxable income remains taxable in the absence of CCF account deposits; thus, eliminating funds available for fleet expansion.

^c Assuming a federal tax at Alpha's highest marginal rate, and a combined federal and state tax rate of 40 percent.

FIGURE 3

Alpha will now make these debt service payments with money taken from its CCF accounts in qualified withdrawals. Acting in this fashion, Alpha's debt service will be made with before-tax dollars. The current debt service cash flow burden will be reduced and Alpha's accumulation of monies for fleet expansion will be correspondingly increased.

Assume that Alpha has annual debt service (principal repay-

ment) obligations for its five existing ITBs vessels that total \$3 million per year. In order to make these \$3 million payments with after-tax income (Alpha's income is taxed at 40 percent), Alpha must earn \$5 million before-tax. Over a five-year period, Alpha will require \$25 million in before-tax dollars to service its \$15 million debt.

Making use of the CCF Program, Alpha will need only

\$15 million in before-tax dollars to service its debt during the same five-year period. If this savings is deposited and invested in CCF Program accounts, Alpha will have an additional \$13.4 million available for ITB fleet expansion at the end of five years. The impact is illustrated in Figures 3 and 4.

3. Alpha's Program Applications 1 & 2: Conclusions

By making use of CCF

Program Applications 1 and 2, Alpha will now have accumulated an "extra" \$9.39 million from current earnings tax savings, and an "extra" \$13.4 million from debt repayment tax savings, or total "extras" of \$22.79 in additional funds. When this \$22.79 is combined with Alpha's basic \$10.76 million of otherwise after-tax accumulated earnings, this will provide a total \$33.6 million for use as vessel equity. This will be enough to fund Alpha's

Retiring Debt with CCF – Two ITBs

Year	Taxable Income ^a	CCF Account Deposits (Jan 1)	Tax Payable	Debt Payments (Jan 1)	CCF Account Balance (Jan 1)	Income on CCF Account Balance (Dec 31) ^b	CCF Account Balance (Dec 31)
1	\$5,000,000	\$5,000,000	-0-	\$3,000,000	\$ 2,000,000	\$ 200,000	\$ 2,200,000
2	\$5,000,000	\$5,000,000	-0-	\$3,000,000	\$ 4,200,000	\$ 420,000	\$ 4,620,000
3	\$5,000,000	\$5,000,000	-0-	\$3,000,000	\$ 6,620,000	\$ 662,000	\$ 7,282,000
4	\$5,000,000	\$5,000,000	-0-	\$3,000,000	\$ 9,282,000	\$ 928,200	\$ 10,210,200
5	\$5,000,000	\$5,000,000	-0-	\$3,000,000	\$12,210,200	\$1,221,020	\$ 13,431,220

Additional funds available for fleet expansion: \$13,431,220 – Two ITBs

^a Taxable income from prior tax year.

^b Assuming a 10.0% rate of return on deposited funds.

FIGURE 4

equity requirements for Alpha's entire proposed five ITB expansion.

Rather than being limited to a one or perhaps a two ITB fleet expansion, by making use of the CCF Program, Alpha will now be able to add the five new ITBs that it needs to enter the Mexican and other Caribbean trades. Alpha will more than double the carrying capacity of its fleet. While the depreciable cost basis of Alpha's newly acquired ITBs will be reduced when these ITBs are placed in service, Alpha will have had the use of before-tax dollars to finance its fleet expansion, with its tax liability substantially deferred. And, so long as Alpha remains in a fleet expansion mode, the tax deferral that Alpha will be able to achieve through fleet basis reductions and vessel proceeds deposits can be essentially ongoing.

CONCLUDING THOUGHTS

We have now seen how the CCF Program can be applied by Alpha, an ITB owner-operator in a U.S. domestic trade, to assist Alpha in financing new ITBs for use in a U.S. foreign trade. Additional Program applications exist for vessel owners and vessel operators, and for financial institution leasing companies and for shipyards. In 1970 the Program's Congressional sponsors believed it to be the most important part of the President's 1970 Act shipbuilding initiative.

"It is believed that these provisions will do more than anything else in the bill to help the ship operating, and therefore the shipbuilding industry to build ships in United States yards which are so urgently needed to modernize our United States merchant marine."

—S. Rep. No. 91-1080,
at 43 (1970)⁴

After its expansion in 1970, the Program made the benefits of Applications 1 and 2 available to a variety of owner-operators. The Program was essential to many of the 1970 Act leveraged lease financing transactions — in which it both enhanced lease yields for owner-lessors and reduced charter hire payments for lessee-users, in both our U.S. foreign and non-contiguous domestic trades. Since 1970 there have been billions deposited to achieve Program tax deferral goals, and billions withdrawn to build or renew U.S. flag vessels under the Program.

The Program's extension to the domestic coastwise trades has been a long-time objective within the maritime financing community. It was included in several Congressional initiatives in the 1990s. MARAD and the Department of Transportation included this extension in their "SEA 21" Short Sea Shipping congestion mitigation proposals in 2002, which were blocked by Administration objections, and there was Congressionally sponsored legislation in 2003.

In August of this year. And House of Representatives passed H.R. 3221, which authorized the extension of the CCF program to container and ro/ro services in all U.S. domestic trades. Over the past 35 years the Program has played a critical role in the expansion

and renewal of our domestic Great Lakes and non-contiguous trades. Isn't it now time to have a close look at this Program's merits and to extend its use to the container and ro/ro services for Short Sea Transportation projects in all of our U.S. domestic trades?



Foot Notes

- ¹ Ownership must generally be by citizens of the United States as defined in 46 U.S.C. 50501. Limited exceptions are provided for certain qualifying leasing, manufacturing and minerals, and oil response company ownership.
- ² The owners of 41 of the 43 container vessels, and 29 of the 30 ro/ro vessels, built in United States shipyards for private sector purchasers since World War II relied upon MARAD Title XI financing. The CCF Program appears to have been used for all 43 of the container vessels and for all but one of the ro/ro vessels. See, U.S. Shipbuilding History, "Containerships Built in U.S. Shipyards," and "Ro-Ro Ships Built in U.S. Shipyards," Maritime Business Strategies, LLC, www.ColtonCompany.com.
- ³ The National Marine Fisheries Service administers a separate capital construction fund program under authority delegated by the Department of Commerce and the National Oceanic and Atmospheric Administration.
- ⁴ The House report states that "This Committee believes that these provisions will do more than anything else in the bill to help the ship operating, and therefore the shipbuilding industry to build ships in United States shipyards which are so urgently needed to modernize our United States merchant marine." H. Rep. No. 91-1073, at 46 (1970).