

The Effective United States Controlled Shipping Fleet: Causes
of Decline and Proposed Remedies

by

Timothy W. Glinatsis

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Signature of Author
Department of Ocean Engineering

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Henry S. Marcus

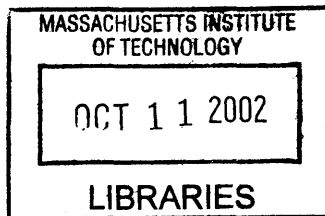
Professor of Ocean Engineering
Thesis Supervisor

Signature redacted

Accepted By
Henrik Schmidt

Professor of Ocean Engineering
Chairman, Department Committee on Graduate Studies

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ABSTRACT

The Effective United States Controlled (EUSC) Shipping Fleet is that group of ships which are owned in majority by United States citizen(s), but operate under foreign flags. Because the owners are citizens of the United States, such vessels can be acquisitioned for use by the government in the event of a national emergency. As such, EUSC ships are included in national defense plans as viable options for the transportation of both U.S. military cargo, and U.S. commercial cargo. Unfortunately, the size of the EUSC fleet has dropped dramatically in the past few decades, leaving the U.S. in a vulnerable position.

Prior to 1986, wherein the Tax Reform Act of 1986 was passed, American shipowners who operated/owned ships under foreign flags were granted certain tax concessions so as to promote competitiveness. Early absolution of tax responsibility was replaced by tax deferral plans, which were ultimately eliminated in favor of standard corporate taxation of U.S.-owned foreign-flag shipping income (by the Tax Reform Act of 1986). Today, the EUSC shipping fleet is a small fraction of what it was just 100 years ago; the primary cause for this situation is the United States' limiting tax policy on foreign-earned shipping income.

Though within the United States taxation of the shipping industry is seen as a simple matter of course, major competing maritime nations have taken a different tack. In an effort to help give their shippers a competitive advantage, most substantial sea-going governments have provided very effective tax reduction plans. By not making a movement in the same direction, the government of the U.S. has provided American

shipowners with little choice but to move abroad: they simply cannot compete with foreign shipowners, if forced to pay taxes on income. This relocation trend has resulted in the degradation of the EUSC, and leaves the U.S. with a potentially crippling disadvantage both economically and militarily.

Fortunately, there have been movements to remedy the situation. A few bills have already seen introduction to Congress, but were never lucky enough to leave committee. Studies have shown that re-adoption of the tax deferral plan would encourage relocation by shipowners to the U.S.; similarly, a flat or tonnage tax plan can be expected to provide sufficient incentive for a relocation with the U.S. In all, the U.S. government has options for revitalizing the EUSC fleet, but does not appear prepared to exercise them.

This thesis was prepared in conjunction with an MIT report, "Increasing the Size of the Effective United States Control Fleet" by Professor Henry Marcus, Steven Torok, Timothy Glinatsis, Parker Larson and Phil Loree. Please reference the report for more detailed information on fleet size, growth/decline patterns and situational impacts of fleet depreciation.

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CHAPTER 1: LEGAL HISTORY

INTRODUCTION

In order to understand the legislative evolution experienced by foreign-flag shipowners in the United States, it behooves us to examine the legal history of the industry. What follows is a brief discussion of each of the key pieces of American legislation impacting the EUSC in the past century.

REVENUE ACT OF 1962

At the time that the Revenue Act of 1962 was under consideration by Congress, U.S. shipowners of foreign flag vessels operated under the general rule that U.S. taxpayers operating abroad are not subject to U.S. taxation on the income of their foreign subsidiaries so long as the foreign earnings were not paid upstream and the foreign subsidiaries were not operating in U.S. business. This rule, which still applies today to most U.S. companies operating abroad, allowed for the deferment of U.S. tax on foreign shipping income pending its payment or “repatriation,” usually in the form of dividends, to U.S. taxpayers. In effect, tax deferral provided U.S. shipowners with options for reinvestment and capitalization.

The 1962 tax bill was aimed at certain types of income (e.g., “tax haven” income) earned by a “controlled foreign corporation” or “CFC” by subjecting those types of income to U.S. taxation irrespective of repatriation to U.S. taxpayers. Of most importance in the income classes established by the 1962 Act is “Subpart F” income which can occur in the

case of a CFC in which the value or voting power is more than 50% controlled (directly, indirectly or constructively) by U.S. taxpayers, accounting for only those with stakes exceeding 10% of the vote. The 1962 Act imposed U.S. tax on the shareholders of the CFC – not on the foreign entity itself – based on the shareholders’ appropriable portions of the Subpart F income. All income that falls under this category is treated as a paid dividend, whether a dividend is paid or not.

During the congressional deliberations on the 1962 Act the Senate Finance Committee gave specific attention to shipping income earned by foreign subsidiaries of U.S. shipowning companies. The result was the Finance Committee voted to exclude such shipping income from the reach of Subpart F and in its Report explained that “this exception was provided by your committee primarily in the interests of national defense.” The 1962 Act that was ultimately passed by Congress contained this specific exclusion.

Consequently, the Revenue Act of 1962 continued tax deferral for shipping income of U.S. owned foreign shipping companies, but it laid the foundation for CFC taxation to come.

TAX REDUCTION ACT OF 1975

Prior to 1976, a blanket exemption existed for companies engaged in international shipping, absolving their profits from CFC tax obligations. The Tax Reduction Act of 1975, effective in 1976, eliminated the previous exemption for the shipping industry. As a result, all income from international shipping became taxable; full-scale shipping

operations, bareboat chartering, ship sales, and unrelated party income were all included in taxable income. Regardless, Congress was aware of the potential impacts such taxation had on an American-controlled merchant fleet in times of war or national emergency. As such, in H. Rep't No. 93-1502, 93d Cong., 2d Sess. (1974) accompanying H.R. 17488, at p. 106 (H.R. Committee Report accompanying a bill to repeal the shipping exemption of subpart F) it was noted:

"...the interests of the United States are best served if we have a significant U.S.-owned maritime fleet. To assume and maintain this status, large amounts of capital are necessary. Further, many U.S. investors in foreign shipping corporations find their investments in such corporations "locked in" by the corporations' financing arrangements and its [sic] need to retain amounts for repairs and maintenance. If the present exclusions for shipping income were simply terminated and such income treated as constructively distributed to U.S. Shareholders, the foreign corporation's ability to meet these obligations would be jeopardized."

In response, Congress excluded from subpart F any international shipping income that was timely reinvested in specified foreign shipping investments. Included in "shipping income" were such items as dividends and interest from other related foreign corporations, gains from the sale of stock in such entities, the corporation's distributive share of a partnership's foreign shipping income, and of course income generated by a corporation's own international shipping activities. A provision of these rules permitted CFCs to combine foreign shipping incomes and qualified investments to determine to

what extent subpart F income would be offset. Though reinvestment was an option, it often proved to be of little value. Restrictions of the deferral required that reinvestment totals not be exceeded by depreciation or sold assets in any given year; any reinvestment made under those circumstances would result in the taxation of the corresponding income. Similarly, income retained for future long-term investment was not protected. Thus, any excessive qualified investment in a given year could not be exempted in future years.

TAX REFORM ACT OF 1986

The Tax Reform Act of 1986 further influenced the shipping industry by eliminating the last vestiges of tax deferral available to U.S.-controlled foreign shipping companies, while leaving existing tax burdens. First, the reinvestment exemption was repealed, meaning that capital must be obtained from earnings after tax. Secondly, the ability to carry-over E&P (earnings and profits) deficits from pre-1987 years was eliminated, and subsequently such deficits could not be used to discount subpart F income. Lastly, the recapture provision which applied to prior year deferrals and reinvestment in international shipping businesses was continued, limiting companies' ability to make investments when needed.

Additional changes were made regarding a CFC's ability to offset E&P deficits of a related CFC's subpart F income. As required, only CFCs in the same chain of ownership, which are 100% owned by other members of the chain, and are formed in the same jurisdiction, may offset each other's subpart F income. This stipulation holds many impracticalities, in that the complexity of foreign registries alone does not lend itself to

alignment under a single jurisdiction. The result is a disallowance of risk distribution both in jurisdiction and ownership - as joint ventures and financing options are eliminated through the 100% ownership requirement.

The U.S.-controlled foreign fleet is now responsible for taxes on its offshore earnings without any avenue for exemption by reinvestment. Similarly, U.S. shipowners are subject to taxation without the option of offsetting for economic operating losses generated in years before 1987.

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CHAPTER 2: A LITERATURE REVIEW

INTRODUCTION

The discussion surrounding the size of the Effective United States Controlled fleet is one that has been ongoing for many decades, particularly since the revocation of the income deferral clause by the Tax Reform Act of 1986. As such, literature is available on this very subject, and much can be learned through a review of this literature. This section of the report summarizes and discusses key points presented in representative pieces of literature. We wish to learn to what extent this literature can explain the decline in the size of the EUSC fleet. We have separated the documents into the following categories: Justification for the EUSC Fleet, Questioning the Impact of the Tax Reform Act of 1986, Current Issues, and Attempts at Improving the Competitiveness of U.S. Shipowners.

JUSTIFICATION FOR THE EUSC FLEET

Introduction

This research is based on the premise that the EUSC fleet can be of military value in time of need. We start the literature review with two documents that explain the justification for the EUSC fleet.

Boleslaw Adam Boczek - Flags of Convenience - An International Legal Study

Mr. Boczek's book, published in 1962, presents a very detailed analysis of the definition and justifications for using flags of convenience in international shipping. Offered in the book is an excellent presentation on the history and predicted future of the Effective U.S. Controlled fleet.

Of most importance in this book is the discussion of the military usefulness of American-owned, foreign-flag ships. Despite being written in 1962, the discussion clearly shows America's dependence on foreign-flag ships during times of emergency. Having access to these ships is an advantage that is clear enough to see. Yet, the primary importance of these ships, according to Mr. Boczek, is that the U.S. military includes these vessels in its count of ships available for transporting military cargo. Were these ships removed from the count, or were the EUSC to dwindle from existence entirely, would the U.S. retain the ability to successfully execute a multiple theater war? The answer, according to Boczek (and the Navy spokesmen cited in the book), is no.

Federation of American Controlled Shipping – “The EUSC Fleet – Trends Relating to Present and Future Availability”

On January 13, 1986, The Federation of American Controlled Shipping (FACS) published an organized discussion of Effective U.S. Controlled shipping issues. A very thorough review of the definition of EUSC vessels is included, and is accompanied by statistical analysis of the fleet’s decline. However, of particular import to our discussion is the collection of quotes regarding EUSC. These statements show the supporting opinions of assorted officials throughout the 20th century.

The Joint Chiefs of Staff, in 1945, included EUSC ships in its strategic outline:

“To be effective as an instrument of national defense U.S. merchant shipping should be under U.S. flag or effective U.S. control and should be of such capacity that it is able to absorb substantial initial losses which may be occasioned by either a surprise attack or an efficient submarine and air interdiction of sea lanes, or both, and still perform the following services. . .”

The National Academy of Sciences-National Research Council completed a study in 1959 entitled “The Role of the U.S. Merchant Marine in National Security.” The report included the following comments on EUSC:

“For purposes of indisputable control, it would be preferable that all U.S.-owned merchant shipping be documented under U.S. flag. Such an ideal situation does not exist. At the same time, U.S. flag merchant tonnage is not adequate to meet our total wartime needs. This is

particularly true with tankers . . . In the event of war it will be necessary to augment U.S. flag shipping. The Maritime Administration and the Navy Department have determined jointly that it will be practicable to bring a portion of the U.S.-owned foreign-flag shipping under direct U.S. control in the event of a national emergency. This effective U.S. control concept is a matter of expediency, rather than choice, and applies essentially to designated shipping under the ‘flags of convenience.’”

Then Under Secretary of State C. Douglas Dillon also stated, in 1959, his support for the EUSC:

“My final thought on this subject is that, until such time as it may be feasible for these American shipowners to operate competitively under the United States flag, my Government retains its interest in the continued operation of ships under foreign flags, including the PANLIBHON (Panama, Liberia and Honduras) registries. From our viewpoint there are important and valid defense requirements which support this position.”

Attesting to the historical success of EUSC inclusion, the Office of Civil and Defense Mobilization reported in 1960:

“. . .in practice during World War II and Korea, when the United States called on privately-owned tonnage to meet defense needs, PANLIBHON vessels subject to emergency

utilization by the United States were immediately made available. In neither case did serious problems develop because of the foreign nationality of the crews.”

In 1966, Maritime Administrator Nicholas Johnson confirmed the reliability of EUSC ships:

“Certainly if the history of Second World War and Korea is valid for purposes of future planning, history is on the side of this judgment. As a practical matter these ships have been available to the United States when needed. . . We are not now talking about ships owned by foreign citizens and registered in foreign countries – which have in a small number of cases refused to carry our defense cargoes – but ships owned by American citizens. We are talking of plans that, by and large, those ships will continue to serve the raw materials import trades that they now serve – although some of them would be directly involved in the defense effort (and are today).”

Secretary of Defense, Robert S. McNamara, said in 1967:

“In a full scale national emergency, we believe ‘effective U.S. controlled ships’ will be as available to DoD as U.S. flag ships.”

Admiral James L. Holloway III, Chief of Naval Operations, said in his policy statement on March 1, 1978, the following things about EUSC:

“The United States has plans for the utilization of foreign flag ships of the Effective U.S. Control Fleet. These are U.S.-owned or U.S.-controlled ships of foreign registry of 1,000 gross tons or more, which are under contract to the Maritime Administration. These can be reasonably expected to be made available for U.S. use in time of emergency.”

On June 8, 1981, Secretary of Defense Caspar W. Weinberger told the National Maritime Council the following things regarding EUSC ships:

“The EUSC fleet is composed of some 465 ships primarily under Liberian registry with a few under Panamanian and Honduran flags. These ships, owned or controlled by U.S. citizens, are considered in contingency plans for sealift requirements primarily as a source of ships to move essential oil and bulk cargoes in support of the national economy. The majority of those vessels are not considered militarily useful...

The EUSC countries of registry have stated that they will assert no control over the employment of ships on their registries, and that they will not interfere with the exercise of emergency authority by the governments of shipowners. They have indicated, with varying degrees of formality, that they would not interpose any objections to the exercise of U.S. requisitioning authority over U.S. owned ships ...the real basis for the effective U.S. control concept is the authority provided by Section 902(a) of the Merchant Marine Act of 1936 which authorizes the Secretary of Commerce to

requisition ships in time of war or national emergency regardless of registry. . . Although we do not consider [foreign] crews as reliable as U.S. crews, we have no basis to believe that most of the ships in question would not be made available when needed.”

Author’s Comments

What we hoped to demonstrate by including this first portion of Chapter 2 was the acknowledged importance of the EUSC fleet. Mr. Boczek’s observations, coupled with the numerous government quotes that follow, show that the greatest value in maintaining an EUSC fleet is not commercial, but military in nature. The practice of using U.S.-owned, foreign-flag ships for the transport of commercial American cargo (and military cargo, in few instances) during times of national emergency is “tried and true,” and presents a viable means of closing the capacity gap created by the decrease in U.S.-flag ships.

QUESTIONING THE IMPACT OF THE TAX REFORM ACT OF 1986

Introduction

When the Tax Reform Act of 1986 was passed there was a difference of opinion as to its future impact. Phil Loree, who was then the Chairman of the Federation of American Controlled Shipping wrote in an op-ed piece in the Journal of Commerce:

“The losers are easy to identify. Heading the list are the U.S. shipowning companies (and their U.S.-based employees) which have basically three choices open to them in the future:

First, they can continue their shipowning operations as before, and attempt to compete in a high risk, capital intensive business with after-tax dollars worth 66 cents while their foreign counterparts continue to amortize, upgrade and expand their fleets with full value dollars. Under this scenario the prospects of a lower return on investment by U.S. companies and the obvious tax advantage enjoyed by foreign owners will surely discourage future investments by the former. If they cannot renew and modernize their fleets on the same terms as their competitors, they will eventually lose their market position and many will be forced out of business.

A second choice is to transfer majority interest in the shipowning company to foreign interests. This would handle the tax problem. But it would be at the expense of control by Americans. For some this would be a distasteful but necessary option.

Obviously the third choice is simply to liquidate the fleets, and, if necessary to meet their own shipping requirements, to rely on tonnage chartered from foreign owners.

There are numerous variations on these approaches, and some companies may have other options open to them. But the bottom line is that repeal of the ability of U.S. companies to meet foreign competition on an even playing field will, under the inexorable laws of the market place, cause many U.S. shipping companies to be squeezed out of international shipping, particularly in the bulk and cruise trades. That process will predictably spill over and dampen future prospects for U.S. flag vessels, simply because many of the companies detrimentally affected by repeal of subpart F [tax deferral] also operate U.S. flag vessels, and in many cases the economic viability of each fleet is inextricably linked to the other.”

We can compare this prediction to the conclusions of four studies completed in the five years following the new Act.

General Accounting Office - Study of Effects of Repealing Tax Deferral

One of the most comprehensive reviews of the EUSC was prepared by the General Accounting Office as per the request of Charles E. Bennett, then Chairman of the Subcommittee on Seapower. Specifically, the GAO was asked to study the "effects of repealing the tax deferral for foreign-earned shipping income," and to present figures for revenue generated by this repeal.

The GAO report begins with an intuitive explanation of the general circumstances surrounding the foreign-earned shipping segment of American shipping. GAO indicates

that the repeal of the tax deferral was effected because Congress "did not consider promoting U.S. investment in foreign flag shipping to be in the United States' interest . . ." Estimated revenue yields from the repeal were between \$160 million and \$240 million over a period of 5 years, as provided by the Department of the Treasury's Office of Tax Analysis. GAO was unable to determine the actual amount of tax revenue generated by foreign-earned shipping income, but it is indicated that the amount of taxable foreign-earned shipping income has risen substantially since the passage of the Tax Reform Act; this rise is attributed largely to the repeal of the tax deferral. In 1984, before the Tax Reform Act of 1986, approximately 21 percent of foreign-earned shipping profit was taxable, while 70 percent of the same profit was taxed after the Tax Reform Act, in 1987.

Though GAO acknowledges a general increase in the proportional taxation of foreign-earned shipping income, it does not believe that such taxation is a cause for the reduction in EUSC ships. The report indicates that the 1986 Tax Reform Act included a general tax reduction for all corporations that helped offset the increase realized by repealing the deferral. Similarly, the amount of income reported for taxation purposes declined after the Tax Reform Act, resulting in less tax revenue. Most interestingly, it is noted that the total tax revenue generated from foreign-earned shipping income may have actually decreased following the Tax Reform Act: ". . . resulted in a small decline in tax revenue generated from foreign-earned shipping income in 1987 compared with 1984. Had the deferral not been repealed, 1987 tax revenues would have been even less."

As mentioned before, GAO did not find any correlation between the reduction in EUSC ships and the repeal of the tax deferral. As cited in the report, the rate of decline of EUSC ships before 1986 is approximately equal to that of years after the Tax Reform Act.

Professor Henry Marcus - "U.S.-Owned Merchant Fleet: The Last Wake-Up Call?"

In July of 1991, Professor Henry Marcus led a study on the future of the U.S. merchant marine, entitled "U.S.-Owned Merchant Fleet: The Last Wake-Up Call?" Sponsored by Skaarup Shipping Corporation, this study analyzes the recent decline of the fleet of American-owned ships, and offers explanations for the decrease.

One of the issues identified by the study is the relationships between American marine corporations and the United States government. Because the interests of the maritime industry leaders are diverse (depending on the market served), lobbying is never consolidated. The result is a garbled expression of needs to the government, and no clear answer from the government. Instead of identifying the problems with proposed legislation in a single voice, the maritime industry retreats into several interest-specific camps and its needs remain unanswered by the government.

Though the higher cost of manning is a disadvantage to American shipowners, the real disadvantage is cited as being duties and taxation, particularly as it affects U.S.-owned foreign-flag ships. As before, the Tax Reform Act of 1986, and the repeal of the tax deferral are included as major setbacks for the industry. In addition, while many foreign

countries do not require their seafarers to pay national income tax, American seamen have no such benefit.

In conclusion, Professor Marcus suggests that it is the responsibility of the U.S. government to act quickly, if it wishes to save the merchant marine. Only pro-maritime legislation and investment can keep the American-owned shipping fleet -- both U.S.-flag and foreign-flag -- from declining dramatically.

"Survey of American Controlled Shipping" – Price-Waterhouse

Another study entitled "Survey of American Controlled Shipping" was published in early 1990. The study, sponsored by the Federation of American Controlled Shipping, presents a complete analytic summary of all ships controlled by Americans.

An official definition of the EUSC is provided, and says that included are any "vessels owned by U.S. citizens or corporations and registered in certain foreign countries which will permit the United States to exercise control over such ships in an emergency." At the time of the study, Liberia, Panama, The Bahamas and Honduras were deemed to permit the requisitioning of U.S. ships, and thus comprise the EUSC countries. Extensive attention is given to the Tax Reform Act of 1986 in this report as well, and is cited as a primary cause for the decrease. A percentage change of -8.6 percent is shown in the number of ships between 1986 and 1988, which equates to a -13.7 percent change in deadweight carrying capacity. An average remaining useful life of 1.9 years was calculated for U.S.-owned ships disposed of in 1989, suggesting that ships were being

scrapped before necessary. Along that line, the average age of a U.S.-owned ship was 12.6 years, suggesting that reinvestment in new ships declined in that period.

Perhaps of greatest interest to the EUSC discussion are the results of the survey provided by assorted U.S. companies. Price Waterhouse conducted a telephone survey of those responding to the initial survey, asking whether or not a reinstatement of the tax deferral would be incentive for re-flagging ships to EUSC. The results of this survey show that "29 percent of nonEUSC ships would be reflagged (to EUSC nations) if deferral of tax on income from EUSC ships were restored. Thus, a restoration of deferral would translate into 1.55 million tons of additional EUSC flag ships." Survey respondents also estimated that the number of dispositions annually would decrease from 452,000 tons/year without the deferral to 363,000 gross tons/year if the deferral were restored.

"Taxation of the International Maritime Industry: A Comparative Study – Price-Waterhouse"

In 1990, a report entitled " Taxation of the International Maritime Industry: A Comparative Study" was prepared as per the request of the Federation of American Controlled Shipping. This study compared the taxation practices of the United States, Norway, Germany, United Kingdom, Japan and Greece; specific attention was given to policy with regard to foreign-flag shipping operations.

The first portion of the study discusses the history of taxation on foreign-controlled shipping corporations. A similar discussion of the legal history of the EUSC is included

in the previous section of this report; much of the material included here was obtained from the corresponding section of "Taxation of the International Maritime Industry: A Comparative Study."

Within the comparisons between countries, some very distinct differences are illustrated. Pooling systems exist in countries such as Norway and United Kingdom and allow for the manipulation of depreciable and taxable assets. These pools may allow the dispersal of gains to unrelated portions of the business (i.e. gains charged against machinery and equipment) in order to facilitate a deferral. Norway allows shipping losses incurred by an individual to be used to offset income from other unrelated sources, e.g. salaries and other business income. Other benefits are seen in Germany, Norway and Japan wherein simply having most of the company operate outside of the country in question is enough to exempt it from CFC status, and absolve it from tax obligations. Greece is in a category of its own, as complete tax exemption is obtained almost without effort.

A complete review of the specific advantages and disadvantages experienced by shipowners of the various major maritime industries (as outlined by "the Price-Waterhouse study") shows that American owned, foreign-controlled shipping companies have far fewer tax advantages than do their contemporaries; furthermore, the same corporations have far more tax disadvantages/burdens than do their competition.

Author's Comments

The above analyses present many different issues to consider in reviewing the Tax Reform Act of 1986. However, all of the literature point in the direction of two primary trends:

- 1.) Shipowners, facing higher taxes and lower profits, opt to leave their current business. Typically, this can be realized by leaving the industry entirely (i.e. liquidation of all assets), or by transferring control/ownership of the corporation to foreign citizens. In many instances 51 percent of a corporation's shares are controlled by a foreign entity, thus alleviating U.S. tax obligations.
- 2.) Shipowners stay in the market, and simply pay the higher taxes. Of course, this option is preferred by the U.S. government, but it also forces the company in question to operate at a guaranteed lower profit margin than its foreign competitors; the result is a decreased ability to compete, and may ultimately lead back to option 1 (leaving the U.S.).

Whether the Tax Reform Act of 1986 facilitated the decline of the EUSC was greatly disputed in the late 1980's and early 1990's, as shown in the conflicting opinions presented above. Regardless, the next section presents current opinions on the impact of the Tax Reform Act of 1986, over a decade after its implementation.

CURRENT OPINIONS

Chris Dupin - "Sailing Away," Journal of Commerce, January 2001

In the January 15-21, 2001 issue of Journal of Commerce Week, Chris Dupin published an article discussing the taxation of U.S.-based shipping companies, and the impact such taxation has had on the industry. As with the other articles reviewed, Dupin cites the Tax Reform Act of 1986 as a primary source of the decline in U.S.-owned foreign-flag ships. A later Price-Waterhouse study is referenced in the article, and it suggests that U.S.-owned tonnage in "open registries" dropped from 21.8 million gross tons (25.8 percent of all ships flying flags of convenience) in 1975 to 11.8 million tons (4.9 percent) in 1996. It is observed in the article that U.S. maritime unions have opposed all attempts to undo the 1986 effects on foreign-flag shipping, but have done so for no apparent purpose. The thought that eliminating U.S.-owned, foreign-flag ships would increase the amount of U.S.-flag tonnage has been disproved, and is apparent in the industry's current reliance on subsidies.

Another valid point is made in regard to the overall tax revenue generated by U.S.-based foreign-flag shipping corporations. Whereas before 1975, tax revenues were as high as \$90 million, 1999 tax revenues were but \$50 million. Thus, while the individual percentage of taxable income has risen, the number of participants in the industry has dropped sufficiently to offset any increased revenue. The article suggests that shipping companies sold their fleets, moved their companies overseas, began joint ventures, or were bought by foreign corporations as a result of an inability to compete.

The article offers several key perspectives on the causes and effects of decline of the American-owned merchant fleet. The most commonly cited cause for the deterioration of the EUSC fleet is clearly the repeal of the tax deferral option in the Tax Reform Act of 1986, which eliminated the option for CFC's to defer taxable income by reinvesting in shipping. This disadvantage is one with which foreign-owned shipping competitors are not faced. Similarly, the information would suggest that the United States has taken a passive approach to the shipping issue. Numerically, the physical decline in the number of EUSC ships is shown, as is an increase in the average age of ships in the EUSC. Comparisons are made between American maritime policy and that of competitive nations, and the results show that American-owned foreign-flag shipowners are given far more stringent tax treatment than are similar owners in countries such as United Kingdom, Greece and Norway.

“Analysis of Selected Maritime Support Measures” - Maritime Transport Committee

In December of 2000, a report was prepared by a consultant, on behalf of the Maritime Transport Committee, addressing fundamental issues surrounding international shipping expenditures. The report addresses some of the key financial/fiscal issues facing various OECD and non-OECD governments, with regard to shipping.

One of the first conclusions found in this study is that shipping is a very capital intensive industry, and is therefore particularly sensitive to differences in returns on capital.

Because of this, many governments will make particular efforts to ensure that shipping companies retain the option of being competitive.

The effective tax rate of a country with regard to shipping is cited as being one of the most important influences on its success. With consolidation, effective tax rates in the world were found to be between –27 percent (i.e. tax credit) and 15 percent under "lean" freight rates. "High" freight rate levels showed an effective tax level between –13 percent and 18 percent. The report summarizes, "With consolidation, all countries except the United States came out with extremely low, and often negative, effective rates."

The report is very intuitive, and covers many assorted specifics regarding the international shipping industry. But most worthy is the conclusion that tax policy is fundamentally deterministic of a country's ability to support a profitable, commercial merchant marine; according to this report, the United States does not have a tax policy that accomplishes this.

“The NFTC Foreign Income Project: International Tax Policy For The 21st Century” – National Foreign Trade Council, Inc., March 25, 1999

In 1999, the National Foreign Trade Council published a study of tax policies and their relationship with foreign income. The analysis of the 1986 Act included in this report is particularly interesting. A very intuitive example, demonstrating the financial disadvantage experienced by U.S. shipowners, is in the report:

“The effect of the 1986 Act can be illustrated by the following simple example. A U.S. Company and a Japanese company both own and operate a shipping fleet through a Panamanian corporation, which is a common flag of convenience. . .Both companies have similar costs. . .and, for the sake of example, both companies earn \$1,000 from international shipping operations. This income is assumed not to be taxable under Panama’s income tax system.

“Under these facts, the Japanese-owned company can reinvest its \$1,000 of profits in new shipping assets, and is not liable for tax in Japan until its shipping profits are repatriated. By contrast, the U.S.-owned shipping company is subject to \$350 of U.S. income tax because the \$1000 of shipping income earned by its Panamanian subsidiary is deemed to distributed to the U.S. parent under subpart F. As a result, the U.S. company has only \$650, after tax, to invest in new shipping assets. . .the cost of capital for the U.S. shipping company is over 50 percent higher than for its Japanese competitor.”

The report also concludes that the “extension of subpart F to shipping income” is largely responsible for U.S.-owned shipping companies’ inability to compete internationally. The U.S.-owned share of world open-registry ships has dropped from 26 percent in 1975 to just 5 percent in 1996. Lastly, the report makes a keen observation regarding tax income: “It is difficult to see how the U.S. economy or U.S. Treasury has benefited from the decline in the U.S.-controlled foreign-flag fleet. . .data indicate that the Treasury actually

collects less tax on foreign shipping income. . .than under the pre-1975 law with full deferral.”

“U.S International Tax Policy Outdated” – National Foreign Trade Council, Inc.

On December 19, 2001, the NTFC released a report regarding the conclusion of the NTFC Foreign Income Project. In this report, the ultimate views of the report are summarized.

“We are dealing with 40-year-old tax laws that were written at a time when the global economy was a substantially different beast. . . Current law was established to discourage U.S. companies from entering into foreign operations. Today’s global economy, however, virtually requires major corporations to establish foreign operations just to remain competitive. In our view . . . the world’s economy has changed drastically, and it is high time to re-evaluate our international tax policies.”

It is further noted in the report that “among the United States’ major world trading partners, no other country taxes the foreign income of its companies as aggressively as the United States.”

Warren L. Dean, Jr. – Testimony Before House Committee on Ways and Means

On June 30, 1999, Warren L. Dean, Jr., Chair of the Subpart F Shipping Coalition, testified before the House Committee on Ways and Means regarding the deferral of foreign-based shipping income. His presentation compares the legislative actions of the

United States with those of competing maritime nations; he describes a general increase in taxation on American ship-owners operating under flags of convenience, countered by a substantial decrease in taxation on foreign-flag shipping of other countries. Mr. Dean also cites a study by the National Foreign Trade Council ("The NFTC Foreign Income Project: International Tax Policy for the 21st Century") that showed "that the U.S.-controlled foreign fleet cannot afford to compete effectively in the international market against trading partners that have adopted tax policies and incentives to support their international shipping industries." Mr. Dean's presentation urged the reinstatement of the taxable income deferral, and included a variety of examples and figures to support the request.

One example is as follows:

Assume an American-controlled shipping company needs, for competitive purposes, to offer service between Indonesia and Japan. U.S.-flag services by a U.S. corporation is not an option. The expense of flying crews back and forth alone would be prohibitive. Subpart F, the purpose of which is to prevent tax-motivated earnings through foreign corporations, reaches this transportation service and taxes it more onerously than it would tax U.S.-flag service – even though this transportation is not within any rational definition of U.S. commerce. There is no legitimate tax policy for this absurd result.

Accompanying Mr. Dean's testimony was the Shipping Income Reform Act of 1999, introduced to the 106th Congress by Representative E. Clay Shaw, Jr. This proposed bill

outlines the current operating disadvantage of American-owned foreign-flag ships caused by tax policy, and proposes that the subpart F exclusion be restored for U.S.-owned ships.

Author's Comments

The above pieces of literature are representative of modern opinion regarding the 1986 Act and the EUSC. As shown before, opinions immediately following the passage of the 1986 Act were speculative and conflicting. But years after the legislation's implementation, a general agreement becomes clear: the EUSC fleet has declined tremendously, and the Tax Reform Act of 1986 is largely responsible for the condition.

While some EUSC shipowners were "trapped" into investing in new ships in order to keep from paying taxes on large amounts of "deferred taxes" that they had accumulated before the Tax Reform Act of 1986, the majority of EUSC shipowners moved in the direction of liquidating their EUSC ships while minimizing new investments.

Next, we will review legislative attempts to alter the 1986 tax code in an effort to revitalize the EUSC fleet.

ATTEMPTS AT CHANGING THE COMPETITIVENESS OF U.S.

SHIPOWNERS

Introduction

Since 1986 attempts have been made at legislation that would increase the competitiveness of U.S. shipowners. Not all these proposed pieces of legislation would help EUSC tanker owners, but some identified below give a flavor of what some members of congress are thinking.

H.R. 3312 “Restore Access To Foreign Trade Act” – Rep. Weller of Illinois,

November 16, 2001

This bill, as introduced, would “amend the Internal Revenue Code of 1986 to eliminate foreign base company shipping income from foreign base company income.” Effectively, the earnings of U.S. owned foreign-flag shipping companies would be tax deferred as they were under the Revenue Act of 1962. This bill was cosponsored by Representatives Judy Biggert, Mark Foley, John Shimkus, Philip M. Crane, and Charles B. Rangel. The last action, on date of introduction (11/16/2001) was referral to House committee.

H.R. 3262 - “Merchant Marine Cost Parity Act” – Rep. Oberstar of Minnesota,

November 2001

This piece of legislation proposes to help the American merchant marine by reducing taxation on U.S. flag ships, and on American sailors. Additionally, for ships that have re-flagged to U.S. registry, the bill seeks to absolve ships from complying with U.S. Coast Guard standards, so long as they are in compliance with IMO regulations. These actions have the potential to decrease the cost of building, owning and operating a ship in the United States. Similar modifications in the insurance law governing vessel insurance would help to reduce total costs for American companies. This bill was cosponsored by Representative Don Young. The last action, on date of introduction (11/8/2001), was referral to House committee.

H.R. 3102 – Rep. Weller of Illinois, October 19, 1999

The bill proposed to amend the Internal Revenue Code so as to eliminate foreign base company shipping income from foreign base company income. This bill was cosponsored by Representatives Judy Biggert, Thomas W. Ewing, Henry J. Hyde, Donald A. Manzullo, Robby L. Rush, Philip M. Crane, Mark Foley, William O. Lipinski, David D. Phelps, and John Shmikus. The last action, on date of introduction (10/19/1999), was referral to House committee.

**H.R. 3730 - “Shipping Income Reform Act of 1997” – Rep. Clay Shaw of Florida,
April 23, 1998**

The Shipping Income Reform Act proposed to exclude certain shipping income from Subpart F. Specifically, any non-oil carrying ship, owned by U.S. citizen(s), operating in foreign-to-foreign trades or in the Caribbean trades, or that belongs to a mixed fleet of U.S. and foreign-flag ships, would not be considered a source of Subpart F income for taxation purposes. This bill was cosponsored by Representative William J. Jefferson. The last action, on date of introduction (4/26/1998) was referral to House committee.

H.R. 2684 – Rep. Clay Shaw of Florida, October 21, 1997

Proposed legislation to amend the Internal Revenue Code of 1986 and provide for elimination of certain foreign base company shipping income from foreign base company income. This bill had no cosponsors. The last action, on date of introduction (10/21/1997), was referral to House committee.

Proposal Scoring – Joint Tax Committee, October 5, 1993

The Joint Tax Committee advised Representative Jefferson that his proposed amendment had been “scored” at a cost of \$535 million over the period of 1994-1998 (effectively killing the proposal because of its perceived high cost).

Proposed Amendment, Jefferson Bill, September 29, 1993

Rep. Sam Gibbons, then Chairman of the House Ways and Means Trade Subcommittee, proposed amending the Jefferson provision to include relief for shipowners involved primarily in the Caribbean region.

CFC Amendment Draft – Rep. Bill Jefferson of Louisiana, 1993

Representative Jefferson drafted an amendment to restore deferral of income for overseas shipping operations by a CFC, provided that the CFC's controlled group maintained a U.S.-flag fleet and the CFC does not carry proprietary cargo.

National Sealift Strategy Task Force Report, 1990

Compiled by the Office of the Assistant Secretary of Defense (Production and Logistics), the report urged Congress to “restore the subpart F deferral for income from foreign shipping subsidiaries of U.S. companies that is reinvested in shipping operations.”

Testimony to Congress, MEBA, February 21, and March 1-2, 1990

During review of the fairness of the Tax Reform Act of 1986, industry and labor submitted testimony to the House Committee on Ways and Means. MEBA testified that “MEBA believes that the repeal of the shipping reinvestment rule . . . departs substantially from the overriding goals of the 1986 Act,” and requested “a limited restoration of the shipping income reinvestment rule, such as that proposed by Overseas Shipholding Group, Inc., which again would permit deferral of current tax on income from shipping cargo on vessels pledged to aid the United States Government [in times of emergency] if such income is reinvested in those shipping operations.”

Author's Comments

The above list shows clearly that foreign-earned shipping income is not out of the minds of all lawmakers. Rather, several official attempts have been made at allowing U.S.

shipowners the opportunity to be more competitive. However, it should be noted that with each of the pieces of proposed legislation, a vote never took place. In other words, Congress hasn't been given the opportunity to approve any of these bills – because they never leave committee. What results is a necessary re-submittal of each bill that goes unaddressed, and explains the similarities between many of the bills (they were simply resubmitted with new reference numbers).

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CHAPTER 3: LEGISLATIVE ALTERNATIVES

INTRODUCTION

This report has already outlined the current state of the Effective U.S. Controlled shipping fleet, and established its importance for the military security of the United States. Given this information, it becomes important to next ask: “What can be done to encourage investment in U.S. controlled shipping, and thus revitalize the EUSC?”

KEY CRITERIA

Key criteria for identifying and evaluating legislative alternatives are:

- It should encourage EUSC tanker owners to maintain or increase the size of the EUSC tanker fleet.
- It should support DoD objectives.
- It should be able to gain the support of the Executive Branch and the Congress.

TAX DEFERRAL

As outlined earlier in this report, tax law prior to 1975 provided a substantial concession with respect to shipping income earned by foreign subsidiaries of American companies. The most obvious approach to providing American shipowners with the incentive, once again, to invest in foreign flag ships is the restoration of tax deferral as it existed prior to the 1975 legislation. Under such an approach, the earnings and profits of the foreign shipping subsidiaries would not be subject to U.S. income tax on a current basis but

would be taxable when paid upstream to the American companies controlling the foreign shipping subsidiaries. Such an approach would greatly decrease the overall cost of EUSC shipping operations and help EUSC shipowners to compete in the international market. Though the immediate benefits to shipowners are easy to see, it is important to realize that such a strategic tax regime has the potential to help the U.S. in three ways:

1. Investment encouraged by tax deferral would contribute directly to the number of tankers available during times of emergency. The U.S. would have a greater number of merchant vessels at its disposal for military operational support.
2. As the number of American owners increases, as a result of the tax deferral incentive, collected income tax will eventually rise when shipping earnings and profits are repatriated. As was shown earlier in the report, the amount of income realized by the government as a result of EUSC income taxation has fallen dramatically since the Tax Reform Act of 1986; even though the percent of taxable income presumably would decrease for this particular group of corporations, if there is a rise in the number of corporations (or overall earnings and profits), an accompanying rise in total collected income tax from this market should eventually occur. In the absence of any new legislation, the size of the EUSC fleet, and accompanying U.S. income tax, would be expected to continue to decline.

3. It supports the U.S. maritime infrastructure including such occupations as ship managers, naval architects, marine engineers, surveyors, ship financiers, insurers, cargo brokers, accountants, admiralty lawyers, etc.

Some attempts have been made to reinstate tax deferral on shipping income, but they have been unsuccessful. Regardless, the United States has a pre-1975 model on which to work, should it choose to reinstate the deferral. Since the precedent has already been set, a tremendous amount of the difficulty associated with policy implementation can be discounted.

TAX EXCLUSIONS OR OTHER REVISIONS

A popular way of providing incentives to shipowners in many major maritime countries is to waive taxes or minimize them. Currently in effect in many major European countries is a tonnage tax. With this plan, shipowners are required to pay a flat tax based on the size of the vessels they operate – not on the amount of profit generated by those ships. Thus, in all situations where substantial revenue is realized, the percent of revenue dedicated to taxes is greatly decreased. Because the level of the tonnage tax can be manipulated, some discretion is afforded the government for variation in tax burdens, should the need for adjustment arise. A plan of this nature would also provide potential entrants with further opportunity to accurately predict their tax burden, and justify entrance.

Many countries have completely alleviated shipowners of all tax obligations; such an option would be an effective way of rejuvenating the EUSC. However, the flat/tonnage tax would help to provide the same end result, without as great a drop in total tax revenues.

The Oberstar Bill proposed a tonnage tax for the owners of U.S. flag ships in international trade. However, it seems unlikely that such legislation will pass in the near future. Consequently, it may be difficult to promote such an approach for EUSC shipowners at this time. However, over the longer term a flat or tonnage tax approach may have more merit.

CARGO PREFERENCE

At the present time U.S. flag shipowners receive a cargo preference benefit in that certain U.S. government cargos are reserved for U.S. flag vessels. It would be a benefit to EUSC shipowners if they could receive preference over other foreign flag vessels when the U.S. government was awarding contracts to move its cargo. Currently the amount of oil cargo moved by the U.S. government on foreign flag tankers is rather limited. According to the MSC website, over the time period from October 2001 through June 2002 only 58 lifts were awarded in the form of voyage or short term charters to foreign flag tankers¹. There were no long term charters awarded to foreign flag tankers during this period.

¹ Military Sealift Command Website, "Cargo Preference Performance Data – Tankers for Oct. – June FY 02", Cargo Preference Performance Data, www.msc.navy.mil, 2002.

HOW NARROW, HOW BROAD?

Before any plan for revitalization of the EUSC can be approved and implemented, the scope of its application must be determined. Which ships would be eligible? Which owners would be eligible? What are the consequences, in terms of bill passage, in each situation?

Since the key criteria for evaluating legislative alternatives include increasing the size of the EUSC tanker fleet and supporting DoD objectives, it would seem reasonable to conclude that any legislation providing tax benefits should be limited to companies controlling EUSC tonnage. This would, in effect, provide an incentive to any American companies controlling tankers registered in non-EUSC registries abroad to reregister them in eligible EUSC registries and thus increase the size of the EUSC tanker fleet. Military Sealift Command expresses its greatest interest in militarily useful tankers under 100,000 DWT. These are the ships that can readily access their needed ports of call, and can adequately replenish a military operation. Thus, in the most narrow scope, any proposed plan could be limited to ships meeting this exact qualification. However, speculation exists as to the value of including tankers of greater than 100,000 DWT. While tankers of greater than 100,000 DWT may not be ideal in terms of size or cargo tank coatings, given the small number of EUSC tankers remaining, it may be useful to include tankers of all sizes.

Proposed legislation can be written to include or exclude certain self-interest groups. In this way the constituency supporting a bill can theoretically be increased. The types of factors that can be considered include: type of vessel (e.g. general cargo, cruiseship, tanker), type of owner (e.g. owner of mixed U.S. flag and EUSC flag fleet, oil company), or geographic trade region (e.g. Caribbean, foreign to –foreign trade). If judiciously done, selective inclusion/exclusion of parties might result in a larger constituency for proposed legislation. On the other hand, the larger the number of ships included in the legislation, the greater the “scoring” of the bill, which is described in the next section.

SCORING

A proper analysis of the amount of U.S. tax revenue that would be lost, if tax deferral was allowed, is very difficult for the following reasons:

- It would be necessary to predict how the international tanker market will react over the desired period, since tanker rates are tied to the industry supply-demand situation.
- It would require access to confidential information which companies do not make available to the public such as profits by EUSC ships within a company fleet and effective tax rates.
- It would be essential to describe the future plans of each EUSC tanker owner in terms of buying, selling, and scrapping in order to determine the size of the EUSC fleet.

Such an analysis is beyond the scope of this research. However, it would be useful to make even a rough estimate of the scoring involved with new legislation that would allow tax deferrals for the EUSC tanker fleet. In order to estimate the amount of tax dollars that would be sacrificed, we have focused our attention on the financial data for Overseas Shipholding Group, Inc. Available data covers the years from 1997-2001 with some level of detail (unlike available data on the other EUSC owners). U.S. flag ship profits are separated from foreign flag vessel profits. In addition, tanker size is differentiated in the data for the four most recent years. Since OSG is the largest EUSC tanker operator, the results from this analysis will be scaled up to estimate the lost U.S. tax revenues from the entire EUSC tanker fleet.

Nevertheless, many problems remain in performing a scoring analysis:

- Dry bulk vessels are not broken out in the profit figures.
- It is not obvious how we should handle the differences in the profits of the EUSC tankers versus the profits from the rest of the fleet (assuming they could be accurately broken out). However, EUSC tankers make up the great majority of the OSG foreign flag fleet during the time period considered.
- When you look at a particular time period (e.g. 1997-2001), the financial data may include the effects of events in earlier periods. In addition, events during the period under consideration may affect tax payments after this time period.
- An overall effective tax rate can be determined, but it is not clear to what extent it would apply to other EUSC tanker owners (or to OSG in future years).

We will briefly outline the procedures used, and the source of included numbers. Please reference the accompanying spreadsheets in Appendix E for numerical results.

It was decided to rely on publicly available profit and tax rate data. While the fleet of each EUSC tanker owner is unique, since OSG is the largest EUSC tanker owner it should be more representative of the overall fleet than any other single owner. While every year is unique in terms of market conditions, profits and tax deductions (including carry forward and carry back figures), by looking at five years of data we hope to cover a reasonable set of values. While the marginal U.S. federal income tax rate is 35%, the actual tax rate that an EUSC ship owner pays depends on the overall profit or loss from his entire fleet as well as tax deductions produced by his entire fleet (including both EUSC and non-EUSC vessels). Since most owners of EUSC tankers also own non-EUSC ships, we decided to use the actual tax rates by OSG on their overall fleet in our scoring analysis.

Fortunately, the OSG annual reports and 10-K documents for years 1999, 2000, and 2001 provide relatively thorough tax information for the five years in 1997-2001. The figure used for income before taxes (or taxable income) can be found in Note J – Taxes. Provided is “the components of income/(loss) before federal income taxes and extraordinary loss,” and each total is provided with distinction between U.S. and foreign earned income. It is important to note that years 1997 and 1998 both show substantial

losses on Domestic operations (\$19,147,000 and \$39,814,000 respectively). What results is a great reduction in total income before taxes, and a negative taxable income in 1998.

Outlined in Note J of these annual reports is a series of numbers for “actual income taxes paid,” and these numbers were cited for the amount of federal tax. The year, 1999, showed a tax credit of \$7.9 million, “all of which related to prior years.” In other words, it appears that the company received credit for substantial losses in the year(s) following the year of loss. This tax credit results in a negative tax expense for 1999, and thus a negative marginal tax rate. Similarly, 1998 has a negative tax rate on account of an operating loss, but positive tax expenditures.

Once the actual tax expenses were determined, we proceeded to ascertain what portion of that tax might be sacrificed if foreign earned income were not included for tax purposes. Our objective is to estimate the income and taxes of the EUSC tankers. Using the provided foreign earned income before taxes, we subtracted out all cruise earnings, as listed in the income statement, from years 1997 and 1998. Dividing the remainder of new “bulk foreign income” into the total taxable income provides us with an estimated percentage of total income derived from foreign bulk operations. Applying these respective percentages to the tax expenses gives us an idea of what percent of taxes were paid on behalf of foreign earned bulk shipping income, and yields the “Estimated Income Tax Paid on F.F. Income” column of the spreadsheet.

Because a portion of the foreign flag bulk fleet of OSG is comprised of ships which are either not EUSC, or not tankers (or both), it is necessary to further separate out EUSC income from foreign flag income. The ship listings for OSG are included, with organization information. Because the tax data estimated for OSG is to be extrapolated to the entire EUSC fleet (for scoring purposes), it is important to obtain an estimate of the tax dollars paid each year, per dwt. However, in order to effectively determine the tax dollars/dwt for any given year, you must know just how many dwt were operated in that year. Because ships are acquired/scrapped fairly often, a weighting system was used and applied to ship deadweights. The number of days a ship was owned in a given year was divided by 365 (days/year), and this factor multiplied by the actual dwt of the ship. These deadweight numbers are used for all calculation purposes in this study, and effectively adjust tonnages for time owned.

In order to look at taxation variations by ship size, we broke down tax expenditures by ship size as well. For years 1998-2001, OSG's annual reports provides specific "Percentage of Income from Vessel Operations" data (Part I, Operations) with differentiation by tanker size. These percentages were applied, in conjunction with tonnage calculations, to determine the amount of tax paid per dwt for VLCC's, Aframax and Product tankers.

Table 8.1 shows the results of the taxes/dwt calculation for the OSG EUSC tankers for the years 1997-2001. The average over this time period is \$1.26/dwt.

	Estimated Income Tax Paid on EUSC Income (\$ 000's)	Total EUSC Tanker DWT	\$ Income Tax / 1 DWT
1997	\$791	4,016,441	\$0.20
1998	\$15,133	4,087,053	\$3.70
1999	(\$3,341)	3,740,905	-\$0.89
2000	\$7,906	3,634,229	\$2.18
2001	\$4,534	4,065,842	\$1.12

Table 8.1 Estimated Amount of Income Tax Paid per Deadweight Ton on OSG EUSC Tankers

In order to extend the tax results to the rest of the EUSC tanker fleet, we applied the \$1.26/dwt average value to the total number of EUSC deadweight tons in 2002, as is shown below in Table 8.2. What results is a cost of approximately \$12.7 million to the U.S. government in one year, if all EUSC tankers were absolved of income tax obligations on foreign earned income.

TOTAL EST. COST OF DEFERRAL	1997-2001 Average \$ Tax / DWT	2002 Total EUSC Tanker DWT	Est. Tax Revenue Lost Per Year
	\$1.26	10,090,756	\$12,714,353

Table 8.2 Anticipated Annual Cost to the Government of Eliminating EUSC Income From Subpart F

For a complete review of the procedures and numbers used in this scoring, please see Appendix L at the end of this report.

CONCLUSIONS

The most practical and realistic way to maintain and increase the size of the EUSC tanker fleet is to pass new legislation to allow EUSC tanker owners to defer U.S. income taxes

as was done before 1975. By focusing on tankers any proposed legislation will have direct potential national security benefits. Including tankers of all sizes will maximize the amount of potential benefits to DoD. The authors have performed a rough estimate of the scoring that would accompany such a bill. It appears that given the small –and decreasing – number of EUSC tankers (as well as U.S. flag tankers), the potential benefits of maintaining or increasing the EUSC tanker fleet outweigh the declining revenue stream to the federal government as the EUSC fleet further decreases over time. The authors also recommend that the U.S. government give cargo preference in the movement of its liquid bulk cargo to EUSC tanker owners over other foreign flag tankers (although only limited cargo volume exists). While including other types of ships in the proposed legislation may increase the support for new legislation from the various self-interest groups that would be involved, the authors prefer to focus on the national security benefits and the lower scoring that would result from including only tankers.

One might argue that proposed legislation should focus on only smaller sizes of tankers which are more militarily useful. However, if the long term objective is to build up the EUSC tanker fleet, the authors feel that a major push for EUSC tanker owners in terms of giving tax benefits to all of their EUSC tankers will be a start in the right direction. We think that even if this proposed legislation is passed, it would be overly optimistic to predict that there will be a substantial increase in the EUSC fleet overnight. Nevertheless, by “leveling the playing field” in the area of income taxes with their competitors, the EUSC tanker owners will finally have some reason to grow their fleets.

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APPENDIX A

Shipping Income Reform Act of 1997 (Introduced in House)

HR 3730 IH

105th CONGRESS

2d Session

H. R. 3730

To amend the Internal Revenue Code of 1986 to provide for the elimination of certain foreign base company shipping income from foreign base company income.

IN THE HOUSE OF REPRESENTATIVES

April 23, 1998

Mr. SHAW (for himself and Mr. JEFFERSON) introduced the following bill; which was referred to the Committee on Ways and Means

A BILL

To amend the Internal Revenue Code of 1986 to provide for the elimination of certain foreign base company shipping income from foreign base company income.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE; AMENDMENT OF 1986 CODE.

(a) SHORT TITLE- This Act may be cited as the `Shipping Income Reform Act of 1997'.

(b) AMENDMENT OF 1986 CODE- Except as otherwise expressly provided, whenever in this Act an amendment or repeal is expressed in terms of an amendment to, or a repeal of, a section or other provision, the reference shall be considered to be made to a section of the Internal Revenue Code of 1986.

SEC. 2. ELIMINATION OF CERTAIN FOREIGN BASE COMPANY SHIPPING INCOME FROM FOREIGN BASE COMPANY INCOME.

Subsection 954(b) is amended by inserting the following paragraph (2):

“(2) Exclusion for certain shipping income-

“(A) INCOME OF CERTAIN FOREIGN CORPORATIONS- For purposes of subsection (a), foreign base company income does not include--

“(i) income derived from the operation of a vessel registered in the Bahamas, Honduras, the Republic of Liberia, the Republic of Panama, the Republic of the Marshall Islands, or such other country as the Secretary of Transportation certifies, if the owner, operator, or a member of its controlled group, as defined in subparagraph (E)(iii), enters into an agreement with the Secretary of Transportation to own or operate a qualified U.S.-flag fleet for at least 320 days of the taxable year; or

“(ii) the shipping income of a controlled foreign corporation that owns or operates vessels that do not derive U.S.-source income (other than dividend or interest income) in the taxable year and have not engaged in the carriage of any cargoes in the U.S. import or export trade in that period.

For purposes of the preceding sentence, the term ‘U.S. import or export trade’ shall mean the carriage of goods or other commodities to or from United States ports whether or not via transshipment at a foreign port; and a charter to a member of a controlled group (as defined in subparagraph (E)(iii)) shall not be considered carriage in the U.S. import or export trade.

“(B) INCOME OF CARIBBEAN BASIN SHIPPING CORPORATION- For purposes of subsection (a), foreign base company income does not include income derived from the

operation of a vessel owned by a Caribbean Basin Shipping Corporation.

‘(C) INAPPLICABILITY TO PETROLEUM

TRANSPORTATION- The exclusions set forth in subparagraphs (A) and (B) shall not apply to foreign base company shipping income properly allocable to any vessel engaged in the carriage of petroleum or related products or byproducts if the controlled group (as defined in section 267(f)(1) without regard to section 1563(b)(2)(C)) of which the taxpayer is a member is engaged principally in the trade or business of exploring for, or extracting, refining or marketing of, petroleum or related products or byproducts.

‘(D) DEFINITION OF CARIBBEAN BASIN SHIPPING

CORPORATION- For purposes of this section--

‘(i) CARIBBEAN BASIN SHIPPING CORPORATION-

The term ‘Caribbean Basin shipping corporation’ means a corporation if, for the taxable year, at least 75 percent of its foreign base company shipping income (determined without regard to this paragraph (2)) is Caribbean Basin shipping income.

‘(ii) CARIBBEAN BASIN SHIPPING INCOME- The term

‘Caribbean Basin shipping income’ means foreign base company shipping income derived from or in connection with the operation of any non-passenger vessel in foreign commerce within any Caribbean Basin country, among Caribbean Basin countries, or between any Caribbean Basin country and the United States, including that portion of any transshipping originating or terminating in any non-Caribbean Basin country that otherwise satisfies these requirements.

`(iii) CARIBBEAN BASIN COUNTRY- The term `Caribbean Basin country' means any beneficiary country (as defined in section 212(a)(1)(A) of the Caribbean Basin Economic Recovery Act); except that such term shall also include Anguilla, Colombia, Mexico, the U.S. Virgin Islands and Venezuela.

`(iv) SPECIAL RULES- For purposes of determining whether a controlled foreign corporation is a Caribbean Basin shipping corporation, all members of the same affiliated group (within the meaning of section 1504(a)) shall be treated as one corporation, except that--

`(I) section 1504(a)(2) shall be applied by substituting 50 percent for 80 percent; and

`(II) section 1504(b)(3) shall not apply.

`(E) DEFINITION OF QUALIFIED U.S.-FLAG FLEET- For purposes of this section--

`(i) QUALIFIED U.S.-FLAG FLEET- The term `qualified U.S. flag fleet' means a fleet of four or more U.S.-flag cargo vessels or two or more U.S.-flag passenger vessels, each such vessel having a deadweight tonnage of not less than 10,000 deadweight tons and, in the case of a passenger vessel, having berth or stateroom accommodations for at least 275 passengers, for which a member of the controlled group of which the controlled foreign corporation is a member is the owner (or demise charterer) and which vessels have been placed in service and operated for at least 320 days in the preceding taxable year with days during which the vessel is drydocked or undergoing survey, inspection or repair considered to be days on which the vessel is operated;

`(ii) U.S.-FLAG VESSEL- The term `U.S.-flag vessel' means any vessel which is documented under the laws of the United States and is subject to the provisions of section 8103 of title 46, United States Code, relating to manning by citizens of the United States.

`(iii) CONTROLLED GROUP- The term `controlled group' has the meaning given such term by section 1563(a) except that--

`(I) section 1563(a) shall be applied by substituting 50 percent for 80 percent; and

`(II) section 1563(b)(2)(C) shall not apply.

`(iv) SPECIAL RULES- In determining the qualified U.S.-flag fleet of a controlled group--

`(I) if a U.S.-flag vessel which is part of a qualified U.S.-flag fleet is destroyed by casualty or purchased by requisition pursuant to section 1242 of title 46, United States Code, it may continue to be included in such qualified U.S.-flag fleet during the replacement period, but only if a member of the controlled group is or becomes the owner (or demise charterer) of a replacement U.S.-flag vessel which is placed in service (and not retired from service) within the replacement period; and

`(II) if a member of the controlled group owns (directly or indirectly) at least 25 percent (by value) of the stock of another corporation, or at least 25 percent of the interest in the capital or profits of a partnership, such member shall be treated as if it were the owner (or demise charterer) of its proportionate share of the U.S. flag vessels of which

such corporation or partnership is the owner (or demise charterer).

`(v) REPLACEMENT PERIOD- The term `replacement period' means the period beginning on the date on which the casualty or purchase by requisition occurs and ending on the earlier of the date--

`(I) on which a replacement U.S.-flag vessel is placed in service, or

`(II) which is four years after the close of the taxable year in which the casualty or purchase by requisition occurs.

`(vi) REPLACEMENT U.S.-FLAG VESSEL- The term `replacement U.S.-flag vessel' means a U.S. flag vessel for which a member of the controlled group has entered into a binding contract for the purchase or construction of such vessel during the period--

`(I) beginning on the day following the date on which there is a loss by casualty or purchase by requisition pursuant to section 1242 of title 46, United States Code, of a vessel included in such controlled group's qualified U.S.-flag fleet, and

`(II) ending on the date which is two years after the date of such casualty or such purchase, but only if such U.S.-flag vessel would be included in the controlled group's qualified U.S.-flag fleet when it is placed in service.'

SEC. 3. REINVESTMENT IN U.S.-FLAG SHIPS.

(a) REINVESTMENT IN U.S.-FLAG SHIPS- Subsection 956(c)(2) is amended by inserting at the end thereof the following:

(J) any amount of funds loaned to a United States person for the acquisition, construction, or reconstruction of a vessel documented under the laws of the United States.

Any interest payable on indebtedness described in (J) shall be free from U.S. income tax withholding under sections 1441 and 1442 if such interest is paid to an individual resident in or corporation or other entity organized under the laws of The Bahamas, Honduras, the Republic of Liberia, the Republic of Panama, the Republic of the Marshall Islands, or such other country as the Secretary of Transportation certifies.'

(b) Conforming Amendments-

(1) Section 956(c)(2)(H) is amended by deleting `; and' and inserting in lieu thereof `;':

(2) Section 956(c)(2)(I) is amended by deleting the period at the end thereof and inserting `; and' in lieu thereof.

SEC. 4. EFFECTIVE DATE.

The amendments made by this Act are effective for taxable years beginning after the date of enactment of this Act.

This legislation was found via the Library of Congress website, accessed at:

[http://thomas.loc.gov/cgi-bin/query/z?c105:H.R.3730:](http://thomas.loc.gov/cgi-bin/query/z?c105:H.R.3730)

APPENDIX B

HR 3262 IH

107th CONGRESS

1st Session

H. R. 3262

To revitalize the international competitiveness of the United States-flag maritime industry through international tax parity, and for other purposes.

IN THE HOUSE OF REPRESENTATIVES

November 8, 2001

Mr. OBERSTAR (for himself and Mr. YOUNG of Alaska) introduced the following bill; which was referred to the Committee on Ways and Means, and in addition to the Committee on Transportation and Infrastructure, for a period to be subsequently determined by the Speaker, in each case for consideration of such provisions as fall within the jurisdiction of the committee concerned

A BILL

To revitalize the international competitiveness of the United States-flag maritime industry through international tax parity, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the 'Merchant Marine Cost Parity Act of 2001'.

TITLE I--INTERNATIONAL TAX PARITY

SEC. 101. ELECTION TO DETERMINE TAXABLE INCOME FROM CERTAIN INTERNATIONAL SHIPPING ACTIVITIES USING PER TON RATE.

(a) IN GENERAL- Chapter 1 of the Internal Revenue Code of 1986 is amended by inserting after subchapter Q the following new subchapter:

Subchapter R--Election To Determine Taxable Income From Certain International Shipping Activities Using per Ton Rate

Sec. 1352. Alternative tax on qualifying shipping activities.

Sec. 1353. Taxable income from qualifying shipping activities.

Sec. 1354. Qualifying shipping tax election; revocation; termination.

Sec. 1355. Definitions and special rules.

Sec. 1356. Qualifying shipping activities.

Sec. 1357. Items not subject to regular tax; depreciation; interest.

Sec. 1358. Allocation of credits, income, and deductions.

Sec. 1359. Disposition of qualifying shipping assets.

SEC. 1352. ALTERNATIVE TAX ON QUALIFYING SHIPPING ACTIVITIES.

(a) **IN GENERAL-** The taxable income of an electing corporation from qualifying shipping activities shall be the amount determined under this subchapter, and the corporate percentages of the items of income, gain, loss, deduction, or credit of an electing corporation and of other members of the electing group of such corporation which would otherwise be taken into account by reason of its qualifying shipping activities shall be taken into account to the extent provided in section 1357.

(b) **ALTERNATIVE TAX-** The taxable income of an electing corporation from qualifying shipping activities, if otherwise taxable under section 11, 882, or 887, shall be subject to tax only under this section at the maximum rate specified in section 11(b).

(c) **TRANSFERS TO FEDERAL VESSEL FINANCING FUND-** The Secretary of the Treasury shall transfer to the Federal Vessel Financing Fund created under title XI of the Merchant Marine Act, 1936, the taxes collected under subsection (b).

**SEC. 1353. TAXABLE INCOME FROM QUALIFYING SHIPPING
ACTIVITIES.**

(a) IN GENERAL- For purposes of this subchapter, the taxable income of an electing corporation from qualifying shipping activities shall be its corporate income percentage of the sum of the amounts determined under subsection (b) for each qualifying vessel operated by such electing corporation or other electing entity.

(b) AMOUNTS- For purposes of subsection (a), the amount of taxable income of an electing entity for each qualifying vessel shall equal the product of--

(1) the daily notional taxable income from the operation of the qualifying vessel in United States foreign trade, and

(2) the number of days during the taxable year that the electing entity operated such vessel as a qualifying vessel in United States foreign trade.

(c) DAILY NOTIONAL TAXABLE INCOME- For purposes of subsection (b), the daily notional taxable income from the operation of a qualifying vessel is 40 cents for each 100 tons of the net tonnage of the vessel, up to 25,000 net tons, and 20 cents for each 100 tons of the net tonnage of the vessel, in excess of 25,000 net tons.

(d) MULTIPLE OPERATORS OF VESSEL- If 2 or more persons have a joint interest in a qualifying vessel and are considered as operators of that vessel, the taxable income from the operation of such vessel for that time (as determined under this section) shall be allocated among such persons on the basis of their ownership and charter interests in such vessel or on such other basis as the Secretary may prescribe by regulations.

(e) NONCORPORATE PERCENTAGE- Notwithstanding any contrary provision of this subchapter, the noncorporate percentage of any item of income, gain, loss, deduction, or credit of any member of an electing group shall be taken into account for all purposes of this subtitle as if this subchapter were not in effect.

**SEC. 1354. QUALIFYING SHIPPING TAX ELECTION; REVOCATION;
TERMINATION.**

(a) IN GENERAL- Except as provided in subsections (b) and (f), a qualifying shipping tax election may be made in respect of any qualifying entity.

(b) CONDITION OF ELECTION- An election may be made by a member of a controlled group under this subsection for any taxable year only if all qualifying entities that are members of the controlled group join in the election.

(c) WHEN MADE- An election under subsection (a) may be made by a qualifying entity in such form as prescribed by the Secretary. Such election shall be filed with the qualifying entity's return for the first taxable year to which the election shall apply, by the due date for such return (including any applicable extensions).

(d) YEARS FOR WHICH EFFECTIVE- An election under subsection (a) shall be effective for the taxable year of the qualifying entity for which it is made and for all succeeding taxable years of the entity, until such election is terminated under subsection (e).

(e) TERMINATION-

(1) BY REVOCATION-

(A) IN GENERAL- An election under subsection (a) may be terminated by revocation.

(B) WHEN EFFECTIVE- Except as provided in subparagraph

(C)--

(i) a revocation made during the taxable year and on or before the 15th day of the 3d month thereof shall be effective on the 1st day of such taxable year, and

(ii) a revocation made during the taxable year but after such 15th day shall be effective on the 1st day of the following taxable year.

(C) REVOCATION MAY SPECIFY PROSPECTIVE DATE- If the revocation specifies a date for revocation which is on or after

the day on which the revocation is made, the revocation shall be effective on and after the date so specified.

`(2) BY ENTITY CEASING TO BE QUALIFYING ENTITY-

`(A) IN GENERAL- An election under subsection (a) shall be terminated whenever (at any time on or after the 1st day of the 1st taxable year for which the entity is an electing entity) such entity ceases to be a qualifying entity.

`(B) WHEN EFFECTIVE- Any termination under this paragraph shall be effective on and after the date of cessation.

`(f) ELECTION AFTER TERMINATION- If a qualifying entity has made an election under subsection (a) and if such election has been terminated under subsection (e), such entity (and any successor entity) shall not be eligible to make an election under subsection (a) for any taxable year before its 5th taxable year which begins after the 1st taxable year for which such termination is effective, unless the Secretary consents to such election.

`SEC. 1355. DEFINITIONS AND SPECIAL RULES.

`(a) DEFINITIONS- For purposes of this subchapter:

`(1) The term 'controlled group' means any group of trusts and business entities whose members would be treated as a single employer under the rules of section 52(a) (without regard to paragraphs (1) and (2) thereof) and section 52(b)(1).

`(2) The term 'corporate income percentage' means the least aggregate share, expressed as a percentage, of any item of income or gain of an electing corporation or electing group of which such corporation is a member from qualifying shipping activities that would, but for an election in effect under this subchapter, be required to be reported on the Federal income tax return of an electing corporation during any taxable period. In the case of an electing group which includes two or more electing corporations, the corporate income percentage of each such corporation shall be determined on the basis of such corporations' direct and indirect

ownership and charter interests in qualifying vessels of the electing group or on such other basis as the Secretary may prescribe by regulations.

`(3) The term `corporate loss percentage' means the greatest aggregate share, expressed as a percentage, of any item of loss, deduction or credit of an electing corporation or electing group of which such corporation is a member from qualifying shipping activities that would, but for an election in effect under this subchapter, be required to be reported on the Federal income tax return of an electing corporation during any taxable period.

`(4) The term `corporate percentages' means the corporate income percentage and the corporate loss percentage.

`(5) The term `electing corporation' means any C corporation that is an electing entity or that would, but for an election in effect under this subchapter, be required to report any item of income, gain, loss, deduction, or credit of an electing entity on its Federal income tax return.

`(6) The term `electing entity' means any qualifying entity for which an election is in effect under this subchapter.

`(7) The term `electing group' means a controlled group of which one or more members is an electing entity.

`(8) The term `noncorporate percentage' means the difference between one hundred percent and the corporate income percentage or corporate loss percentage, as applicable.

`(9) The term `qualifying entity' means a trust or business entity that--

 `(A) operates one or more qualifying vessels, and

 `(B) meets the shipping activity requirement in subsection (c).

`(10) The term `qualifying shipping assets' means any qualifying vessel and other assets which are used in core qualifying activities as described in section 1356(b).

`(11) The term `qualifying vessel' means a self-propelled (or a combination self-propelled and non-self-propelled) United States flag vessel of not less than 10,000 deadweight tons used in the United States foreign trade.

`(12) The term `United States domestic trade' means the transportation of goods or passengers between places in the United States.

`(13) The term `United States flag vessel' means any vessel documented under the laws of the United States.

`(14) The term `United States foreign trade' means the transportation of goods or passengers between a place in the United States and a foreign place or between foreign places.

`(b) OPERATING A VESSEL- For purposes of this subchapter:

`(1) Except as provided in paragraph (2), an entity is treated as operating any vessel owned by, or chartered (including a time charter) to, the entity.

`(2) An entity is treated as operating a vessel that it has chartered out on bareboat charter terms

only if the vessel is temporarily surplus to the entity's requirements and the term of the charter does not exceed three years.

`(c) SHIPPING ACTIVITY REQUIREMENT- For purposes of this section, the shipping activity requirement is met for a taxable year only by an entity described in paragraph (1), (2), or (3).

`(1) An entity in the first taxable year of its qualifying shipping tax election if, for the preceding taxable year, the test in paragraph (4) is met.

`(2) An entity in the second or any subsequent taxable year of its qualifying shipping tax election if, for each of the two preceding taxable years, the test in paragraph (4) is met.

`(3) An entity that would be described in paragraph (1) or (2) if the test in paragraph (4) were applied on an aggregate basis to the controlled group of which such entity is a member, and vessel charters between members of the controlled group were disregarded.

`(4) The test in this paragraph is met if on average at least 10 percent of the aggregate tonnage of qualifying vessels operated by the entity were owned by the entity or chartered to the entity on bareboat charter terms. For purposes of the preceding sentence, vessels chartered to an entity by a

member of a controlled group which includes the entity shall be treated as chartered to the entity on bareboat charter terms.

`(d) EFFECT OF TEMPORARILY CEASING TO OPERATE A QUALIFYING VESSEL-

`(1) A temporary cessation by an electing entity in operation of a qualifying vessel shall be disregarded for purposes of subsections (b) and (c) until an occurrence described in paragraph (3) if the electing entity gives timely notice to the Secretary stating--

`(A) that it has temporarily ceased to operate the qualifying vessel, and

`(B) its intention to resume operating the qualifying vessel.

`(2) Notice shall be deemed timely if given not later than the due date (including extensions) for the electing entity's tax return (as set forth in section 6072(b)) for the taxable year in which the temporary cessation begins.

`(3) The disregard provided by paragraph (1) continues until the earlier to occur of--

`(A) the electing entity abandoning its intention to resume operation of the qualifying vessel, or

`(B) the electing entity resuming operation of the qualifying vessel.

`(e) EFFECT OF TEMPORARILY OPERATING A QUALIFYING VESSEL IN THE UNITED STATES DOMESTIC TRADE-

`(1) The temporary operation in the United States domestic trade of any qualifying vessel which had been used in the United States foreign trade shall be disregarded for purposes of this subchapter until an occurrence described in paragraph (3) if the electing entity gives timely notice to the Secretary stating--

`(A) that it temporarily operates or has operated in the United States domestic trade a qualifying vessel which had been used in the United States foreign trade, and

`(B) its intention to resume operation of the vessel in the United States foreign trade.

`(2) Notice shall be deemed timely if given not later than the due date (including extensions) for the electing entity's tax return (as set forth in section 6072(b)) for the taxable year in which the temporary cessation begins.

`(3) The disregard provided by paragraph (1) continues until the earlier to occur of--

`(A) the electing entity abandoning its intention to resume operations of the vessel in the United States foreign trade, or

`(B) the electing entity resuming operation of the vessel in the United States foreign trade.

`(f) EFFECT OF CHANGE IN USE-

`(1) Except as provided in subsection (e), a vessel that is used other than for operations in the United States foreign trade on other than a temporary basis ceases to be a qualifying vessel when such use begins.

`(2) For purposes of this subsection, a change in use of a vessel, other than a commencement of operation in the United States domestic trade, is taken to be permanent unless there are circumstances indicating that it is temporary.

`(g) REGULATIONS- The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this section.

`SEC. 1356. QUALIFYING SHIPPING ACTIVITIES.

`(a) QUALIFYING SHIPPING ACTIVITIES- For purposes of this subchapter the 'qualifying shipping activities' of an electing entity consist of--

`(1) its core qualifying activities,

`(2) its qualifying secondary activities, and

`(3) its qualifying incidental activities.

`(b) CORE QUALIFYING ACTIVITIES-

`(1) The 'core qualifying activities' of an electing entity are its--

`(A) activities in operating qualifying vessels in United States foreign trade, and

`(B) other vessel-related activities of the electing entity and other members of its electing group that are a necessary and integral part of its business of operating qualifying vessels in United States foreign trade, including ownership and operation of barges and containers that are the complement of a qualifying vessel and terminal facilities.

`(2) `Core qualifying activities' do not include the provision by an entity of facilities or services to any person other than another member of such entity's electing group.

`(c) QUALIFYING SECONDARY ACTIVITIES- For purposes of this subsection--

`(1) the term `secondary activities' means the active management or operation of vessels in the United States foreign trade and such other activities as may be prescribed by the Secretary pursuant to regulations, and

`(2) the term `qualified secondary activities' means the secondary activities of an electing entity, but only to the extent that, without regard to this subchapter, the gross income derived by such entity from such activities does not exceed 20 percent of the gross income derived by such entity from its core qualifying activities.

`(d) QUALIFYING INCIDENTAL ACTIVITIES- Shipping-related activities carried on by an electing entity are qualified incidental activities if--

`(1) they are incidental to its core qualifying activities,

`(2) they are not qualifying secondary activities, and

`(3) without regard to this subchapter, the gross income derived by such entity from such activities does not exceed 0.1 percent of the entity's gross income from its core qualifying activities.

**SEC. 1357. ITEMS NOT SUBJECT TO REGULAR TAX; DEPRECIATION;
INTEREST.**

(a) EXCLUSION FROM GROSS INCOME- Gross income of an electing entity shall not include the corporate income percentage of--

- (1) its income from qualifying shipping activities in the United States foreign trade,
- (2) its income from money, bank deposits and other temporary investments which are reasonably necessary to meet the working capital requirements of its qualifying shipping activities, and
- (3) its income from money or other intangible assets accumulated pursuant to a plan to purchase qualifying shipping assets.

(b) ELECTING GROUP MEMBER- Gross income of a member of an electing group that is not an electing entity shall not include the corporate income percentage of its income from qualifying shipping activities that are taken into account under this subchapter as qualifying shipping activities of an electing entity.

(c) DENIAL OF LOSSES, DEDUCTIONS, AND CREDITS-

(1) GENERAL RULE- Subject to paragraph (2), the corporate loss percentage of each item of loss, deduction (other than for interest expense), or credit of any taxpayer with respect to any activity the income from which is excluded from gross income under this section shall be disallowed.

(2) DEPRECIATION- Notwithstanding paragraph (1), an owner but not operator of qualifying shipping assets shall be allowed the deduction for depreciation.

(A) Except as provided in subparagraph (B), the straight line method of depreciation shall apply to the corporate income percentage of qualifying shipping assets the income from operation of which is excluded from gross income under this section.

`(B) Subparagraph (A) shall not apply to any qualifying shipping asset which is subject to a charter entered into prior to the effective date of this subchapter.

`(3) INTEREST- The corporate loss percentage of an electing entity's interest expense shall be disallowed in the ratio that the fair market value of its qualifying vessel assets bears to the fair market value of its total assets.

`SEC. 1358. ALLOCATION OF CREDITS, INCOME, AND DEDUCTIONS.

`(a) QUALIFYING SHIPPING ACTIVITIES- For purposes of this chapter the qualifying shipping activities of

an electing entity shall be treated as a separate trade or business activity distinct from all other activities conducted by the entity.

`(b) EXCLUSION OF CREDITS OR DEDUCTIONS-

`(1) No deduction shall be allowed against the taxable income of an electing corporation from qualifying shipping activities, and no credit shall be allowed against the tax imposed by section 1352(b).

`(2) No deduction shall be allowed for any net operating loss attributable to the qualifying shipping activities of a corporation to the extent that such loss is carried forward by the corporation from a taxable year preceding the first taxable year for which such corporation was an electing corporation.

`(c) TRANSACTIONS NOT AT ARM'S LENGTH- Section 482 applies in accordance with this subsection to a transaction or series of transactions--

`(1) as between an electing entity and another person, or

`(2) as between an entity's qualifying shipping activities and other activities carried on by it.

`SEC. 1359. DISPOSITION OF QUALIFYING SHIPPING ASSETS.

`(a) IN GENERAL- If an electing entity sells or disposes of qualifying shipping assets (as defined in subsection (c)) in an otherwise taxable transaction, at the election of the entity no gain shall be recognized if replacement qualifying

shipping assets are acquired during the period specified in subsection (b), except to the extent that the amount realized upon such sale or disposition exceeds the cost of the replacement qualifying shipping assets.

`(b) PERIOD WITHIN WHICH PROPERTY MUST BE REPLACED- The period referred to in subsection (a) shall be the period beginning one year prior to the disposition of the qualifying shipping assets and ending--

`(1) 3 years after the close of the first taxable year in which the gain is realized, or

`(2) subject to such terms and conditions as may be specified by the Secretary, on such later date as the Secretary may designate on application by the taxpayer. Such application shall be made at such time and in such manner as the Secretary may by regulations prescribe.

`(c) TIME FOR ASSESSMENT OF DEFICIENCY ATTRIBUTABLE TO GAIN- If an electing entity has made the election provided in subsection (a), then-

`(1) the statutory period for the assessment of any deficiency, for any taxable year in which any part of the gain is realized, attributable to such gain shall not expire prior to the expiration of 3 years from the date the Secretary is notified by the entity (in such manner as the Secretary may by regulations prescribe) of the replacement tonnage tax property or of an intention not to replace, and

`(2) such deficiency may be assessed before the expiration of such 3-year period notwithstanding the provisions of section 6212(c) or the provisions of any other law or rule of law which would otherwise prevent such assessment.

`(d) BASIS OF REPLACEMENT QUALIFYING SHIPPING ASSETS- In the case of replacement qualifying shipping assets purchased by an electing entity which resulted in the nonrecognition of any part of the gain realized as the result of a sale or other disposition of qualifying shipping assets, the basis shall be the cost of such property decreased in the amount of the gain not so recognized; and if the property purchased consists of more than one piece of property, the basis

determined under this sentence shall be allocated to the purchased properties in proportion to their respective costs.

“(e) REPLACEMENT QUALIFYING SHIPPING ASSETS MUST BE ACQUIRED FROM UNRELATED PERSON IN CERTAIN CASES-

“(1) IN GENERAL- Subsection (a) shall not apply if the replacement qualifying shipping assets are acquired from a related person except to the extent that the related person acquired the replacement qualifying shipping assets from an unrelated person during the period applicable under subsection (b).

“(2) RELATED PERSON- For purposes of this subsection, a person is related to another person if the person bears a relationship to the other person described in section 267(b) or 707(b)(1).’

(b) TECHNICAL AND CONFORMING AMENDMENT- The second sentence of section 56(g)(4)(B)(i) is amended by striking ‘or under section 114.’ and inserting ‘, under section 114 or under section 1357.’

(c) EFFECTIVE DATE- The amendments made by this section shall apply to taxable years beginning after the date of the enactment of this Act.

SEC. 102. INCOME OF MERCHANT SEAMAN EXCLUDABLE FROM GROSS INCOME AS FOREIGN EARNED INCOME.

(a) SECTION 911 EXCLUSION- Section 911(d) of the Internal Revenue Code of 1986 (relating to citizens or residents of the United States living abroad) is amended by redesignating paragraph (9) as paragraph (10) and by inserting after paragraph (8) the following:

“(9) APPLICATION TO CERTAIN MERCHANT MARINE CREWS- In applying this section to an individual who is a citizen or resident of the United States and who is employed for a minimum of 90 days during a taxable year as a regular member of the crew of a qualified vessel (as defined in section 1355)--

“(A) the individual shall be treated as a qualified individual without regard to the requirements of paragraph (1), and

`(B) any earned income attributable to services performed by that individual so employed on such a vessel while it is engaged in transportation between the United States and a foreign country or possession of the United States shall be treated (except as provided by subsection (b)(1)(B)) as foreign earned income regardless of where payments of such income are made.'

(b) EFFECTIVE DATE- The amendment made by this section shall apply to taxable years beginning after the date of the enactment of this Act.

TITLE II--INSPECTION AND INSURANCE PARITY

SEC. 201. CERTIFICATE OF INSPECTION.

Section 3309 of title 46, United States Code, is amended by adding at the end the following:

`(d) CERTIFICATE OF INSPECTION-

`(1) IN GENERAL- A qualified vessel (as defined in section 1355 of the Internal Revenue Code of 1986) shall be eligible for a certificate of inspection if the Secretary determines that--

`(A) the vessel is classed by and designed in accordance with the rules of the American Bureau of Shipping or another classification society accepted by the Secretary;

`(B) the vessel complies with applicable international agreements and associated guidelines, as determined by the country in which the vessel was documented immediately before becoming a documented vessel (as defined in that section); and

`(C) that country has not been identified by the Secretary as inadequately enforcing international vessel regulations as to that vessel.

`(2) CONTINUED ELIGIBILITY FOR CERTIFICATE- Paragraph (1) does not apply to a vessel after any date on which the vessel fails to comply with the applicable international agreements and associated guidelines referred to in paragraph (1)(B).'

SEC. 202. AGREEMENTS REGARDING INJURY OR DEATH OF CREW.

(a) AGREEMENTS- Notwithstanding the Death on the High Seas Act (46 U.S.C. App. 761 et seq.) or any other provision of law (other than subsection (b)), including general maritime law--

(1) the operator of a qualified vessel (as defined in section 1355 of the Internal Revenue Code of 1986) and the operating crew of such a vessel may agree to any mutually-acceptable system limiting or otherwise controlling liability and damages from death or injury of a crew member; and

(2) the terms of any such agreement shall take precedence over, and apply in lieu of, any otherwise applicable provision of any law of the United States with respect to the liability of the owner, employer, and operator, and damages, for such injury or death.

(b) EVIDENCE OF FINANCIAL RESPONSIBILITY REQUIRED- Subsection (a)(2) shall not apply to an agreement under subsection (a)(1) unless the owner or operation of the vessel to which the agreement relates has insurance or other evidence of financial responsibility that has been approved by the Secretary of Transportation to provide for compensation in accordance with the agreement for death or injury of seamen engaged on the vessel.

END

This legislation was found via the Library of Congress website, accessed at:

<http://thomas.loc.gov/cgi-bin/query/C?c107:/temp/~c107IGv75w>

APPENDIX C

HR 3312 IH

107th CONGRESS

1st Session

H. R. 3312

To amend the Internal Revenue Code of 1986 to eliminate foreign base company shipping income from foreign base company income.

IN THE HOUSE OF REPRESENTATIVES

November 16, 2001

Mr. WELLER (for himself, Mr. RANGEL, Mr. CRANE, Mr. FOLEY, Mr. SHIMKUS, and Mrs. BIGGERT) introduced the following bill; which was referred to the Committee on Ways and Means

A BILL

To amend the Internal Revenue Code of 1986 to eliminate foreign base company shipping income from foreign base company income.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the 'RAFT (Restore Access to Foreign Trade) Act'.

SEC. 2. ELIMINATION OF FOREIGN BASE COMPANY SHIPPING INCOME

AS FOREIGN BASE COMPANY INCOME.

(a) ELIMINATION OF FOREIGN BASE COMPANY SHIPPING INCOME-

Section 954 of the Internal Revenue Code of 1986 (relating to foreign base company income) is amended--

- (1) by striking paragraph (4) of subsection (a) (relating to foreign base company shipping income), and

(2) by striking subsection (f) (relating to foreign base company shipping income).

(b) CONFORMING AMENDMENTS-

(1) Subparagraph (D) of section 904(d)(2) of such Code (relating to the definition of shipping income for purposes of the foreign tax credit) is amended to read as follows:

`(D) SHIPPING INCOME-

`(i) IN GENERAL- The term `shipping income' means income derived from, or in connection with, the use (or hiring or leasing for use) of any aircraft or vessel in foreign commerce, or from, or in connection with, the performance of services directly related to the use of any such aircraft, or vessel, or from the sale, exchange, or other disposition of any such aircraft or vessel.

`(ii) SPECIAL RULES-

`(I) Such term includes dividends and interest received from a foreign corporation in respect of which taxes are deemed paid under section 902 (other than dividends from a noncontrolled section 902 corporation out of earnings and profits accumulated in taxable years beginning before January 1, 2003) and gain from the sale, exchange, or other disposition of stock or obligations of such a foreign corporation to the extent that such dividends, interest, and gains are attributable to shipping income.

`(II) Such term includes that portion of the distributive share of the income of a partnership attributable to shipping income.

`(III) Such term includes any income derived from a space or ocean activity (as defined in section 863(d)(2)).

`(IV) Such term does not include, except as provided in subclause (I), any dividend or interest income which is foreign personal holding company income as defined in section 954(c).

`(V) Such term does not include financial services income.'

(2) Section 952(c)(1)(B)(iii) of such Code is amended by striking subclause (I) and redesignating subclauses (II) through (VI) as subclauses (I) through (V), respectively.

(3) Section 953 of such Code is amended--

(A) by striking `954(i)' and inserting `954(h)' in subsections (b)(3) and (e) each place it appears, and

(B) by striking `954(h)(7)' and inserting `954(g)(7)' in subsection (e)(7)(A).

(4) Section 954 of such Code is amended--

(A) in subsection (a) by inserting `and' at the end of paragraph (3) and redesignating paragraph (5) as paragraph (4),

(B) in subsection (b)--

(i) by striking `the foreign base shipping income,' in paragraph (5),

(ii) by striking paragraphs (6) and (7), and

(iii) by redesignating paragraph (8) as paragraph (6), and

(C) by redesignating subsections (g), (h), and (i) as subsections (f), (g), and (h), respectively.

(c) EFFECTIVE DATE- The amendments made by this section shall apply to taxable years of foreign corporations beginning after December 31, 2001, and to taxable years of United States shareholders (within the meaning of section 951(b)

of the Internal Revenue Code of 1986) within which or with which such taxable years of such foreign corporations end.

This legislation was accessed via the Library of Congress website, found at:

[http://thomas.loc.gov/cgi-bin/query/z?c107:H.R.3312:](http://thomas.loc.gov/cgi-bin/query/z?c107:H.R.3312)

APPENDIX D:

This appendix is taken from Chapter 2 of “Increasing the Size of the Effective United States Control Fleet (Steven Torok),” and provides a good review of the EUSC’s decline, numerically and statistically.

The strategic sealift plans of the United States military rely on a variety of sources to meet the predicted requirements for marine vessels during military emergencies. The U.S. military’s initial source of strategic sealift vessels comes from vessels owned or on long-term charter by the Military Sealift Command. These vessels are maintained in a constant state of readiness and serve actively in support of the U.S. military. As additional vessels are required to meet military sealift needs, the Ready Reserve Force (RRF), which is maintained by MARAD, would be activated if U.S. flag or foreign flag ships were not available for charter. Following the commitment of both the MSC vessels and the RRF, the U.S. government could declare a national military emergency and either begin the reactivation of the National Defense Reserve Fleet (NDRF) or authorize the acquisition of U.S. flag merchant ships and/or certain foreign flag vessels that are majority owned by U.S. citizens. The latter category of ships is referred to as the Effective U.S. Control fleet or the EUSC fleet.

As the MRS-05 Sealift Tanker Analysis confirms, the adequate transport of petroleum, oil, and lubricants (POLs) to a military theater is critical to the highly fuel dependent operational requirements of the Department of Defense (DoD). Therefore, one of the most important categories of military sealift vessels is tankers, a category in which the

EUSC fleet traditionally has been strong. In this chapter, historical and current information on the EUSC fleet as a source of military sealift tankers will be summarized. In addition, a comparison of the total strategic sealift resources available to U.S. military planners will be presented. U.S. flag ships always take precedence over EUSC vessels as long as the U.S. flag ships are available.

U.S. OWNED, FOREIGN FLAG FLEET

It is important to differentiate between U.S. owned vessels registered in foreign countries generally and those U.S. owned, foreign flag vessels in the EUSC fleet. The latter is a subset of the former, and in terms of military sealift planning has, as will be explained herein, much greater significance.

It has been a common practice, dating back to the Nineteenth Century, for American shipowning companies to own and operate vessels under various registries for a variety of reasons: lower construction and operating costs, lower tax (certainly so in earlier years), very attractive subsidies, marketing or natural resource extraction opportunities, national flag requirements, neutrality in time of war, etc. Particularly in earlier years, the size of the overall U. S. owned, foreign flag fleet was indeed substantial. For instance, if the U.S. owned segment of foreign flag tonnage in 1900 was deemed to be a fleet all by itself, compared to other national flag fleets it would have ranked as the fourth largest fleet in the world.

In the early years of the Twentieth Century, the European registries accounted for most of the American owned tonnage registered abroad. However, in the 1920s and increasingly

so in the 1930s American shipowners registered vessels in Panama and, to a much lesser extent, Honduras. These registries, along with more recent additions, are sometimes referred to pejoratively as “flags of convenience,” although the phrase “open registries” (a United Nations creation) is more commonly accepted today. As distinguished from the so-called “traditional registries” of the United States, Europe, Japan, etc., the open registries offer shipowners of other nations no restrictive shipowning nationality requirements, no national restrictions on shipbuilding or repair, no limitations on crew nationalities, less restrictive manning requirements, and more favorable tax structures. Today, open registries still account for a significant percentage of the world’s merchant tonnage. U.S. shipowning companies were once the predominant nationality among owners of open registry tonnage but their share has declined sharply in more recent years. On the other hand, American shipowners, ever since the onset of World War II, have continued to favor open registries over other traditional foreign registries as well as the “second registries” some European nations have adopted to be more competitive with open registries.

Nevertheless, there are currently a small number of vessels owned by U.S. shipowning companies and registered in several foreign nations other than Liberia, Panama, Honduras, the Bahamas and the Marshall Islands. Notably, under U.S. law (Section 902 of the Merchant Marine Act of 1936, as amended in 1939) these vessels would be subject to requisition, use or charter by the United States in the event of a national emergency. However, they cannot be deemed to be under Effective U.S. Control because they do not meet the considerations established by the Joint Chiefs of Staff following World War II,

one of which is that the nation of registry must be "...willing and able to bring the vessel under control of the United States in an emergency for such use as the United States may wish to make of the vessel..." (J.L.S. 1454/11). From the standpoint of military sealift planning, the problem is that the non-EUSC flag states have not tacitly or explicitly consented in advance to making the U.S. owned ships flying their flags available in such manner because they may want the vessels to meet their own sealift needs, or because of political, sovereignty or neutrality considerations, etc. Thus, reliance on non-EUSC vessels to meet U.S. emergency sealift needs would be, at best, problematic. The problem is compounded by the rule of international law that clearly recognizes the paramount rights of the flag states to exercise control over vessels flying their flags.

On the other hand, there is some value in tracing the growth and decline of the overall U.S. owned, foreign flag fleet because there are some clearly discernible parallels with the growth and decline of its subset, the EUSC fleet. In considering these parallels it should be kept in mind that the overall U.S. owned, foreign flag fleet has been generally impacted by the 1975 and 1986 changes in U.S. tax laws to the same extent as the EUSC fleet.

The historic trends of both the U.S. owned, foreign flag and the EUSC fleets will be traced from 1970 to 2000. This period covers the growth of these fleets to their historic peaks and their subsequent decline through the year 2000 in terms of deadweight tonnage (dwt). Data for earlier years was intermittent and deemed less important with regard to the impact of the changes in U.S. tax laws in 1975 and 1986. However, it is useful to

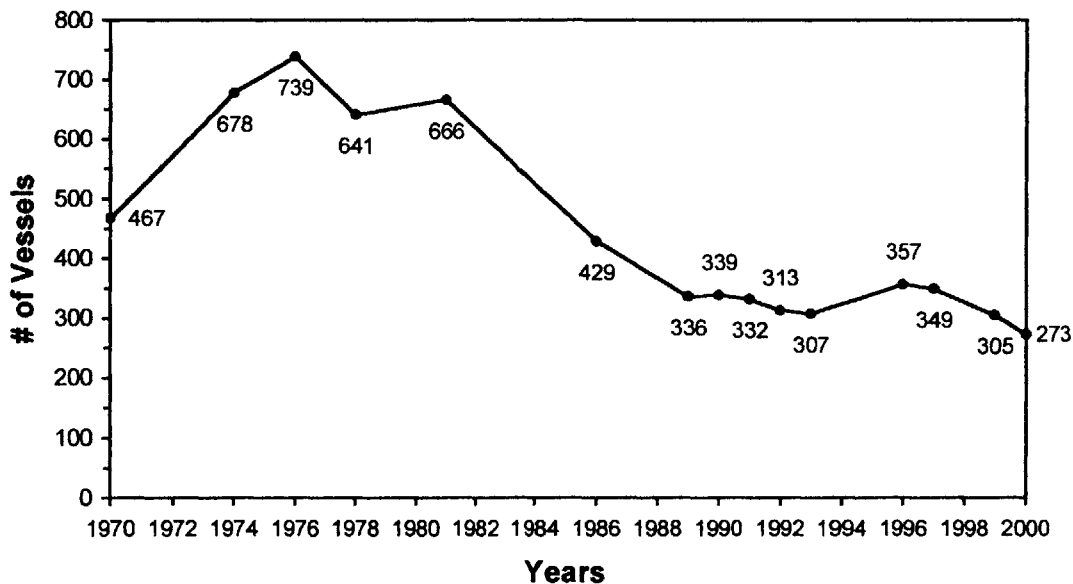
first consider the importance placed upon obtaining access to sealift vessels by military planners in the wake of World War II. The Merchant Vessel Register was a quarterly report compiled by the Merchant Vessel Section of Naval Transportation Service in the Office of the Chief of Naval Operations that tracked the inventory of U.S. controlled merchant vessels. This publication monitored government owned and privately owned vessels, including both the U.S. flag and the effectively controlled foreign flag fleets. The June 30, 1949, Register reports that the modern EUSC fleet contained 202 vessels with a combined dwt of 2,476,500, which included 140 tankers consisting of 2,063,900 dwt. Even in an era where the U.S. flag fleet of 1202 vessels dwarfed the EUSC fleet, the EUSC tankers still accounted for 22 percent of America's tanker sealift planning by dwt. In the years after 1949, the size of the U.S. owned, foreign flag fleet grew rapidly until the mid-1970's. Since its peak, this fleet has experienced a substantial decline while the total world fleet has continued to grow. It will be demonstrated in the remainder of this chapter that the current significance of the contribution of the EUSC tanker fleet to America's sealift planning has increased despite its present state of decline.

The historic trends of the U.S. owned, foreign flag fleet in terms of number of vessels and of dwt since 1970 are contained in Figure 2.1 and Figure 2.2 respectively. From these graphs, it is apparent that the total number of vessels in the overall U.S. owned, foreign flag fleet peaked in approximately 1976 and has been in decline since that year. The sharpest period of decline in terms of total numbers occurred between 1981 and 1989. In terms of dwt, the total fleet size declined by 72 percent between 1981 and 2000. Between 1986 and 2000, the total dwt declined by 53 percent. The MARAD database of the U.S.

owned, foreign flag fleet for April 2000, the last year for which a complete MARAD database of the U.S. owned, foreign flag fleet is available, is contained in Appendix A.

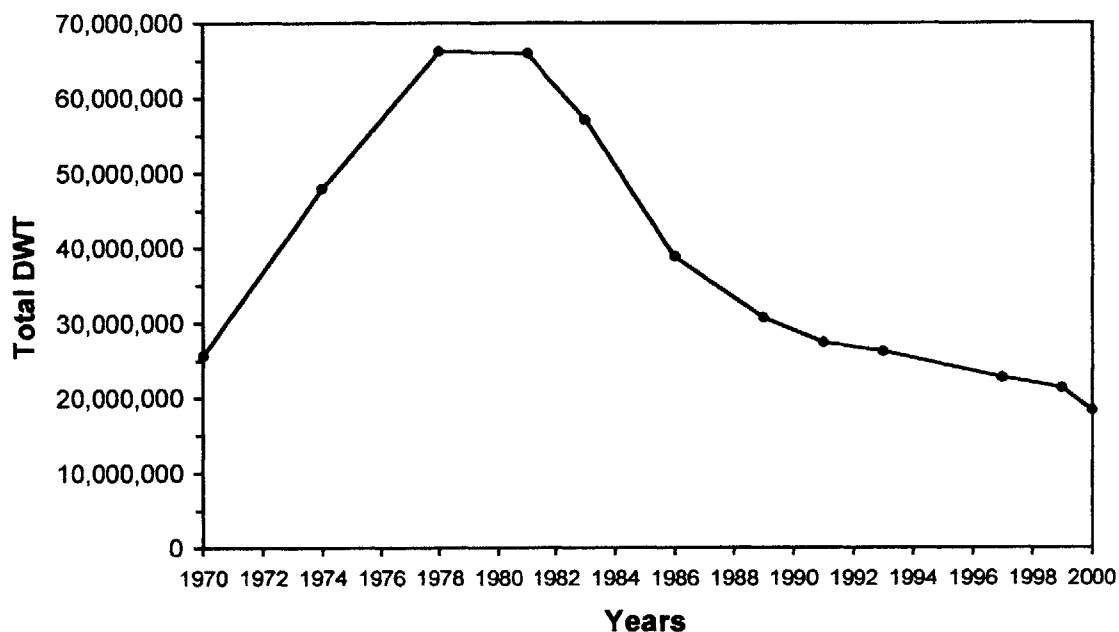
The composition of the U.S. owned, foreign flag fleet includes container vessels, breakbulk vessels, passenger vessels, bulk carriers, and tankers. The largest segment of this fleet is the tanker portion, which accounted for 82 percent of the total dwt of the fleet in 2000. The trend in tanker ownership by U.S. companies has followed the historic pattern of the combined U.S. owned, foreign flag fleet.

Figure 2.3 displays the total



- Source: 1) Marcus, Henry et. al., "U.S. Owned Merchant Fleet: The Last Wake-Up Call?", M.I.T., 1991.
 2) Dean, Warren L. and Michael G. Roberts, "Shipping Income Reform Act of 1999: Background Materials Regarding Proposal to Revitalize the U.S. Controlled Fleet Through Increased Investment in International Shipping." Thomas Coburn LLP, 1999.
 3) U.S. Owned, Foreign Flag Fleet Database, MARAD, January 1997.
 4) U.S. Owned, Foreign Flag Fleet Database, MARAD, July 1999.
 5) U.S. Owned, Foreign Flag Fleet Database, MARAD, April 2000.

Figure 2.1, Historical U.S. Owned, Foreign Flag Fleet - # of Vessels



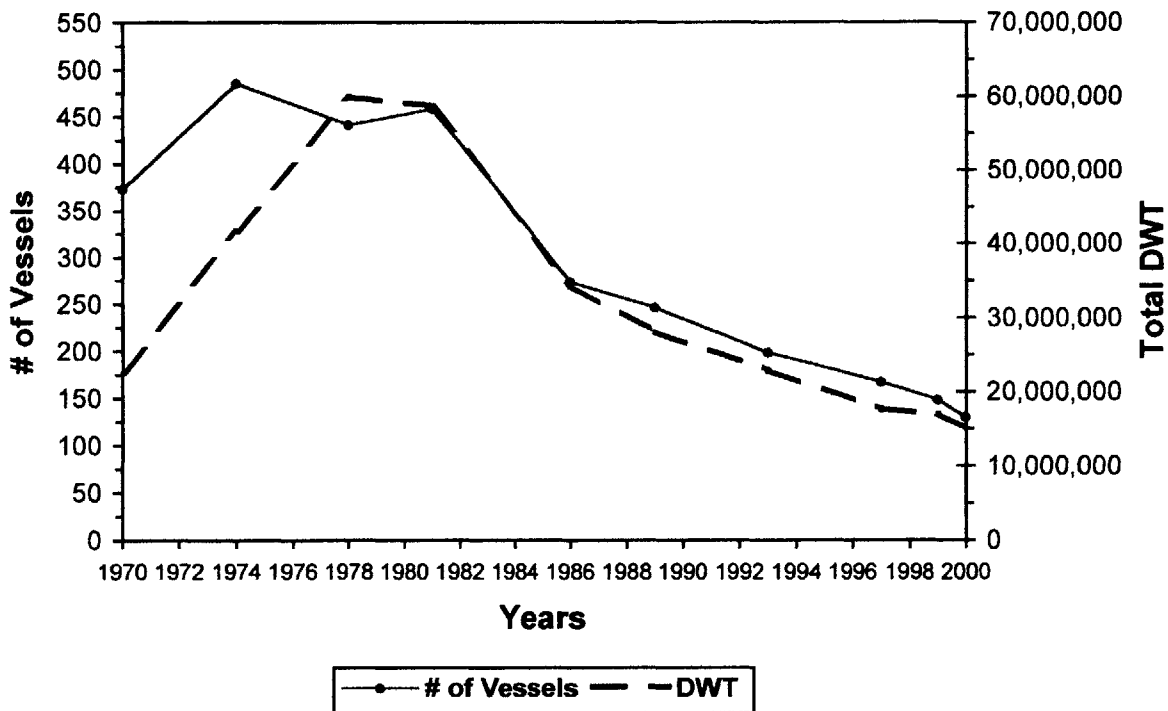
- Source: 1) Marcus, Henry et. al., "U.S. Owned Merchant Fleet: The Last Wake-Up Call?", M.I.T., 1991.
 2) Waters, Robert C. and Philip C. Koenig, "Decline of the U.S. Owned, Foreign Flag Merchant Fleet." 36th Annual Forum, Transportation Research Forum, 1994.
 3) U.S. Owned, Foreign Flag Fleet Database, MARAD, January 1997.
 4) U.S. Owned, Foreign Flag Fleet Database, MARAD, July 1999.
 5) U.S. Owned, Foreign Flag Fleet Database, MARAD, April 2000.

Figure 2.2, Historical U.S. Owned, Foreign Flag Fleet – Total DWT of Fleet

number and total dwt of tankers within this fleet from 1970 to 2000. In 2000, there were a total of 130 tankers. The dwt of this subset of the U.S. owned, foreign flag fleet dropped by 56 percent between 1986 and 2000.

The long term decline of the U.S. owned, foreign flag fleet reflects the selling or scrapping of vessels by their owners. It is apparent that vessels were removed from this fleet at a faster pace than owners sought to replace those ships. Figure 2.4 presents the

average age of the vessels comprising the U.S. owned foreign flag fleet from 1978 to 2000. The graph reveals a steady increase in the average age of the fleet between 1978 and mid-1996, which reflects the tendency of U.S. owners to avoid replacing ageing vessels after 1978. Since 1996, the average age has stabilized at about 15 years.

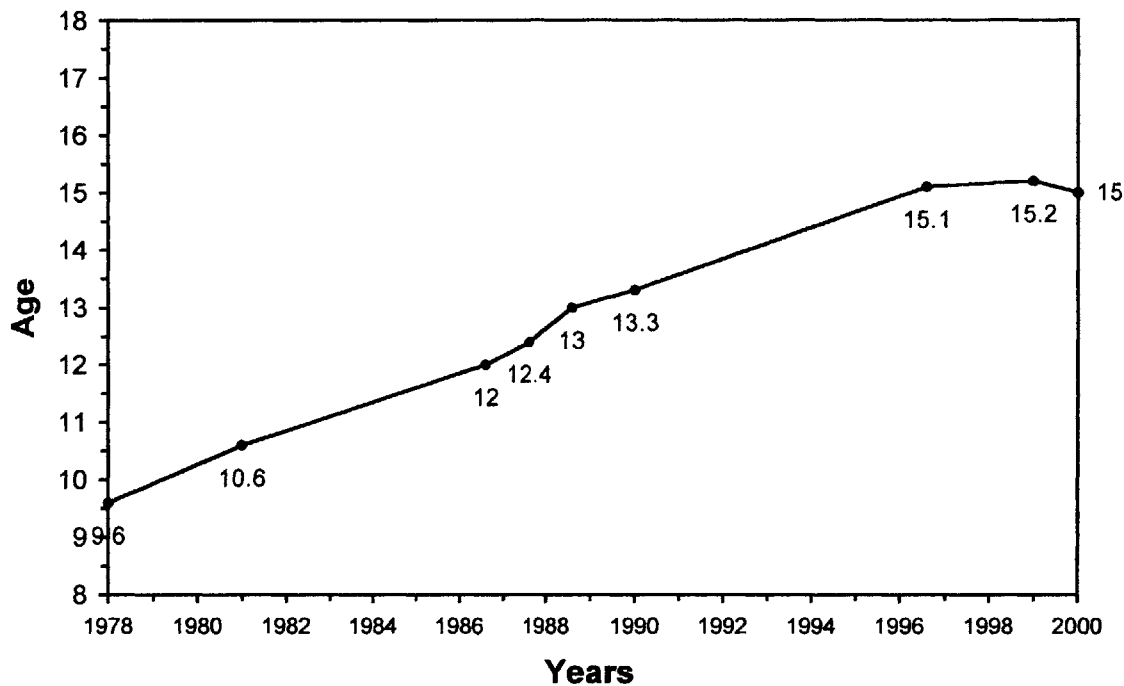


- Source: 1) Marcus, Henry et. al., "U.S. Owned Merchant Fleet: The Last Wake-Up Call?", M.I.T., 1991.
 2) Waters, Robert C. and Philip C. Koenig, "Decline of the U.S. Owned, Foreign Flag Merchant Fleet." 36th Annual Forum, Transportation Research Forum, 1994.
 3) U.S. Owned, Foreign Flag Fleet Database, MARAD, January 1997.
 4) U.S. Owned, Foreign Flag Fleet Database, MARAD, July 1999.
 5) U.S. Owned, Foreign Flag Fleet Database, MARAD, April 2000.

Figure 2.3, Historical U.S. Owned, Foreign Flag Tankers – # of Vessels & Total DWT

An additional measure of the decline of the U.S. owned, foreign flag fleet is the decrease in the number of U.S. companies participating in this industry. The total number of U.S.

companies that owned foreign flag vessels in 1987, 1990, 1993, 1997, 1999, and 2000 is presented in Table 2.1. In 2000, seventeen American parent companies owned foreign flag tankers.



Source: 1) Dean, Warren L. and Michael G. Roberts, "Shipping Income Reform Act of 1999: Background Materials Regarding Proposal to Revitalize the U.S. Controlled Fleet Through Increased Investment in International Shipping." Thomas Coburn LLP, 1999.
 2) U.S. Owned, Foreign Flag Fleet Database, MARAD, July 1999.
 3) U.S. Owned, Foreign Flag Fleet Database, MARAD, April 2000.

Figure 2.4, Historical U.S. Owned, Foreign Flag Fleet – Average Age

# of U.S. Companies w/ Foreign Flag Vessels	Years					
	<u>1987</u>	<u>1990</u>	<u>1993</u>	<u>1997</u>	<u>1999</u>	<u>2000</u>
	52	43	38	48	39	35

Source: 1) Waters, Robert C. and Philip C. Koenig, "Decline of the U.S. Owned, Foreign Flag Merchant Fleet." 36th Annual Forum, Transportation Research Forum, 1994.
 2) U.S. General Accounting Office, Tax Policy: "Uncertain Impact of Repealing the Deferral for Reinvested Shipping Income", (GAO/GGD-90-35), Washington, D.C., 1990.
 3) U.S. Owned, Foreign Flag Fleet Database, MARAD, January 1997.
 4) U.S. Owned, Foreign Flag Fleet Database, MARAD, July 1999.

5) U.S. Owned, Foreign Flag Fleet Database, MARAD, April 2000.

Table 2.1, Number of U.S. Owners of Foreign Flag Vessels

EFFECTIVE U.S. CONTROL FLEET

A. Historical Perspective

Effective U.S. Control is a long standing policy formulated by the Joint Chiefs of Staff that has its roots in the years leading up to and during the World War II. In essence, it provides that U.S. owned vessels registered under the laws of certain open registries can be deemed to be under the effective control of the United States for use in time of national emergency. It is noteworthy that not all open registries (e.g., Cyprus, Malta, Vanuatu, St. Vincent, etc.) have been deemed to be eligible EUSC registries, but that the five eligible open registries have all come into being with the strong support of American shipowning interests and, in most cases, the indirect support of the U.S. government.

The formulation of EUSC policy and the growth of open registries have run on parallel courses. Panama created the first open registry in the early years of the 1920s when two former German flag passenger vessels, having been transferred to the U.S. flag as war reparations, were transferred by Harriman Lines to the Panamanian registry in order to avoid the prohibition against sale of alcohol on U.S. flag vessels under the Volstead Act. In the years that followed another open registry came into being when the United Fruit Company began to register its ships in Honduras. The Panamanian fleet experienced a growth spurt during the mid-1930s when the Standard Oil Company of N.J. transferred

its fleet of 25 tankers flying the flag of the Free City of Danzig to Panama in order to assure that the ships did not fall under Nazi control.

As originally enacted, the emergency requisitioning and use authority under Section 902 of the Merchant Marine Act of 1936 applied only to U.S. flag vessels. In the spring of 1939, however, as the likelihood of war in Europe and the Far East became increasingly apparent, Rear Admiral Emory S. Land, Chairman of the United States Maritime Commission and the official responsible for marshalling the nation's sealift assets during World II, appeared before Congress to urge enactment of certain amendments to Section 902 that the Navy and the Maritime Commission believed were "desirable, in the interest of our national defense." He told Congress that "...The power to requisition or purchase should not be confined to vessels 'documented under the laws of the United States,' because many vessels owned by our citizens are now under foreign registry. Accordingly, the authority to requisition or purchase should extend to all vessels or watercraft owned by citizens of the United States." (Hearings on H.R. 4983 Before the House Committee on Merchant Marine and Fisheries, 76th Cong., 1st Sess. (1939), p. 9) (Emphasis added.) The House Report on Section 902 repeated verbatim this portion of his testimony. The amended Section 902 was enacted into law three weeks prior to the Nazi invasion of Poland.

When the war began, the Neutrality Act of 1939 prohibited U.S. flag vessels from trading with belligerents. This caused the Roosevelt Administration, seeking to ship oil and other essential supplies to Great Britain and France, to encourage the transfers of 70 U.S. flag ships to Panama and Honduras. In 1941, before the United States entered the war,

the Maritime Commission requisitioned (under a statute passed earlier that year) 40 Danish flag vessels in U.S. ports and then arranged for the transfer to Panama of 30 of the vessels, which were then operated by U.S. shipping companies. During 1941 and 1942 the Maritime Commission also arranged for the transfer of 47 other European owned vessels (primarily Italian and Finnish) it had seized in U.S. waters. Various other European flag vessels, including Norwegian and Greek ships, were transferred to Panama by their owners in order to assure that authorities controlled by the Germans would have no legal claim over them. Throughout the war the Panamanian and Honduran flag ships sailed alongside U.S. flag ships and other allied vessels, suffering many losses in the process. For instance, the ESSO tanker fleet flying the Panamanian flag lost 20 ships to enemy action, while the United Fruit Company fleet lost 17 ships. By May of 1944 the War Shipping Administration controlled a total of 127 Panamanian flag ships, including 61 owned and under charter from American companies and 66 either confiscated or requisitioned by the United States and operated for the most part by American companies.

It was during the war that the term “effective control” was adopted by the War Shipping Administration to differentiate between U.S. flag ships and those under foreign flags, principally Panamanian. In 1945 the Joint Chiefs of Staff considered the role of merchant shipping from the standpoint of national defense and concluded that “to be effective as an instrument of national defense U.S. merchant shipping should be under U.S. flag or effective U.S. control....” It further stated that “the term ‘effective United States control’ as applied to shipping is considered to include all shipping which can be

expected to be available for requisition by the United States Government in time of national emergency even though such shipping may not be under the United States flag...” (J.C.S. 1454/1).

In 1947 the Joint Chiefs of Staff clarified its earlier definition, apparently seeking to resolve the problem of those flag states that would not consent to the use of the vessels in their registries by the United States, as follows:

“The term ‘effective United States control’ as used [in J.C.S. 1454/1] appears to be inadequately defined. On a number of occasions doubt as to the meaning of the term has arisen. Except through agreement there are no legal means by which the United States can regain control of a United States merchant vessel the registry of which has been transferred to another country. From a legal standpoint therefore it can be considered that the only time a vessel is under absolute ‘effective United States control’ is when it flies the United States flag.

Actually, however, there are certain countries in this hemisphere which through diplomatic or other arrangements will permit the transfer to their registry of United States ships owned by United States citizens or United States corporations and allow these citizens or corporations to retain control of these vessels. Prior to entry of the United States into World War II, United States vessels were transferred to Panamanian registry for the purpose of rendering aid to the allies. Such a case as the above can be considered to be within the meaning of the term ‘effective United States control.’

When the foreign authorities who are in a position to dictate to the owner, master, crew, charterer or other individual or agency having physical control of the vessel are willing and able to bring the vessel under control of the United States in an emergency for such use as the United States may wish to make of the vessel, such vessel may also be considered to be under

‘effective United States control.’ It can be concluded, therefore, that the primary considerations in determining whether or not a United States merchant ship would still be under ‘effective United States control’ are:

- a. The practice followed in the past in regard to transfer of United States merchant vessels to foreign registry.
- b. The status of diplomatic relations between the United States and the foreign country concerned.
- c. Its relations with countries opposed to our system of government or foreign policy.
- d. Proximity of the foreign country to the United States.
- e. The stability of its government.” (J.C.S. 1454/11)

World War II had introduced many U.S. shipping companies to open registries.

Following the war the Merchant Ship Sales Act of 1946 enabled the companies to acquire tankers and dry cargo vessels built during the war and transfer them to foreign registry.

This growth spurt caused American shipowners to seek out another open registry more to their liking. In 1948, while preparations for a new Liberian registry were underway, the Joint Chiefs of Staff approved the status of Liberia as an EUSC registry, conditioned on the agreement by the Liberian government and shipowners that vessels would be returned to the United States in time of emergency.

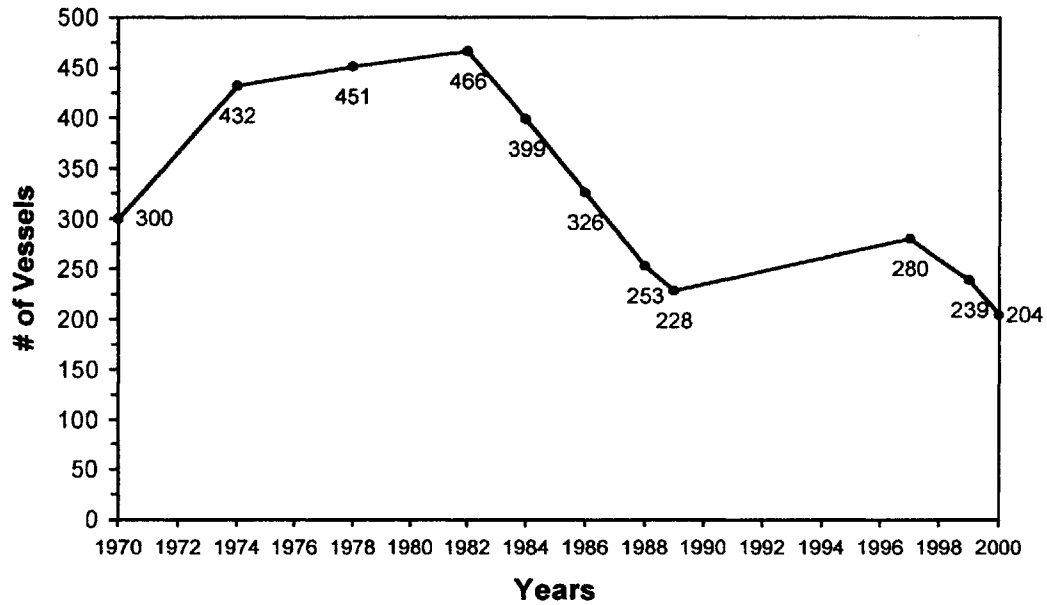
For more than three decades the so-called PANLIBHON registries constituted the three eligible EUSC registries. However, in the early 1980s in the wake of political turmoil in Liberia, American shipowners undertook the search for another desirable open registry, an effort that resulted in the modernization of the almost moribund Bahamian registry,

which was recognized as an eligible EUSC registry in 1983. In 1990, again with the support of American shipping companies, the Marshall Islands also was recognized as an eligible registry.

B. Growth and Decline

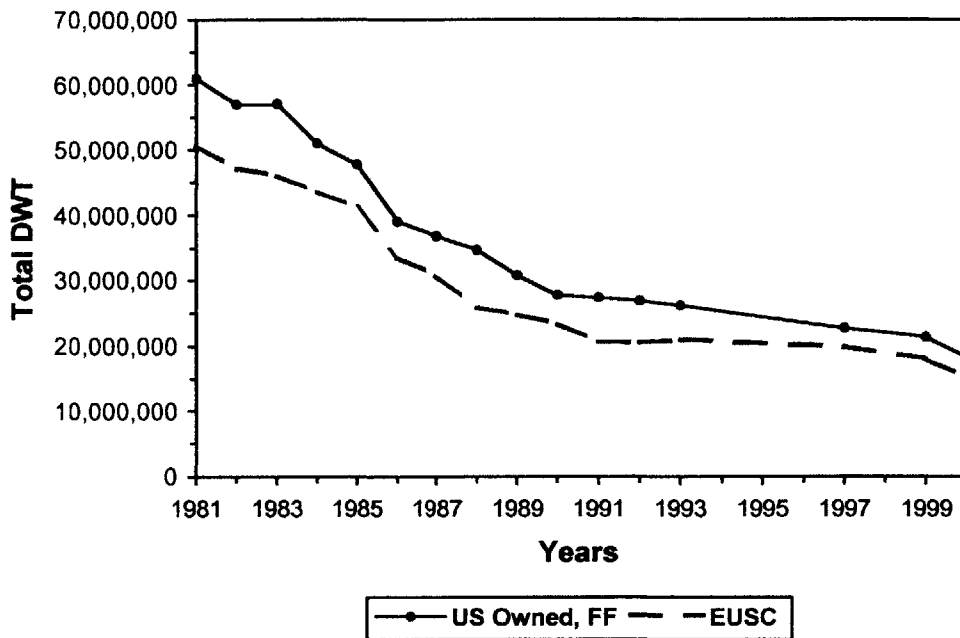
Not surprisingly, the growth and decline of the EUSC fleet over the past three decades is similar to the historical pattern of the overall U.S. owned, foreign flag fleet. In addition, the patterns of an increase in average age and of a decrease in the numbers of participating U.S. companies for the U.S. owned foreign flag fleet also apply to the EUSC fleet. Figure 2.5 and Figure 2.6 provide the trends for this fleet's size for the period 1970 to 2000 and 1981 to 2000, respectively. From Figure 2.5, a reversal of the decline in the number of EUSC vessels is apparent between 1989 and 1997. This upswing corresponds to a similar trend for this period for the U.S. owned, foreign flag fleet. It is possible that the addition of the Marshall Islands to the list of eligible flag states in 1990 was a cause for this upturn as both U.S. owners using ineligible foreign flags and several U.S. flag owners switched to the Marshall Islands registry. The historical pattern for dwt in the U.S. owned, foreign flag fleet is also included in Figure 2.6. A comparison of the sizes of the EUSC and total U.S. owned, foreign flag fleets reveals that the EUSC fleet encompasses the vast majority of the total fleet, which suggests that references to these fleets have increasingly become synonymous. While the number of EUSC and U.S. owned, foreign flag vessels realized an increase between 1989 and 1997, the total dwt of both fleets has maintained its decline. The number of

tankers and total dwt of this portion of the historical EUSC fleets are presented in Figure 2.7. In 2000, the tanker subset comprised 84 percent of the total dwt of the EUSC fleet.



- Sources: 1) Marcus, Henry et. al., "U.S. Owned Merchant Fleet: The Last Wake-Up Call?", M.I.T., 1991.
2) U.S. Owned, Foreign Flag Fleet Database, MARAD, January 1997.
3) U.S. Owned, Foreign Flag Fleet Database, MARAD, July 1999.
4) U.S. Owned, Foreign Flag Fleet Database, MARAD, April 2000.

Figure 2.5, Historical EUSC Fleet - # of Vessels

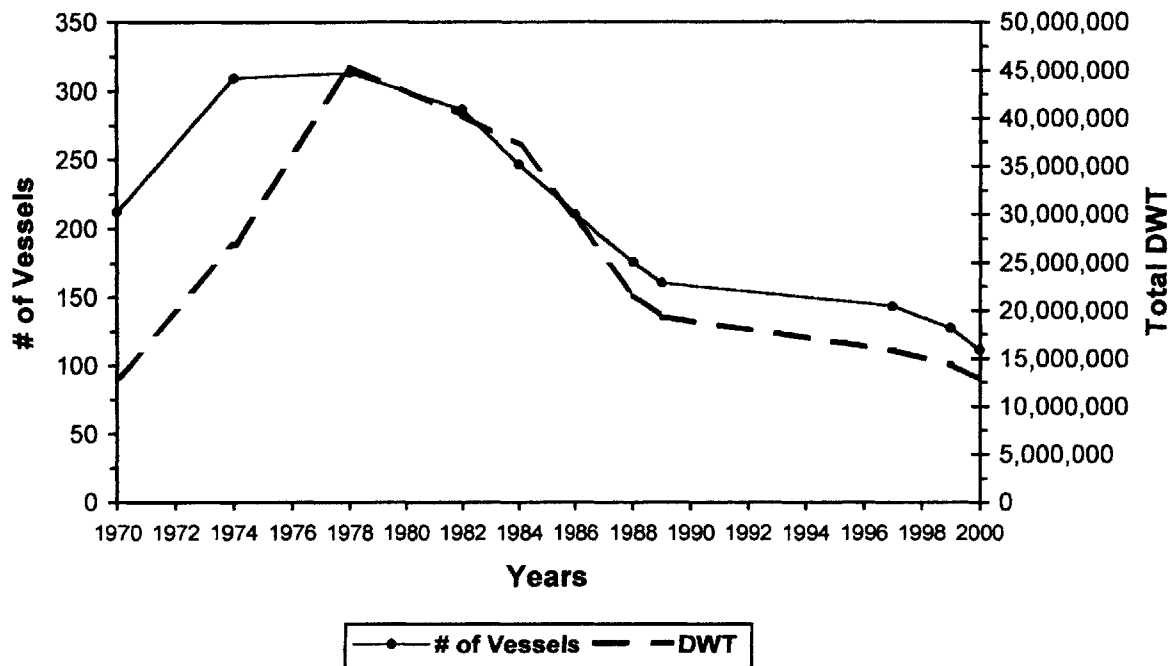


Sources: 1) Waters, Robert C. and Philip C. Koenig, "Decline of the U.S. Owned, Foreign Flag Merchant Fleet." 36th Annual Forum, Transportation Research Forum, 1994.

2) U.S. Owned, Foreign Flag Fleet Database, MARAD, January 1997, July 1999, April 2000.

Figure 2.6, Total DWT of Historical Fleets: U.S. owned, foreign flag and EUSC

On a dwt or carrying capacity basis, the EUSC tanker fleet has experienced a 72 percent decline between 1978 and 2000. For the period 1986 to 2000, the dwt of the tanker portion of the EUSC fleet dropped by 57 percent.



Source: 1) Marcus, Henry et. al., "U.S. Owned Merchant Fleet: The Last Wake-Up Call?", M.I.T., 1991.
 2) U.S. Owned, Foreign Flag Fleet Database, MARAD, January 1997.
 3) U.S. Owned, Foreign Flag Fleet Database, MARAD, July 1999.
 4) U.S. Owned, Foreign Flag Fleet Database, MARAD, April 2000.

Figure 2.7, Historical EUSC Tanker Fleet – # of Vessels & Total DWT

MILITARILY USEFUL EUSC TANKER FLEET

The numbers presented in Figure 2.7 represent the totals for all tanker vessels in the EUSC fleet. In terms of military sealift capabilities, not all of these vessels can be defined as *militarily useful*. The term *militarily useful* has different relevance in regard to dry cargo vessels and bulk liquid carriers. In addition, the Joint Chiefs of Staff has altered the bulk liquid carrier standard over time. For example, the 1990 tanker standard was identified as:

- ✓ Sized between 6,000 and 100,000 dwt
- ✓ Possessing a beam less than 106-feet

- ✓ Capable of handling petroleum product cargos.²

This standard permitted the use of chemical carriers but excluded specialty tankers, such as liquefied natural gas (LNG) carriers.

For the tank vessels of concern in this study, the term refers to bulk liquid carriers, including most types of tankers and integrated tug-barges, that meet the following criteria as defined by the Joint Chiefs of Staff under CJCSI 3110.11B of January 30, 1996:

- ✓ Sized between 2,000 and 100,000 dwt
- ✓ Possess a speed greater than 12 knots.

While chemical carriers are deemed militarily useful, specialized tankers such as liquefied natural gas (LNG) and liquefied petroleum gas (LPG) are still excluded.

Most literature on the subject of the EUSC fleet does not provide information on the historical size for the militarily useful portion of this fleet. As a result of the decline in the total size of the EUSC fleet over recent decades, the remaining militarily useful portion has become an increasing concern for military sealift planners. Two sources provide a limited historical view of the militarily useful tankers within the EUSC fleet. A 1990 Government Accounting Office (GAO) report cited the U.S. Navy as identifying 92 militarily useful tankers to be drawn from the EUSC fleet. As of January 2001, the Maritime Administration's (MARAD's) database of militarily useful tankers within the total EUSC fleet identified 63 vessels. The information from these sources indicates a decline of approximately 32 percent in the number of militarily useful tankers in just over

² U.S. General Accounting Office, Tax Policy: "Uncertain Impact of Repealing the Deferral for Reinvested Shipping Income", (GAO/GGD-90-35), Washington, D.C., 1990.

a decade. Table 2.2 provides the size and composition of the militarily useful portion of the EUSC tanker fleet as contained in the MARAD database for January 1, 2001. The 2001 MARAD database for the militarily useful EUSC fleet is contained in Appendix B. The average age of this portion of the EUSC fleet was 13.4 years in 2001.

<u>Type</u>	<u>#</u>	<u>Characteristics</u>	
		<u>DWT</u>	<u>Barrels</u>
Product Tanker < 80,000 DWT	28	1,281,928	9,595,005
Product Tanker > 80,000 DWT	7	609,250	4,369,410
Crude Carriers	18	1,642,623	11,702,755
Chemical Tankers	10	210,077	2,875,286
Total	63	3,743,878	18,947,451

Source: Maritime Administration, U.S. Department of Transportation, Militarily Useful, EUSC Tanker Fleet Database, January 2001.

Table 2.2, Size and Composition of the Militarily Useful, EUSC Tanker Fleet (2001)

The militarily useful standard for 1996 will be the baseline applied to all EUSC and U.S. flag tankers throughout this study. There are additional standards that can be applied to the tanker fleets. One additional requirement for modern tankers calls for the vessel to be 25 years or less in age. This condition is appropriate as many refineries and prominent oil companies are refusing to deal with tankers over this age. This standard was included by the military planners in the MRS-05 Sealift Tanker Analysis report. Another requirement, that is appropriate in light of the Oil Pollution Act of 1990 and MARPOL's Resolution 13/G, involves the phasing out of non-double hull tankers. These regulations will be discussed further in Chapter 5. As these regulations take effect, there will be few remaining trade routes where non-double hulled tankers will be permitted to trade. Therefore, it seems reasonable to expect that these vessels will be scrapped upon reaching their respective phase out dates. Where these requirements are applied in addition to the JSC militarily useful standard, it will be noted.

OTHER SOURCES OF MILITARY SEALIFT TANKERS

There are three other primary sources of strategic sealift vessels available to U.S. military planners in addition to EUSC vessels. These sources include the Military Sealift Command, the National Defense Reserve Fleet, and the privately owned, U.S. flag merchant fleet. In addition, the MSC can charter foreign owned tankers, but these ships are not considered for planning purposes. The past and present sizes of these fleets are summarized in the following sections.

Military Sealift Command

The Military Sealift Command (MSC) operates a fleet of dry cargo ships and tankers in support of U.S. military forces. As a part of the U.S. Navy, this fleet is active in both peacetime and during military crises. These vessels are directly owned by the U.S. government, borrowed from the Ready Reserve Force (RRF) maintained by MARAD, or obtained through long-term charters of U.S. flag vessels owned by U.S. companies or citizens. According to its official website, MSC currently operates 122 active, non-combatant vessels in sealift, prepositioning, special mission, and naval fleet auxiliary force roles. MSC's operating plans call for a pool of fifteen Common User Tankers comprised of nine RRF and six long term chartered vessels. The six chartered vessels are privately owned, U.S. flag product tankers. For the purposes of this report, the chartered vessels are considered the only MSC vessels that could be committed to supporting the transport of POLs during military emergencies. The RRF tankers are included with the National Defense Reserve Fleet discussed in the next section. It should be noted that these vessels are usually committed to on-going MSC duties, and they may not be

available for sealift purposes. Table 2.3 contains the number, deadweight, and average age of the tanker sealift portion of the MSC fleet.

	#	Characteristics	
		DWT	Average Age
MSC Tanker Sealift Fleet	6	156,315	14.3

Source: 1) Military Sealift Command Website, www.msc.navy.mil, 2001.

2) Clarkson Research Studies, "Clarkson Register CD – 2001 Edition", London, January 2001.

Table 2.3, MSC Tanker Sealift Fleet Characteristics

National Defense Reserve Fleet & Ready Reserve Fleet

During World War II, a vast number of merchant vessels were constructed by the U.S. government to support the movement of supplies, military hardware, and troops from the United States to various locations around the world. Following the conclusion of World War II, the U.S. government possessed an excessive amount of tonnage for its sealift needs. To deal with the issue of these excess vessels, the NDRF was formed under the Merchant Ship Sales Act of 1946. Under this act, a portion of the excess tonnage was to be kept as an inactive fleet maintained by MARAD for use during national emergencies. During the decades following its inception, many vessels within the fleet were sold or scrapped, while naval auxiliaries and other government vessels retired from active service have been added to its total. The total number of vessels within the NDRF between 1946 and 2000 is graphed in Figure 2.8. The fleet currently encompasses 325 vessels of various types according to MARAD's Annual Report for 2000.

In terms of military sealift, the vessel totals for the NDRF are misleading. The vessels of the NDRF are maintained at a time-to-readiness of 60 days.³ Further, as of September 2000, only 143 of these vessels were "being kept for the purposes of emergency

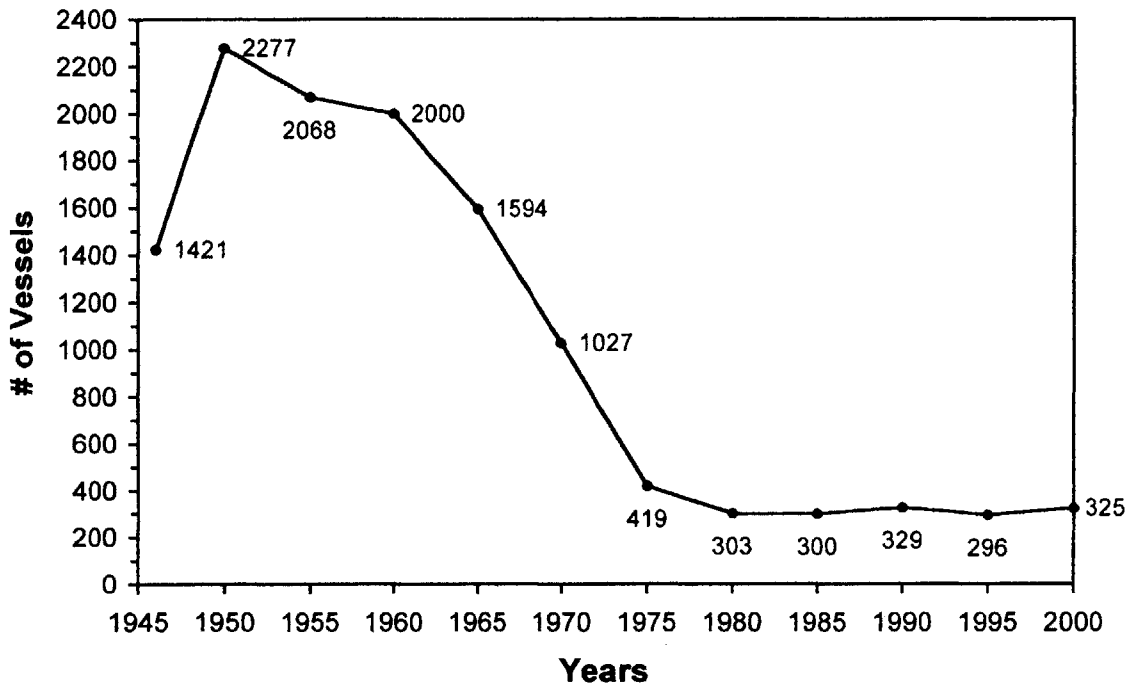
³ Ibid.

activations, future historic display, spare parts, or congressionally legislated sale” according to the MARAD annual report for 2000. The remaining vessels are scheduled for scrapping or are being maintained by MARAD on behalf of other government agencies. For these reasons, the DoD only considers the use of a portion of this fleet in its current military sealift analyses. Within the pool of 143 “retention status” vessels is a subset of the NDRF referred to as the Ready Reserve Force (RRF), which is maintained at between 4 and 20 days of readiness.⁴

The tankers of the RRF serve as a source of additional tonnage for the DoD following the full mobilization of the MSC tanker fleet. In 1990, the RRF included 11 product tankers. The current total size and tonnage of the tanker portion of the RRF is presented in Table 2.4. All vessels within this fleet are product tankers of less than 80,000 dwt. The average age of the tanker portion of the RRF was 41 years in 2002, and the youngest vessel in this fleet was 32 years old. It should be noted that some of these vessels have limited usefulness in terms of interregional military sealift because of their small size and low speed. In addition, MSC occasionally uses RRF vessels for long term duties other than sealift, such as the current use of the Chesapeake and Petersburg in MSC’s Prepositioning Program.⁵

⁴ Maritime Administration, U.S. Department of Transportation, The Annual Report of the Maritime Administration for Fiscal Year 2000, July 2001.

⁵ Military Sealift Command Website, www.msc.navy.mil, 2001.



Source: 1) Maritime Administration, U.S. Department of Transportation, The Annual Report of the Maritime Administration for Fiscal Year 1999, May 2000.
 2) Maritime Administration, U.S. Department of Transportation, The Annual Report of the Maritime Administration for Fiscal Year 2000, July 2001.

Figure 2.8, Historical NDRF - # of Vessels

<u>Vessel Name</u>	<u>DWT</u>	<u>Characteristics</u> <u>Speed (knots)</u>	<u>Age</u>
Alatna	7,300	10.4	46
Chattahoochee	7,300	10.4	46
Chesapeake	14,977	14.0	38
Mission Buenaventura	45,243	14.0	34
Mission Capistrano	45,877	14.0	32
Mount Washington	65,800	15.3	40
Nodaway	5,984	8.5	57
Petersburg	48,993	14.5	39
Potomac	35,330	15.7	38
Total Product Tankers	276,804		Avg. Age = 41

Source: 1) Military Sealift Command Website, www.msc.navy.mil, 2001.
 2) American Bureau of Shipping, "ABS Record 2002", 134th Edition, Port City Press, Baltimore, 2002.

Table 2.4, RRF Sealift Tanker Characteristics

U.S. Flag Merchant Fleet

Private companies and citizens own the majority of the U.S. flag fleet. The U.S. flag fleet can be divided based upon the trading regions served by the vessels. The foreign trade share of the fleet sails between American ports and foreign ports or between foreign ports. The domestic portion of the privately owned, U.S. flag fleet sails between American ports. These trade routes are restricted to certain vessels under the U.S. flag through cabotage laws. These cabotage laws, in conjunction with the Merchant Marine Act of 1920, known as the Jones Act, require that vessels trading between U.S. ports meet the following requirements:

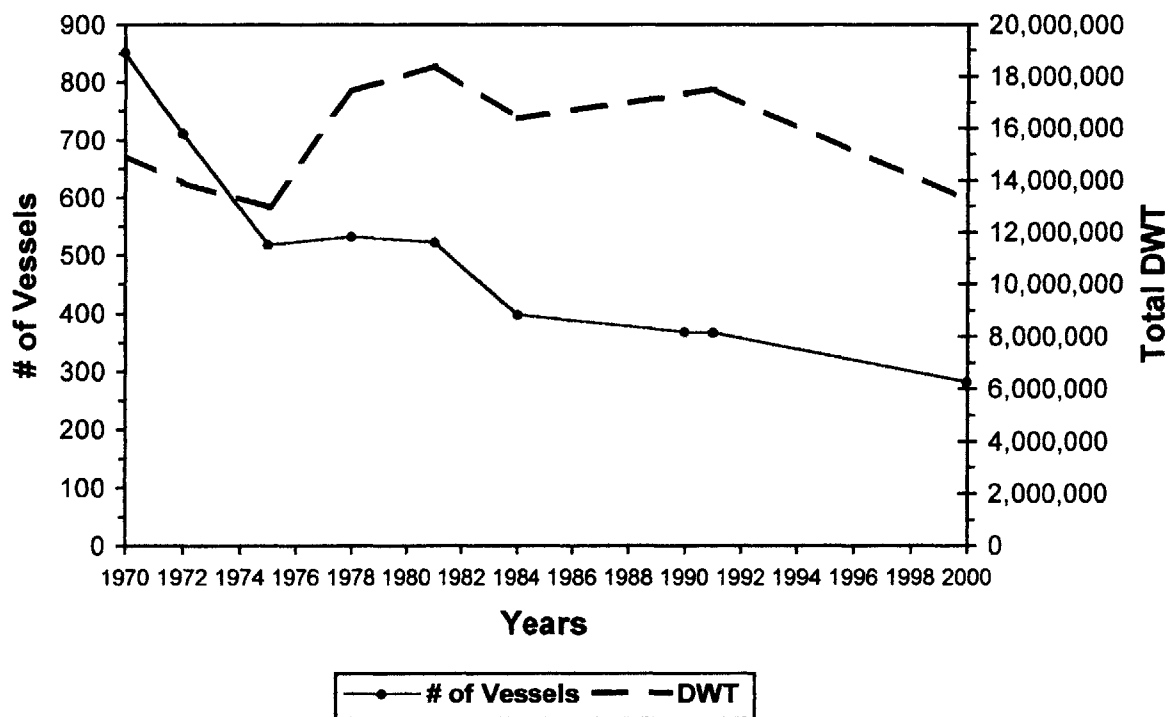
- 1) Vessels must be U.S. flag
- 2) Vessels must be owned by U.S. citizens
- 3) Vessels must be built and repaired in U.S. shipyards
- 4) Vessels must be crewed by U.S. citizens.

For privately owned, U.S. flag vessels operating on foreign trade routes, the competitiveness of the marketplace has resulted in a steady decline of this portion of the fleet over the past three decades. The higher crewing costs, higher insurance rates, more demanding regulations, and higher tax burden of vessels employing U.S. citizens and operating under the U.S. flag, as compared to most foreign flag vessels, has greatly reduced this segment. Many of the companies who owned these vessels have been forced to re-flag or sell their ships as they became uncompetitive in international trade.

A few older, U.S. flag tankers have been retained for the government-sponsored PL480 grain program. These privately owned tankers survive because U.S. flag carriers are guaranteed a portion of this trade. In 2001, there were approximately twelve U.S. flag

ex-tankers operating in this trade. A few of these tankers have not yet reached their non-double hull phase out dates under the requirements of the Oil Pollution Act of 1990 (discussed in Chapter 5), and these are included in the current figures in this report. The remaining PL480 vessels, now only capable of carrying dry bulk cargos, do not appear as tankers in any of the current figures in this document as they can no longer carry oil in U.S. waters.

With the domestic market protected from foreign competition, the cabotage fleet must compete only with land-based alternatives. This fleet has also benefited from the opening of the Alaska North Slope to oil production in the mid 1970's, which resulted in



Note: Totals for 2000 include all self-propelled vessels over 1000 GRT including ITBs and ATBs.

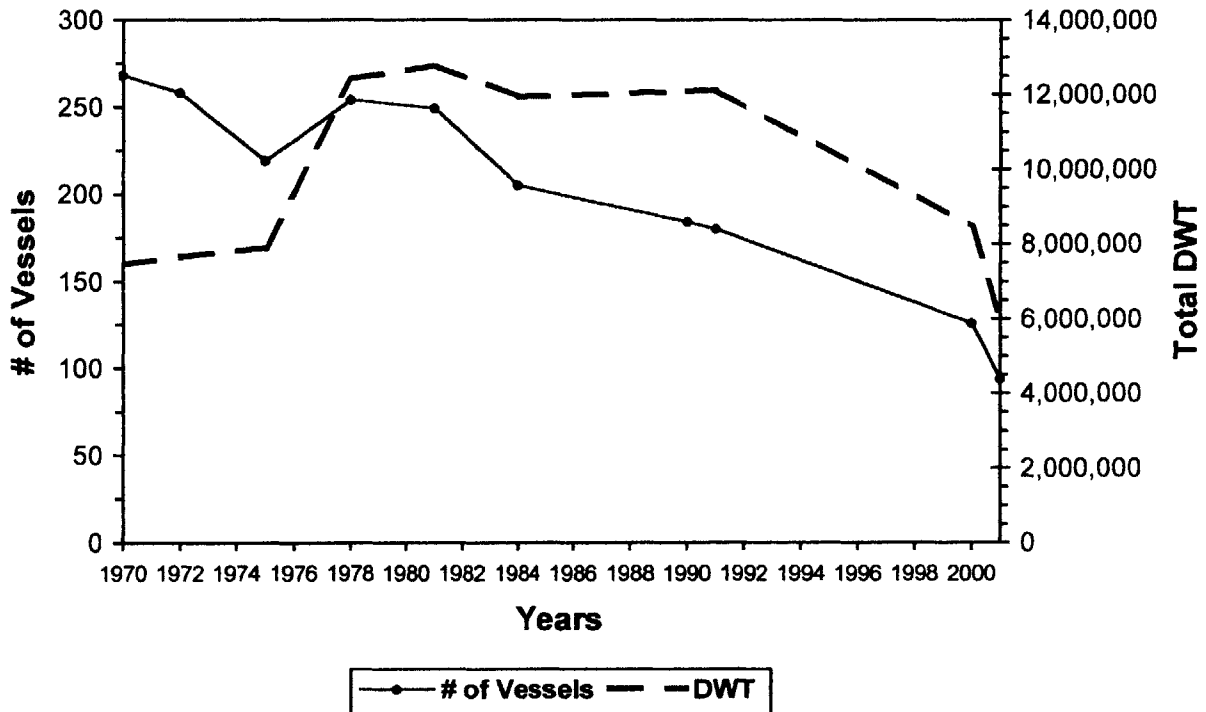
Source: 1) MARAD Annual Reports for 1970, 1972, 1975, 1978, 1981, 1984, 1990, 1991

2) Maritime Administration, "Cargo-Carrying Capacity of U.S. Flag Fleet by Area of Operation for January-June 2000", www.marad.dot.gov, 2001.

Figure 2.9, Historical Privately Owned, U.S. Flag Fleet – # of Vessels & DWT

substantial growth in the domestic crude oil trade. While the total domestic seaborne trade has grown substantially over the past thirty years, the average size and deadweight of vessels in this trade also grew. As a result, the domestic fleet has maintained a relatively stable size in terms of dwt while the number of vessels has declined steadily since 1970. The total number of ships and the deadweight tonnage of the combined domestic and foreign trades since 1970 are shown in Figure 2.9.

The U.S. flag fleet contains a significant number of tankers. The historical size, in terms of number of vessels and of capacity in barrels, of the privately owned, U.S. flag tanker



Note: DWT of tanker fleet for 2001 is estimated by dividing fleet capacity in barrels by 7.1 barrels/DWT.
 Source: 1) MARAD Annual Reports for 1970, 1972, 1975, 1978, 1981, 1984, 1990, 1991

- 2) Maritime Administration, "Cargo-Carrying Capacity of U.S. Flag Fleet by Area of Operation for January-June 2000", www.marad.dot.gov, 2001.
- 3) U.S. Coast Guard, U.S. Department of Transportation, "Status of the Replacement of U.S. Single Hull Tank Vessels with Double Hull Tank Vessels under OPA 90." 2001.

Figure 2.10, Historical Privately Owned, U.S. Flag Tankers – # of Vessels & DWT

fleet is shown in Figure 2.10. The U.S. flag tanker fleet, including integrated tug barges and articulating tug barges, contained a total of 94 tankers in 2001, according to a United States Coast Guard (USCG) report to Congress concerning the U.S. flag tanker fleet. The

modern tanker fleet can be further separated into crude oil tankers, product carriers, chemical carriers, LNG and LPG tankers, and specialty tankers.

Specialty tankers include asphalt, bitumen, and molten sulphur carriers. There are currently no LNG tankers or LPG tankers in the U.S. flag fleet. The most recent breakdown of the U.S. flag tanker fleet is presented in Table 2.5.

<u>Type</u>	<u># of Vessels</u>	<u># of Double Hulls</u>
Crude Carriers	28	4
Product Tankers	55	20
Chemical Tankers	15	3
Specialty Tankers	1	0
LNG & LPG Tankers	0	0
Fleet Total	94	27

- Source: 1) U.S. Coast Guard, U.S. Department of Transportation, "Status of the Replacement of U.S. Single Hull Tank Vessels with Double Hull Tank Vessels under OPA 90." 2001.
 2) Clarkson Research Studies, "Clarkson Register CD – 2001 Edition", London, January 2001.

Table 2.5, Composition of Privately Owned, U.S. Flag Tanker Fleet in 2001

As with the EUSC fleet, not all of these tank vessels are considered militarily useful by the DoD. If the same Joint Chiefs of Staff standard applied to the EUSC tanker fleet is applied to the U.S. flag tanker fleet, there is a substantial reduction in the size of this fleet. In addition, the OPA-90 phase out dates for non-double hulled tankers cited by the report are used to remove individual vessels that can no longer trade in U.S. waters after

June 2001. While these retired tankers could presumably still trade in other areas of the world, the combination of similar MARPOL regulations for other trade routes and of the present inability of U.S. flag tankers to compete in the remaining markets, except in special circumstances, justifies their elimination. After all vessels have been screened for capacity, speed, and phase out requirements, the fleet is reduced from 94 to 62 vessels as of July 1, 2001. Of these militarily useful tank vessels, only 19 are double-hulled. It should be noted that U.S. flag vessels on long term charter to MSC were removed to avoid double counting and that specialty tankers, such as asphalt carriers, have been removed. In addition, integrated and articulating tug-barges were removed because these tank vessels were excluded by the Joint Staff/OSD study approved by the Director of the Joint Staff on January 27, 2001. These tug-barge combinations may have been excluded because either their operating speeds were below 12 knots or they were deemed unsuitable for sustained transoceanic voyages. Although some of the newer tug-barge combinations may be able to travel at 12 knots, it apparently would be unsafe for the tug and barge to disconnect if the weather got too rough on a transoceanic voyage.

The total U.S. flag tanker fleet database for 2001 and the militarily useful, U.S. flag tanker fleet database for July 1, 2001, are included as Appendix C. Both databases utilize the U.S. Coast Guard database of all U.S. flag tank vessels as of February 2001 as a

<u>Type</u>	<u># of Vessels</u>	<u># of Double Hulls</u>
Crude Carriers	16	1
Product Tankers	37	15
Chemical Tankers	9	3
Fleet Total	62	19

Note: Vessels on MSC Charter, asphalt carriers, ITBs, and ATBs excluded.

The JSC 1996 militarily useful standard plus OPA-90 phase out requirements by the end of June, 2001, were applied to the remaining tankers.

Source: 1) U.S. Coast Guard, U.S. Department of Transportation, "Status of the Replacement of U.S. Single Hull Tank Vessels with Double Hull Tank Vessels under OPA 90." 2001.
2) Clarkson Research Studies, "Clarkson Register CD – 2001 Edition", London, January 2001.

Table 2.6, Militarily Useful Privately Owned, U.S. Flag Tanker Fleet in July 2001

baseline source. Table 2.6 summarizes the composition and characteristics of the militarily useful portion of the privately owned, U.S. flag tanker fleet in July 2001.

STRATEGIC SEALIFT SOURCES

The MRS-05 Sealift Tanker Analysis is the most recent tanker sealift study by the Department of Defense (DoD). According to the unclassified portion of the MRS-05 report, the Military Sealift Command's fleet, the Ready Reserve Force, the privately owned U.S. flag fleet, and the EUSC fleet comprise the primary sources of strategic sealift for U.S. military planners. In the event of a protracted conflict, the DoD would presumably call upon these sources of tankers in the following order:

1. Vessels owned or chartered by the Military Sealift Command
2. Vessels chartered from the U.S. market on a voluntary basis (required by law before other government vessels may be activated)⁶
3. Ready Reserve Force vessels from the NDRF
4. Requisitioned U.S. Flag vessels (requisitioning enabled after Presidential declaration of a national emergency)
5. Requisitioned EUSC vessels (requisitioning enabled after Presidential declaration of a national emergency)

While there are a few tankers within the NDRF not used by the RRF, the remaining tankers of the NDRF are presumably excluded as a result of the age of these vessels and the extended period of time required to reactivate these vessels.

⁶ Military Sealift Command Website, www.msc.navy.mil, 2001.

In certain wartime scenarios, the U.S. military could gain access to tankers promised by NATO and/or South Korea.⁷ However, as will be discussed in the later chapters, the most pressing war scenarios in terms of POL sealift are expected to involve regions that do not require participation by our NATO or South Korean allies. In addition, the South Korean's had pledged no tankers as part of their sealift contribution according to the GAO report of 1990. The MSC is also able to charter vessels on the world markets to meet sealift requirements. This method was utilized during the Gulf War after MSC and RRF sources were exhausted. This conflict was of short duration and did not involve an opponent capable of attacking this chartered shipping. This approach may not be feasible in all scenarios, and it is outlined as a last resort by military planners in the unclassified version of the MRS-05 study.

Table 2.7 summarizes the total strategic tanker sealift sources available to U.S. military planners in 1990 and in July 2001. As previously mentioned, the EUSC fleet provided 22 percent of America's controlled tanker sealift capacity in June 1949. The EUSC fleet

	Militarily Useful Tankers		Change
	<u>1990</u>	<u>2001</u>	
Military Sealift Command ^{1,2}	24	6	- 75%
Ready Reserve Fleet ^{1,2}	11	9	- 18%
U.S. Flag Merchant Vessels ^{1,4}	134	62	- 54%
Effective U.S. Control Fleet ^{1,3}	92	63	- 32%
Total	261	140	- 46%

Note: The most recent JCS standard for militarily useful tankers was applied to vessels of the EUSC and U.S. flag fleets for 2001. An earlier standard was applied to these fleets in the 1990 GAO report.
Source: 1) U.S. General Accounting Office, Tax Policy: "Uncertain Impact of Repealing the Deferral for Reinvested Shipping Income", (GAO/GGD-90-35), Washington, D.C., 1990.
2) Military Sealift Command Website, www.msc.navy.mil, 2001.
3) Appendix B for Militarily Useful, EUSC Tanker Fleet

⁷ U.S. General Accounting Office, Tax Policy: "Uncertain Impact of Repealing the Deferral for Reinvested Shipping Income", (GAO/GGD-90-35), Washington, D.C., 1990.

4) Appendix C for Militarily Useful, U.S. Flag Tanker Fleet

Table 2.7, U.S. Strategic Tanker Sealift Sources for 1990 and 2001

provided 35 percent of the DoD's primary tanker sealift vessels in 1990. As of 2001, the EUSC fleet's contribution had reached 45 percent of the total vessels in the primary strategic sealift pool. The total estimated dwt of the primary fleet of militarily useful tankers was 7,261,252 in 2001. See Appendix B, Appendix C, Table 2.3, and Table 2.4. Of this total dwt, the EUSC tanker fleet contribution was 52 percent.

CONCLUSIONS

Several conclusions can be drawn about the primary sources of strategic sealift vessels available to U.S. military planners from the information presented in the previous sections. These conclusions can be summarized as follows:

- 1) The U.S. owned, foreign flag fleet has been declining in terms of total vessels and total dwt since 1976 and 1978, respectively. Between 1986 and 2000, the total carrying capacity of the fleet fell by 53 percent. The increase in the average age of this fleet after 1978 and the decrease in the number of U.S. companies participating in this industry after 1987 are also indicators of a decline within this fleet.
- 2) The size of the EUSC fleet is nearly synonymous with the size of the U.S. owned, foreign flag fleet, and it has followed the latter fleet's historical decline. Tankers comprised 84 percent of the total deadweight of the EUSC fleet in 2000. The EUSC tanker fleet experienced a 57 percent decline in DWT between 1986 and 2000. The number of militarily useful tankers within the EUSC fleet has fallen nearly 32 percent in the past 11 years.

- 3) The Military Sealift Command has exclusive access to just 6 tank vessels to commit to strategic sealift efforts as of 2001. These tankers are key contributors to daily MSC duties and may not be available for tanker sealift needs because of other commitments.
- 4) Many of the vessels of the NDRF are no longer included as strategic sealift assets by the Department of Defense. The tankers in the Ready Reserve Force portion of this fleet, which is still included in U.S. strategic sealift planning, has shrunk 18 percent, to 9 vessels, since 1990, and it has an average age of 40.1 years. Several vessels lack the speed and capacity to serve in a significant interregional sealift role. These vessels may be unavailable at times as they can also be called upon by MSC for extended support roles, such as the Prepositioning Program.
- 5) The privately owned, U.S. flag fleet has witnessed a steady decline in terms of total fleet size and of total tankers over the past 30 years. The militarily useful portion of the U.S. flag tanker fleet has fallen by 54 percent since 1990. This sharp decline is the result of the application of more recent Joint Chief of Staff bulk liquid carrier standards, reflagging, non-double hulled tanker phase out requirements, the scrapping of vessels, and the replacement of product tankers with combination tug-barges.
- 6) Between 1990 and 2001, the total pool of strategic sealift vessels available to the Department of Defense fell from 261 to 140 vessels, or 46 percent. The EUSC fleet's contribution, in terms of number of militarily useful tankers, to this pool has risen from 35 to 45 percent despite its own decline during this

period. In June of 1949, the EUSC militarily useful tankers made up 22 percent of the military's combined tanker sealift resources by dwt. The EUSC militarily useful tankers comprised 52 percent of the total primary tanker sealift resources in terms of dwt for 2001. As such, the remaining EUSC militarily useful tanker fleet provides a larger portion of the dwt to America's strategic tanker sealift resources than it did in June of 1949, which was only a few years after the inception of the U.S. effective controlled concept created during World War II.

- 7) This chapter has relied on MARAD databases and on other sources referencing MARAD databases to establish the historical EUSC fleet. In Chapter 5, we will analyze the accuracy of the most recent databases in more depth when describing the current EUSC militarily useful tanker fleet.

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APPENDIX E

Legislative Scoring Calculations



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