Statement of Horizon Lines, Inc.[1]

Submitted to the

Subcommittee on Oversight

and the

Subcommittee on Select Revenue Measures

Committee on Ways and Means

United States House of Representatives

on

Modernizing the Capital Construction Fund Program to Create U.S. Maritime Industry Jobs

February 1, 2012

Horizon Lines, Inc. commends the Subcommittees for holding their February 1 hearing on maritime tax issues and appreciates the opportunity to provide these comments for the hearing record. Horizon Lines, Inc. is the Nation's leading domestic ocean container shipping and integrated logistics company. Horizon Lines owns or leases 20 U.S.-flag vessels and operates five port terminals. Horizon Lines offers regular service between the Mainland United States and, respectively, Alaska, Hawaii, and Puerto Rico. All vessels operated by Horizon Lines are U.S. citizen crewed.

We (Horizon Lines) take this opportunity to address an important maritime tax issue, the need to improve the Capital Construction Fund (CCF) program,

Action to remove regulatory obstacles, not required by statute, and modernize the CCF program can help create jobs and economic growth, benefitting vessel operators, mariners, and shipyards. In particular, as explained below, an administrative practice that precludes the use of CCF funds for lease payments, contrary to report language of the Ways and Means Committee, should be stopped, allowing CCF funds to be used for acquisition of vessels through lease, in accord with mainstream modern financial practice.

Overview -- Allow Capital Construction Funds to Be Used For Lease Payments

One of the very few tools available to modernize the U.S.-flag vessel fleet is the Capital Construction Fund. A Capital Construction Fund is a tax advantaged account that, to simplify, allows the owner or operator of a U.S.-flag vessel to deposit funds into the account, deferring taxes on the funds deposited. Funds can accumulate in the account to facilitate vessel acquisition. These are a company's own funds, not taxpayer funds, so no appropriation is required. The CCF program is administered by the Maritime Administration, USDOT, with tax aspects administered jointly with the Treasury Department (IRS).

The CCF program must be modernized to allow funds in a CCF to be used for lease payments, not just mortgage (purchase) payments. The current restrictive approach needlessly limits the ability of vessel operators to make the most effective financial decisions when considering acquiring U.S. built vessels. Taking a more modern, flexible approach could facilitate some vessel acquisitions, has the potential to create American jobs in shipbuilding and other benefits, and should be put in place promptly.

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Shipbuilding generates jobs and other benefits.

> Building a new large oceangoing vessel can support 300 or more direct jobs for 1-2 years and up to 4 times as many jobs in supplier industries.
>
> After construction, shipboard jobs are generated, which are good for the economy and help maintain a pool of mariners to aid in the national defense.
>
> New vessels are environmentally superior to the vessels they replace both in terms of fuel efficiency and other systems.
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> Ship construction helps maintain the nation's industrial base, including but not limited to the defense industrial base.

Accordingly, policymakers should aggressively pursue all reasonable opportunities to facilitate shipbuilding in U.S. shipyards, including through enabling CCF participants to make qualified withdrawals from CCFs for lease payments on vessels.

Today, it appears that more ship acquisition transactions are through lease than purchase. As to major containership operators, recent data shows that a majority of vessels and vessel capacity is leased (Journal of Commerce, September 12, 2011 at 41). So, the program as administered has become increasingly non-responsive to market conditions.

The statute, however, refers to vessel "acquisition", not purchase. So, agency practice precluding the use of lease payments from a CCF is needlessly inflexible. There is also legislative history expressly stating that lease payments should be an allowable use of CCF funds.

USDOT has said that a lease does not have a basis and that qualified withdrawals from a CCF can only be made for an asset with a basis. Yet, there are a number of ways that the agencies can reconcile basis provisions with allowing lease payments from a CCF. For example, there is the opportunity for the lessor and lessee to coordinate as to a CCF so that, for example, if the lessor does not have a CCF, the lessee could benefit from the CCF program and the lessor's basis in the asset can be used to meet applicable CCF requirements. The law already allows coordination between a vessel owner (lessor) and a lessee as to making CCF deposits and it is inconsistent to not allow it as to CCF withdrawals.

So, the Executive Branch has the authority to allow qualified CCF withdrawals for certain lease payments and it should implement that authority promptly. The Subcommittees' encouragement to MARAD to allow this flexibility would be a welcome step supporting job creation. Alternately, legislation can clarify that there is such authority.

More Detailed Discussion

The Merchant Marine Act, 1936, as modified in 1970, established the CCF program, under which owners or operators of vessels are permitted to establish tax-deferred CCFs to be used in the "acquisition" or construction of vessels.[2] The statutory provisions include conditions regarding transactions that may be financed through a CCF and the tax consequences of contributions to, and withdrawals from, CCFs. In the Tax Reform Act of 1986, Congress added section 7518 to the Internal Revenue Code "to coordinate

[2] 46 U.S.C. §§ 53501-53517.

the application of the Internal Revenue Code of 1986 with the capital construction program under the Merchant Marine Act."[3]

Traditionally, vessel owners and operators have used CCFs in connection with *purchases* of vessels – i.e., for the acquisition of *title* to vessels. However, nothing in the statutory provisions in either the Merchant Marine Act, as amended, or the Internal Revenue Code limits the reach of the program to "purchases"; neither the term "purchase" nor the term "title" appears in the language. Rather, the operative term in the statutory provisions is "acquisition." That term is best construed, in context, to apply to the lease of vessels, as well as to the purchase of vessels, where the nature of the lease makes it treated as an acquisition.

First, the statutory provisions explicitly authorize lessees of vessels to establish CCFs; it seems incongruous for MARAD not to authorize lessees and other vessel operators to make withdrawals from CCFs for the purpose of leasing vessels. Second, the application of the CCF program to the acquisition of vessels by lease is strongly supported by the legislative history of the program.

Finally, in today's economy, leasing is very widely utilized. A recent report on leading containership operators found that 53% of their capacity, and nearly 60% of their container vessels, are leased and not owned.[4] Clearly, the marketplace finds leasing to be an effective and efficient means of financing the acquisition of vessels.

In short, action authorizing the use of CCFs for the acquisition of vessels by lease would be consistent with the statutory language and legislative history of the program and with current marketplace practices. Action enabling CCF funds to be used for lease payments could have the effect of spurring the construction of new ships in the United States and creating or preserving thousands of jobs.

Statutory Analysis

The Merchant Marine Act, 1936, as amended, provides that a United States citizen entity "*owning or leasing* an eligible vessel may make an agreement with the Secretary under this chapter to establish a capital construction fund for the vessel" (emphasis added).[5] The Act then provides that the purpose of the agreement "shall be to provide *replacement* vessels, additional vessels, or reconstructed vessels" (emphasis added).[6] It is quite straightforward that a "replacement" for a leased vessel could be a leased vessel. The Act also includes provisions for coordinating CCF contributions between lessees and owners with respect to the same vessel.[7] In brief, the Merchant Marine Act fully and explicitly anticipates the participation of lessees in the CCF program.

The Act authorizes CCF participants to make "qualified withdrawals" from CCFs for the "acquisition," construction, or reconstruction of vessels or for the payment of principal of indebtedness incurred in such acquisition, construction, or reconstruction.[8] This provision does not specify the manner in which the CCF participant must acquire the vessels. The provision does not require the acquisition of title; nor does it require the vessel to be purchased.

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[3] § 261(a), Pub. L. No. 99-514. The language in section 7518 of the Internal Revenue Code tracks that of its counterpart in the Merchant Marine Act, as amended, with minor wording variations. For simplicity, this statement generally will refer only to the provisions in the Merchant Marine Act, as amended.
[4] *Alphaliner's Top 50 Global Container Fleet Operators*, reprinted in Journal of Commerce (Sept.12, 2011) at 41.
[5] 46 U.S.C. § 53503(a).
[6] 46 U.S.C. § 53503(b).
[7] 46 U.S.C. § 53505. Among other amounts, a lessee is permitted to contribute an amount equal to the tax depreciation on the agreement vessel. However, that amount is reduced by the amount of depreciation which the agreement requires or permits the owner to contribute.
[8] 46 U.S.C. § 53509.

The term "acquisition" is far broader than the term "purchase." For example, the standard dictionary definition of the verb "to acquire" is to "gain possession of."[9] The term is not a synonym for "purchase;" one can gain the possession of property by purchase, by lease, or by a number of other methods. Similarly, in the Internal Revenue Code, the term "acquisition" is used in dozens or hundreds of places as a catch-all.[10] By contrast, the Internal Revenue Code uses the term "purchase" -- again in many places -- to refer specifically to the narrower transaction where ownership is transferred for value.[11]

The difference in reach of the terms "acquisition" and "purchase" for tax purposes is illustrated clearly by section 1.263(a)-4(c) of the Treasury Regulations. That provision requires taxpayers to capitalize the cost of acquiring certain acquired intangible assets, but only if the assets are "acquired from another party in a purchase or similar transaction." In other words, it is not enough that the taxpayer obtain possession of the intangible assets -- through a lease or loan of the assets, for example; rather, the taxpayer must have purchased those assets. The provision demonstrates that the term "acquisition" can sweep in a broad array of transactions through which the possession of assets can change.[12] See also section 45L(b)(4) of the Internal Revenue Code, which clarifies that, for purposes of the new energy efficient home credit, "the term 'acquire' includes purchase." In other words, the drafters understood that a taxpayer could acquire a home in a variety of ways -- one of which was through a purchase.

In title 46 as well, Congress has sometimes chosen to refer to a "purchase" rather than to an "acquisition", further demonstrating that the terms are not synonymous. See 46 U.S.C. section 53706.

In short, the term "acquisition" can be sensibly read to be far broader than the acquisition of ownership or a standard purchase. Given the explicit statutory authorization for the establishment of CCFs by lessees, and given that the statute explicitly states that one of its purposes is to "provide replacement vessels" for eligible entities owning or leasing eligible vessels, and in light of the legislative history discussed below, MARAD would be taking an obvious and short step in reaching the conclusion that the statutory language permits withdrawals from CCFs for certain lease payments, as well as for purchases.

There appears to be nothing in the statute to preclude interpretation of the term "acquisition" in the CCF context as including acquisition through lease. In fact, the opposite conclusion would appear to frustrate the intent of the legislation. Additionally, as recited above, the Merchant Marine Act permits withdrawals from CCFs for the purpose of paying off indebtedness incurred in the acquisition of vessels. It is hard to imagine that Congress would have intended for debt payments (i.e., mortgage payments) to qualify but not lease payments. In the modern commercial world, there is simply little difference between the two payments; leases are a method of finance, as are loans. If loan payments are permissible, lease payments should be permissible as well.

Legislative History

The legislative history makes it even clearer that the drafters of the CCF program fully intended to permit CCF participants to make qualified withdrawals for the lease of vessels. As described above, the tax provisions for the CCF program were re-codified in the Internal Revenue Code in the Tax Reform Act of 1986. The General Explanation of the Tax Reform Act of 1986, prepared by the staff of the Joint Committee on Taxation, describes Congressional intent as follows:

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[9] See, e.g., The American Heritage Dictionary of the English Language (1975). See also, Black's Law Dictionary (1996) (defines "acquisition" as "[t]he act of gaining possession or control of something").

[10] See, e.g., 26 U.S.C. § 42(e)(2)(B); 26 U.S.C. § 47(c)(2)(B)(ii).

[11] 26 U.S.C. § 36(a); 26 U.S.C. § 45L(b)(4) (clarifies that the term "acquire" includes purchase).

[12] Other examples of the distinction are found in the wash sale rules of section 1091, the small business expensing rules of section 179, and the accelerated cost recovery rules for cellulosic biofuels plant property and recycling property of section 168.

"… the phrase 'acquisition, construction, or reconstruction of a 'qualified vessel' is to be interpreted as including acquisition through either purchase or lease of an agreement vessel for a period of five years or more. This interpretation parallels the structure of: (1) the scope of eligibility to establish a capital construction fund under section 607(a) of the Merchant Marine Act, 1936 (which permits deposits into a CCF fund by either an owner/lessor or the lessee of an eligible vessel, of both, subject to certain limitations), and (2) the scope of qualified withdrawals for vessel acquisitions through either purchase (in the form of a down payment toward the purchase price) or payment of long-term indebtedness on an agreement vessel. This interpretation is also consistent with current industry acquisition practices reflecting a long-term trend toward vessel acquisition through lease rather than purchase." [13]

That language originated in the following statement in the report of the House Ways and Means Committee on the 1986 act:

"For purposes of the definition of the term 'qualified withdrawals,' under new section 7518(e) (sec. 607(f) of the Merchant Marine Act, 1936), the committee intends the phrase, 'acquisition, construction, or reconstruction of a qualified vessel' to be interpreted as including acquisition through either purchase or lease of an agreement vessel for a period of five years or more." [14]

Moreover, when the Congress revised the Capital Construction Fund provision in the Merchant Marine Act, 1970, the committees of jurisdiction clearly provided for flexibility as to the form of a vessel acquisition with CCF funds. The report of the Senate Committee on Commerce accompanying the 1970 legislation stated:

"Your committee expects that care will be taken to permit use of legitimate financing techniques to further the purposes of the capital construction funds maintained under this section. For example, the term 'acquisition' should be interpreted in a broad sense to include legitimate financing techniques that are the substantial equivalents of acquisitions in terms of furthering the purposes of this section." [15]

In that same year, the report of the House Committee on Merchant Marine and Fisheries accompanying the legislation stated:

"Your committee expects that care will be taken to permit use of legitimate financing techniques to further the purposes of the capital construction funds maintained under this section." [16]

In sum, the legislative history from both 1970 and 1986 reflects a general Congressional intent that the term "acquisition" be construed broadly to include leases, in accordance with the CCF program's goal of promoting vessel construction in the United States.

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[13] STAFF OF JOINT COMM. ON TAXATION, 99TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 (Comm. Print 1987).
[14] H. REP. NO. 99-426 (1986) (Committee on Ways and Means). The Conference Committee on the 1986 legislation adopted the Ways and Means approach.
[15] S. REP. NO. 91-469 (1970) (Committee on Commerce), reprinted in Pike and Fischer, Shipping Regulation at 52:640.
[16] H. REP. NO. 91-1073 (Committee on Merchant Marine and Fisheries) at 53 (1970).

<u>The Tax Basis Rule Is Not a Barrier to Authorizing Qualified Withdrawals for Lease Payments</u>

Against the flexibility inherent in the statutory wording and the legislative history, USDOT has noted the tax basis rule. The CCF tax rules in the Merchant Marine Act and the Internal Revenue Code provide for the basis in a vessel acquired with qualified withdrawals from a CCF to be reduced in the amount of the withdrawals. That reduction in basis, which results in correspondingly reduced depreciation deductions, serves the purpose of recapturing the tax saving resulting from the original contributions to the CCF.

To treat the tax basis rule as a bar to use of CCF funds for lease payments, however, is to conclude that Congress, in passing a provision described clearly in the legislative history as authorizing qualified withdrawals for lease payments, meant that one subsection of the same provision would cancel out the authorization provided by another subsection. The subsection defining "acquisition", 26 U.S.C. § 7518(e), was structured and intended to authorize CCF withdrawals for lease payments (see discussion above). To conclude that the tax basis rule in the adjacent subsection -- 26 U.S.C. § 7518(f) -- precludes qualified withdrawals for lease payments is needlessly inflexible. To construe the statutory scheme as a whole and give effect to all the provisions, the Executive Branch must take a more flexible view of 46 U.S.C. § 53510. There are a number of ways this can be done.

<u>Coordination with Owner Contemplated By Statute</u>. The statute specifically contemplates contributions to CCFs by lessees for replacement vessels. The statute further explicitly precludes a lessee from contributing funds to a CCF with respect to a replacement vessel to the extent the lessor has contributed funds to a CCF with respect to the same vessel. In other words, the statute requires coordination between the lessor and the lessee.

To deal with the basis issue, MARAD and the IRS similarly could require the lessor of a vessel to agree to a basis reduction as a condition of the use of CCF funds by the lessee (in cases of leases that were not treated as conditional sales). There appears to be no statutory obstacle to such an agreement; the statute refers to reducing the basis of the vessel, not to reducing the basis of vessels held by the acquirer/lessee. A coordinated approach between owner and lessee as to basis would follow the approach used as to contributions, protect against providing double benefits, and not run afoul of 46 U.S.C. § 53510 or its title 26 equivalent.

It would be consistent with both the CCF statute and the promotional objectives of the Merchant Marine Act (of which the CCF program is a part), to provide a CCF agreement holder the flexibility to make lease payments from a CCF pursuant to such a coordinated approach (in cases of leases that were not treated as conditional sales). Further, to ensure that such an approach is limited to circumstances where a major commitment is made to a vessel, MARAD could limit such flexibility to cases involving longer term leases, such as those of at least 10 years.

<u>Denial of deduction for lease payments</u>. Alternatively, in the case of withdrawals from CCFs for purpose of making lease payments (in cases of leases that were not treated as conditional sales), MARAD (and IRS) could simply recognize that the functional equivalent of a basis reduction would be denial of the deduction for the lease payment. MARAD could require such a deduction disallowance as part of an arrangement to allow CCF withdrawals for lease payments.

Such a provision would give effect to the legislative history supporting flexibility in the form of acquisition, while avoiding any expansion of the CCF tax benefit. While 46 U.S.C. § 53510 sets forth a number of rules, that provision does not address every possible fact pattern. To administratively fill the gap with an equivalent tax treatment for leases is more consistent with the flexibility in the definition of "acquisition" -- particularly as explained in the legislative history -- than to deny the flexibility in that definition and crystal clear legislative history.

Substance Over Form. Reliance on the tax basis rule to deny the use of CCF funds for lease payments is also unpersuasive as to certain transactions styled as leases. The IRS has long held that a transaction, even if styled as a lease, can in substance be a sale and treated as such for tax purposes. This results from the straightforward approach of placing substance over form. In such cases the IRS will treat the "lease" payments as payments towards principal and interest and find that the "lessee" has a depreciable interest -- in other words, a basis -- in the asset in question. IRS has long laid out general principles for determining whether a transaction styled as a lease is really a lease or really a conditional sale, with the "lessee" having a basis in the property. See Rev. Rul. 55-540, 1955 C.B.-2 39; and Rev. Proc. 2001-28, 2001-1 C.B. 1156. At least one reported case of this nature involved a vessel "lease" which was found to be in the nature of a sale -- with the result that the "lessee" was found to have a depreciable interest in the vessel. See Rev. Rul. 72-543, 1972-2 C.B. 87.

If a transaction, though styled as a lease, is considered a conditional sale for tax purposes, with the "lessee" having a basis in the property, there seems to be no reason for MARAD to take a different approach as to the CCF program and be more restrictive than the IRS. In such cases, for MARAD not to allow an agreement holder the flexibility to use the CCF for payments towards the "lease" would be contrary to the promotional purposes of the Merchant Marine Act, not to mention the legislative history and other aspects of the CCF statute indicating that Congress intended to allow withdrawals from a CCF for lease payments. MARAD should not take an approach to the tax basis rule that is more restrictive than has been taken by the IRS under the above noted rulings.

Policy Support. Moreover, there are policy reasons for the agency to permit qualified withdrawals for certain lease payments. USDOT/MARAD has suggested that lease payments should not be a permissible use of CCF funds by reasoning that vessel owners will have CCFs and lessees will benefit as the owner passes through CCF benefits via the lease terms.

Yet there cannot be certainty that an owner's CCF benefits will be passed through in the lease terms. Nor can MARAD assume that prospective owners of leased vessels will always have or create CCFs (and CCF benefits to pass through). Financial institutions, for example, could be reluctant to subject themselves to regulation by MARAD (e.g., citizenship affidavits required for CCF agreement holders, 46 CFR §390.2(a)(2)(i)). This, combined with the increasing use of leasing as a means of acquiring vessels, suggests that the exclusion of lease payments from uses of CCF funds makes the CCF program less relevant than it should be to the acquisition of vessels built in this country. An approach that precludes the lessee from CCF benefits when the lessor does not participate in a CCF fails to follow through on policy objectives of strengthening the U.S.-flag fleet.

CCF Leasing Should Be Effected Promptly

The time has come to allow certain lease payments as a qualified withdrawal from a CCF. As explained above, this can be done promptly by the Executive Branch because it is warranted by analysis of the statute, the legislative history, the purpose of the CCF program (to facilitate shipbuilding in the United States), and the widespread use of leasing in the marketplace.

There are undoubtedly a number of formulations that the Executive Branch could use in making the determination to allow certain lease payments as a qualified withdrawal from a CCF. The guidance or other action could establish that an "acquisition" includes a lease of a vessel by means of bareboat charter if the Secretary determines that the lease period is for at least 10 years or for the remaining useful life of the vessel, whichever is less. The 10 year test would provide the benefit of a bright line (at least in some cases), to facilitate planning by vessel operators, and is based on a vessel's depreciable life.[17]

Conclusion – CCF Leasing

The Subcommittees should encourage the Executive Branch to promptly allow lease payments to be made from a CCF. This more flexible approach would modernize the CCF program and help ensure its continued relevance in an era that features extensive use of leasing. Alternatively, legislation should clarify the authority to allow CCF leasing.

CCF for Maintenance, Repairs and Modifications.

Before closing, we also note our support for legislation that would enable CCFs to be used for maintenance, repair and modifications of U.S.-flag vessels. A vessel is a long-term asset and good maintenance is important to the quality of the U.S.-flag fleet and to maintaining this country's shipyard base, which is in competition with shipyards overseas.

We have seen legislation in past years that would provide for maintenance and repair costs from a CCF. We suggest that legislation also provide for CCF funds to be used for vessel modifications that are not as extensive as a "reconstruction" of a vessel. Costs toward the reconstruction of a vessel are already CCF eligible. It would be awkward for vessel planning by an operator if a statutory scheme allowed CCF funds to be used for very major work (reconstruction), or mere repair or maintenance work, but not small vessel improvements that are often undertaken in conjunction with repair and maintenance. Such a gap should be closed by also allowing CCF funds to be used for modifications that are less extensive than reconstruction – otherwise the scheme would miss a chance to encourage the use of U.S. shipyards for even for maintenance work, as that work not infrequently is combined with work on small improvements.

Conclusion

Improvements to the CCF program, particularly to allow CCF funds to be used for lease payments are overdue and can facilitate job creation and a stronger U.S.-flag fleet. Horizon Lines thanks the Subcommittee for its consideration and welcomes its support in achieving elimination of the barriers to job creation that we have described in this statement.

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[17] The Instructions for IRS Form 4562, page 10, list a vessel as 10 year property for depreciation. A bareboat charter condition, by requiring operating control of the vessel in the lessee, would further reinforce that the lease would be in the nature of an acquisition, as a bareboat charterer exercises possession and control of the vessel.