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Report to the Chairman, Subcommittee on Seapower and Strategic and Critical Materials, House Committee on Armed Services, House of Representatives

March 1990

TAX POLICY

Uncertain Impact of Repealing the Deferral for Reinvested Shipping Income

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Washington, D.C. 20548

General Government Division

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March 26, 1990

The Honorable Charles E. Bennett
Chairman, Subcommittee on Seapower
and Strategic and Critical Materials
Committee on Armed Services
House of Representatives

Dear Mr. Chairman:

This report responds to your request that we study the effects of repealing the tax deferral for foreign-earned shipping income. Until this deferral was repealed by the Tax Reform Act of 1986, subpart F of the Internal Revenue Code allowed shipping income, if earned outside the United States and reinvested in shipping assets, to be excluded from income subject to taxation in the year earned. In your request, you asked about the additional tax revenues generated by the deferral's repeal and expressed particular concern about the effect of the repeal on the availability of merchant ships that the military plans to use for strategic sealift in national emergencies.

Background

U.S. corporations often choose to register merchant vessels in other countries. Liberia and Panama, where most of these ships are flagged, have less restrictive registration and operating requirements and impose registration fees in lieu of taxes. As a result, operating costs, and particularly labor costs, are significantly less for a foreign flag vessel than for one flagged in the United States. In January 1989, 43 U.S. corporations owned 328 oceangoing merchant ships registered under foreign flags.

Before 1975, the United States taxed foreign-earned shipping income only when it was repatriated as dividends to the U.S. parent company, rather than when it was earned. As a result of the Tax Reduction Act of 1975, shipping income earned by a U.S.-controlled foreign corporation became subject to tax in the year earned but only to the extent that the income exceeded reinvestments in shipping assets. Congress did not believe foreign-earned shipping income should be allowed to accumulate tax-free, yet it wanted to maintain U.S. investment in foreign shipping assets.

The 1975 act established the deferral, technically termed the "exclusion for reinvested shipping income," which allowed foreign-earned shipping income to be excluded from current taxable income if reinvested in qualified shipping assets. If the value of the qualified shipping asset account

declined—that is, depreciation exceeded new investment or assets were sold—then the previously deferred income became taxable. (The "deferral" is also known as an "exclusion" because, while the income was excluded from current taxation, it was deferred only until the assets' value declined.)

With the Tax Reform Act of 1986, Congress repealed this deferral because it did not consider promoting U.S. investment in foreign flag shipping to be in the United States' interest, and because it believed that U.S. shareholders might be able to escape tax on foreign-earned shipping income indefinitely. The Department of the Treasury's Office of Tax Analysis estimated the revenue yield from repealing the deferral would be between $160 and $240 million over 5 years.

Results in Brief

Since the passage of the Tax Reform Act of 1986, a higher percentage of foreign-based shipping income is subject to immediate taxation. We believe the repeal of the deferral for reinvested shipping income is largely responsible for this increase. From the available tax data, we could not determine the actual amount of tax revenue generated from foreign-earned shipping income because the parent corporation pays tax on its total operations. However, even though a larger percentage of the income is subject to taxation, tax revenue may have fallen in 1987 compared with 1984 due to lower corporate tax rates and a decline in reported foreign-earned shipping profits.

The impact of the repeal on owners' decisions to reinvest in ships is unclear. As Department of Defense (DOD), Maritime Administration (MarAd), and industry representatives told us, the tax changes may ultimately accelerate the decline in the number of U.S.-owned foreign flag ships and, in turn, adversely affect the military's plans to use some of these ships in wartime. But other factors, such as the small average tax burden relative to other ship operating costs and companies' ability to find other ways to offset taxable income, suggest the changes will not necessarily lead to significantly fewer ships. We found no evidence that the deferral's repeal has affected the number of U.S.-owned foreign flag ships to date.

In response to your interest in this issue, we reviewed the military's plans for these ships and found that it plans to use 124 of the 328 U.S.-owned oceangoing foreign flag ships for wartime sealift. However, there are unresolved issues about the availability of these ships to the United States in wartime. U.S. requisitioning authority—its legal right to

demand civilian vessels for military use—may not extend to ships owned by foreign subsidiaries of U.S. corporations, and the flag state, rather than the United States, may have the right to control these ships.

Proportion of Earnings Declared as Subpart F Income Increased but Tax Revenues May Not Have

On the basis of our analysis of 1984 and 1987 controlled foreign corporation tax returns, we determined that a higher percentage of foreign-earned shipping income was subject to U.S. corporate tax after the Tax Reform Act of 1986. Overall, about 21 percent of foreign shipping subsidiaries' earnings and profits was taxable in 1984 while 70 percent was taxable in 1987 after the repeal. Although several other exclusions were also restricted in 1986, Treasury and industry officials believe this increase was largely the result of repealing the shipping deferral. Furthermore, while the repeal exposed a higher percentage of income to taxation, the combination of a lower corporate tax rate effective July 1, 1987; a decline in income reported for tax purposes by these foreign shipping subsidiaries; and the use of other exclusions may have 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.

Moreover, repeal of the reinvestment deferral did not affect the companies equally because not all companies used the deferral when it was available. Even after the repeal, half of the companies excluded all their profits from taxable subpart F income—the taxable portion of the U.S.-controlled foreign corporation's profits. In 1984, at least one-fourth of the shipping companies reporting a profit did not use the reinvestment deferral—either because they did not reinvest in shipping or because they had other ways to exclude income for tax purposes. In 1987 (the only year after the repeal for which tax data were available), fewer than half of the foreign shipping subsidiaries reporting a profit showed taxable subpart F income equal to their earnings and profits. The remaining half apparently had other exclusions and declared none of their 1987 earnings and profits as taxable subpart F income. Internal Revenue Service (IRS) data, however, are not sufficient to determine which exclusions these companies used to reduce or eliminate taxable subpart F income in 1987.

Impact on the Number of Ships Available Is Unknown

Industry representatives argue that the deferral's repeal will result in fewer U.S.-owned foreign flag vessels in the future as shipowners respond to what they project to be an increased tax burden. In order to reduce or eliminate foreign-earned income taxable under subpart F provisions, the companies may choose to charter, rather than own, ships. Alternatively, U.S. corporations could change their ownership structure by owning only a minority share of the ships with foreign partners so they no longer meet the tax code definition for U.S. ownership. In this case, the shipping income would not be subject to U.S. taxation until it is repatriated—that is, distributed as dividends to the U.S. shareholders or parent corporation.

We could not establish a link between the tax changes and a decline in the number of ships to date. The number of U.S.-owned foreign flag ships had already been declining before the deferral was repealed, largely reflecting worldwide scrapping of excess oil tankers in the 1980s. The decline in ships after 1986 was not significantly different in magnitude from the decline that occurred before 1986.

On the basis of our analysis of the 1987 tax returns, we estimated that the tax revenue generated from foreign-earned shipping income was, at most, $47 million for that year. This amount is relatively small compared with ship operating and construction costs. We calculated that the tax burden for a new 100,000 ton tanker would be about 2.3 percent of its annual operating cost and about 5 percent of its construction cost over its 20-year life.

More importantly, although the deferral's repeal tended to increase the amount of taxable subpart F income, it may not have resulted in a net increase in tax revenue. This is because the Tax Reform Act also reduced the corporate tax rate from 46 percent to 34 percent, and shipping profits reported for tax purposes fell in 1987 compared with 1984.

U.S. Authority to Requisition U.S.-Owned Foreign Flag Ships Is Uncertain

The military plans to use 124 of the 328 U.S.-owned oceangoing foreign flag ships to transport military equipment and supplies in war. These 124 ships are from U.S.-owned ships registered in Liberia, Panama, Honduras, and the Bahamas and represent only 10 percent of the total number of merchant ships that the military plans to use for wartime sealift. (The military's plans were not affected by the November 1989 ban on Panamanian flag vessels from U.S. ports, which was rescinded after the invasion of Panama and before it was to take effect in January 1990.) The 92 militarily useful tanker ships, which transport refined or

crude petroleum and are owned mostly by large U.S. oil companies, are the most critical of these 124 ships. U.S.-owned foreign flag ships that the military does not plan to use but that are available will be used to supply the civilian economy. The tax deferral, which was very broadly defined and not targeted only to militarily useful vessels, also benefited owners of the remaining 204 ships and other much smaller ships that are not useful for wartime sealift.

U.S. legal authority to these ships in wartime is uncertain. Our 1988 legal opinion concluded that U.S. requisitioning authority may not apply to ships owned by foreign subsidiaries of U.S. corporations.[1] Requisitioning authority over U.S.-owned foreign flag merchant ships has never been used. The United States has used these ships to support conflicts—for example, in Vietnam—but they were chartered, rather than requisitioned from their owners.

Furthermore, international maritime law has traditionally held that the flag state has the right to control vessels registered under its laws and to requisition them in wartime. The maritime law of Liberia, where 87 (or 70 percent) of the 124 militarily useful ships are flagged, clearly retains the right to control these vessels. In response to our work on this issue, the Director of the Navy's Strategic Sealift Division informed us that he was arranging for written approvals from Liberia recognizing U.S. authority to requisition U.S.-owned ships registered under its flag. He intended to pursue similar arrangements with other registries.

Agency Comments

We informally discussed the contents of this report with officials at IRS, MarAd, and DOD. IRS officials agreed with the facts we presented and made suggestions for technical accuracy that we incorporated in the report as appropriate. MarAd and DOD officials took exception with our position that repealing the deferral may not necessarily lead to significantly fewer ships. They strongly believed that repealing the deferral eliminates the incentive to reinvest foreign-earned shipping income in shipping assets and will result in fewer U.S.-owned foreign flag ships over the long term. In addition, the Director of the Strategic Sealift Division told us about actions taken in response to our work, which we incorporated in the final report.

[1] B-229258, April 14, 1988.

Appendix I of this report provides background information on subpart F provisions, the deferral, and U.S.-owned foreign-registered vessels. A detailed discussion of our tax analysis and the impact of repealing the deferral is contained in appendix II, and appendix III provides our analysis of military planning and requisitioning authority.

As arranged with the Subcommittee, we plan no further distribution of this report until 3 days from the date of this letter unless you publicly release its contents earlier.

Major contributors to this report are listed in appendix IV. If you have any questions about this report, please call me on 272-7904.

Sincerely yours,

Paul L. Posner
Associate Director, Tax Policy
and Administration Issues

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Abbreviations

DOD	Department of Defense
EUSC	Effective U.S. Control
IRS	Internal Revenue Service
JCS	Joint Chiefs of Staff
MarAd	Maritime Administration
NATO	North Atlantic Treaty Organization

Background

This appendix presents background information on the Internal Revenue Code's subpart F provisions for foreign-earned income. It also presents background on U.S.-owned foreign flag shipping that benefited from the now-repealed deferral and from which the military identifies vessels for wartime sealift plans. In addition, this appendix contains the objective, scope, and methodology for our review.

Subpart F and the Deferral

Subpart F of the Internal Revenue Code imposes current taxation on foreign-earned income of U.S.-controlled foreign corporations in the year earned, even if the income has not been distributed to the U.S. shareholders. The original 1962 legislation did not include shipping income as foreign-earned income subject to current U.S. tax. The 1975 amendments to subpart F legislation included shipping income but allowed income reinvested in shipping assets to be excluded from current taxation, thereby deferring the tax due until the value of the shipping assets declined. The Tax Reform Act of 1986 repealed the reinvestment exclusion and tightened a number of other subpart F exclusions. When the legislation was under consideration, Treasury estimated that the repeal would generate revenues of between $160 million and $240 million over the first 5 years.

Subpart F

The Internal Revenue Code's subpart F provisions provide a means for taxing foreign-source income. Established in the Revenue Act of 1962, subpart F was to end deferral of tax for certain types of income earned by U.S.-controlled foreign corporations. Previously, foreign-earned income of all foreign corporations (whether U.S.-controlled or not) was taxed only when it was repatriated—that is, distributed to its U.S. shareholders, which are generally parent corporations.

Under the subpart F provisions, the U.S. parent corporation of a controlled foreign corporation is taxed on certain types of foreign-earned income in the year earned, whether or not the income has been distributed. To be recognized under the tax code as a U.S.-controlled foreign corporation, the corporation must be more than 50 percent owned by U.S. shareholders. In addition to shipping income, other types of foreign-earned income subject to subpart F treatment include sales, services, personal holding company, and oil-related income.

Under the tax code, a foreign corporation that is 50 percent or less owned by U.S. shareholders is not U.S. controlled, and its U.S. shareholders are subject to tax on the foreign corporation's earnings only

when distributed. Thus, a non-U.S.-controlled foreign corporation that conducts only foreign operations is not generally subject to U.S. tax. The U.S. shareholders of a noncontrolled foreign corporation are subject to U.S. tax on foreign-earned income when that income is repatriated—for example, through dividends. If the foreign-earned income is never repatriated, then U.S. tax does not have to be paid.

The Exclusion for Reinvested Shipping Income

Until 1975, foreign earned shipping income was not defined as subpart F income and, therefore, taxation was deferred until the income was distributed to the U.S. shareholders. The Tax Reduction Act of 1975 made foreign-earned shipping income taxable in the year earned but only to the extent that the income exceeded reinvestments in shipping assets. So while subjecting foreign-earned shipping income to immediate taxation, the 1975 act also provided a means to defer tax on current earnings if the income was reinvested in qualified shipping assets. Congress intended this deferral to be a means to maintain U.S. competitiveness in world shipping; thus, it was not limited to militarily useful vessels.

The implementing regulations of the act defined foreign-earned shipping income and qualified shipping assets broadly. Shipping income included "gross income derived from or in connection with the use (or hiring or leasing for use) of any aircraft or vessel in foreign commerce." Hence, shipping referred to both water and air transportation. The deferral was not just available to owners of ships but also to companies that derived income in connection with shipping. Shipping income included income generated from foreign exchange gains, interest, dividends, or gains on the sale of an aircraft or ship.

The regulations also broadly defined qualified shipping investments to include investments in any vessel used in foreign commerce and in related shipping assets. This definition encompassed all types of watercraft (oceangoing, barges, and tugs), as well as related equipment, such as containers and terminal facilities. Related shipping assets included accounts receivable, temporary cash investments, and other liquid assets. As long as the value of the qualified shipping asset account did not decline—that is, new investments were equal to or exceeded depreciation and the sale of assets—the income remained deferred.

The 1986 Tax Reform Act repealed the exclusion for reinvested foreign shipping income. As a result, foreign shipping income is currently taxable to U.S. shareholders, whether or not such income is reinvested in shipping assets. In addition, previously excluded subpart F income is

still recognized as taxable when the value of the qualified shipping assets declines through depreciation or sale. The repeal took effect for tax years beginning after December 31, 1986. The Joint Committee on Taxation's report pointed out that the deferral promoted U.S. investment in foreign flag shipping operations. Congress, in repealing the deferral, did not consider it in the United States' interest to promote U.S. investment in other nations' shipping. The Joint Committee report recognized that with the deferral such foreign-earned shipping income might escape current taxation by any country and that U.S. shareholders might be able to escape tax indefinitely.

In 1986, Treasury's Office of Tax Analysis estimated the repealed reinvestment deferral would generate between $160 million and $240 million in additional tax revenues over 5 years, or about $40 million per year. The estimate was based on aggregated IRS data for tax years 1980 and 1982, which were projected to 1987 through 1991 and lowered to reflect the depressed shipping market.

Tax Reform Act of 1986 Tightened Other Exclusions

Other tax provisions allow foreign-earned income, such as foreign-earned shipping income, to be excluded from subpart F income. These include exclusions for

- income derived exclusively in the foreign country in which the controlled foreign corporation is incorporated and in which the vessel is registered ("same country exclusion"),
- income that has already been subject to certain foreign taxes,
- income that constitutes less than a certain percentage or amount of the subsidiary's entire gross income ("de minimis exception"), and
- income distributed through a chain of ownership.

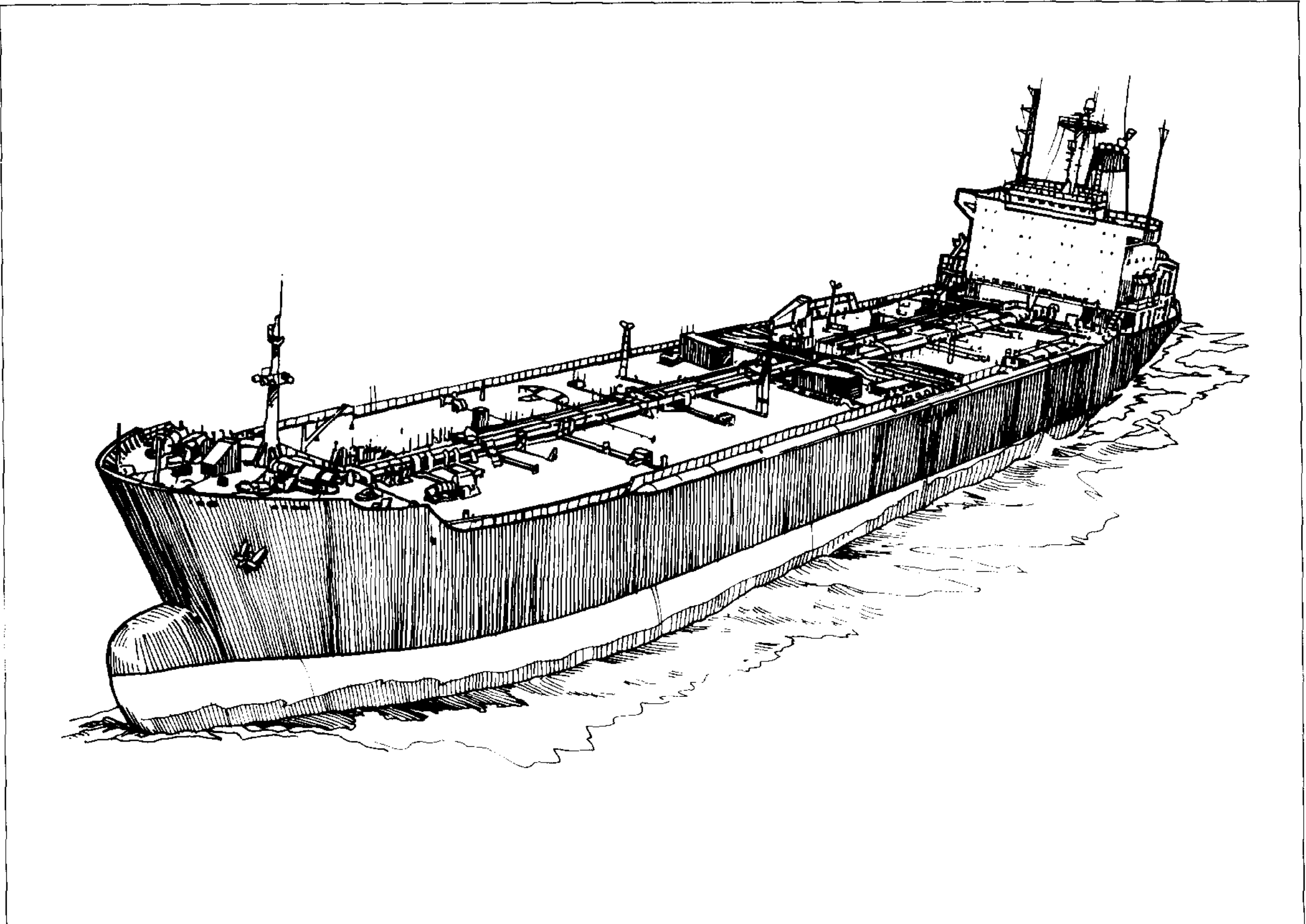
These four exclusions could exempt the foreign-earned income from all current U.S. taxation. Furthermore, an exclusion for U.S.-source trade or business income excludes the income for the U.S. shareholder, but the foreign subsidiary remains subject to current taxation on this U.S.-source income.

In addition to repealing the reinvestment deferral, the Tax Reform Act of 1986 tightened these other provisions, except for the same country exclusion, which was not changed. These restrictions may account for some of the increased taxation of foreign-earned shipping income, as discussed in appendix II.

U.S.-Owned Foreign Flag Shipping

Many U.S. shipowners, primarily large corporations, register their merchant vessels in foreign countries. Foreign registration offers shipowners such benefits as lower labor costs and more favorable tax treatment. As of January 1989, Liberia registered half of the 328 U.S.-owned foreign-registered oceangoing vessels. Almost three-fourths of the ships are tankers, mostly owned by large U.S. oil companies and used to transport petroleum products. Despite the benefits of foreign registry, the number of U.S.-owned foreign-registered vessels has declined by half in recent years.

Figure I.1: Oil Tanker With Coated Tanks to Carry Refined Petroleum Products Such as Fuel Oils



Reasons for Foreign Registry

U.S. shipowners can reduce operating costs through foreign registration. The term "open registry," or "flag of convenience," refers to nations whose maritime laws offer favorable tax, regulatory, and other incentives to shipowners from other nations. Open registries offer substantial cost savings, primarily through minimal manning regulations. At the same time, the flag states receive tonnage taxes and registration fees, important sources of foreign revenues for registry countries.

Traditional maritime nations require the shipowner and the ship's crew to be citizens of the country of registry. In contrast, open registries often have only nominal citizenship requirements, satisfied by registering the ships under a foreign-incorporated subsidiary of the U.S. parent corporation. Panama and Liberia are among the oldest open registries, but a number of other developing countries have instituted open registries in recent years.

Operating under a flag of convenience can cost less than operating a U.S. flag ship, due primarily to lower labor costs. These savings arise not only from lower wage levels for foreign crews but also from fewer restrictions on crew size. At least 75 percent of the crew and 100 percent of the officers on U.S.-registered vessels must be U.S. citizens and must be paid U.S.-scale wages. In contrast, Liberia and the Bahamas, for example, place no restrictions on crew nationality.

Foreign flag ships, with few exceptions, are built outside of the United States where ship construction costs are substantially lower. For example, U.S.-built vessels can cost two to three times more than Japanese or Korean built ships. Not surprisingly, all but 3 of 328 U.S.-owned ocean-going foreign flag ships were built outside the United States. In contrast, U.S. flag vessels are often built in domestic shipyards in order to qualify for cargo preferences, operating subsidies, or transporting domestic cargoes.

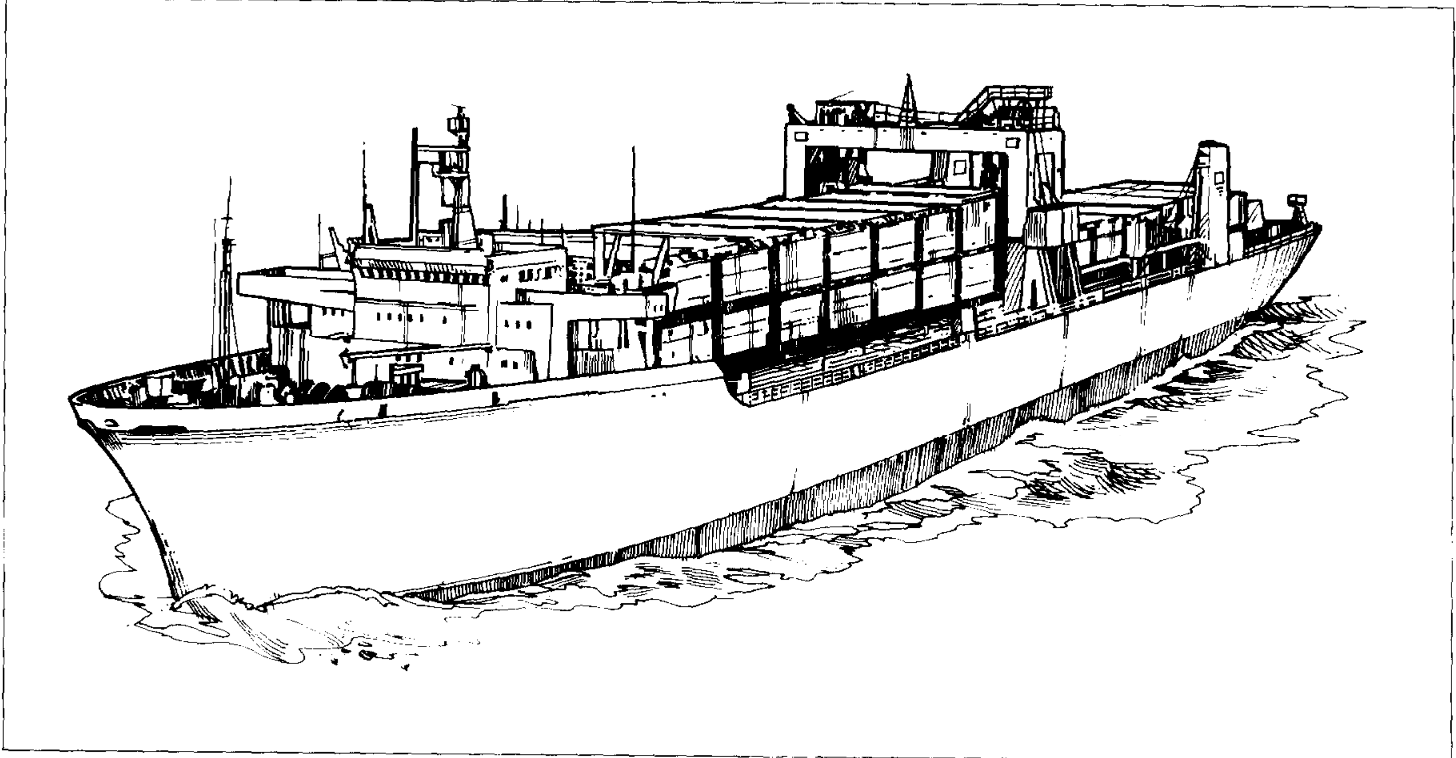
Foreign ship registration also offers owners tax savings. Open registry countries rarely tax shipping income, and, until it was repealed, the reinvested shipping income exclusion permitted favorable treatment of foreign-earned shipping income under the U.S. tax code.

Registry fees and tonnage taxes generate large flows of hard currency for open registry countries. This revenue can be substantial. For example, ship registration fees are Liberia's largest source of U.S. dollar foreign exchange, providing about $22 million to $26 million per year.

Characteristics of U.S.-Owned Foreign Flag Ships

Most U.S.-controlled foreign flag ships are owned by corporations that use the ships to transport their own products. In particular, U.S. oil companies own the largest number of foreign flag ships. As a result, tankers represent 71 percent of the total number and 91 percent of the total capacity of these 328 vessels. The majority of vessels are registered in Liberia and Panama, two of the largest open registries.

Figure I.2: Float-On/Float-Off Barge Carrier With Containers Stacked on Deck



Shipowners Transport Their Own Products

As shown in table I.1, U.S. owners of foreign flag ships are generally not independent shipping companies that provide shipping services to others. (Data from this table and all tables citing U.S.-owned foreign flag ship data are from MarAd reports through January 1, 1989.) Instead, most own vessels primarily for transporting their own products. These owners include the oil companies, which transport petroleum products; raw materials processors, such as Alcoa, USX, and USG (formerly US Gypsum); and food processors, such as Del Monte, Castle and Cooke's Bumble Bee Seafoods, and United Brands. The independent shipping companies own ships primarily for transporting other companies' products. Overseas Shipholding Group, with 43 ships; CSX (Sea-Land); OMI

(formerly Ogden Marine); and Marine Transport Lines are traditional shipping companies. Passenger cruise lines, including Carnival Cruise, Seabourn, and Premier Cruise Lines (owned by Greyhound), are another traditional shipowning industry. Finally, banks and insurance companies also own ships as trustees or through other financing roles.

A few companies own a large proportion of these 328 oceangoing merchant ships. The top six owners control 196, or nearly 60 percent, of these vessels. Five of the six largest owners are oil companies.

Table I.1: U.S. Parent Companies of Foreign Flag Ships

Parent Company	Number of ships
Exxon Corp.	63
Overseas Shipholding Group	43
Mobil Oil Corp.	37
Chevron Corp.	27
Amoco Corp.	13
Texaco, Inc.	13
Carnival Cruise Lines, Inc.	7
CSX Corp.	7
Nicor, Inc.	7
OMI Corp.	7
Bank of California N.A. (Trustee)	6
Castle and Cooke, Inc.	6
Del Monte Corp.	6
Fairfield-Maxwell, Ltd.	6
Loews Corp.	6
Marine Transport Lines, Inc.	6
Phillips Petroleum Co.	6
U.S. Trust Co. of N.Y. (Trustee)	6
Alcoa Steamship Co., Inc.	5
Manufacturers Hanover (Trustee)	5
USX, Inc.	5
International Shipholding Corp.	4
United Brands Co.	4
USG Corp.	4
Amerada Hess Corp.	3
Equili Company and Equitable Life	3
Greyhound Corp.	3
Chagents, Inc.	2
Citizens Trust Co. (Trustee)	2
Connecticut Bank & Trust (Trustee)	2
Wells Fargo Leasing Corp	2
General Carrier, Inc.	1
Halliburton Co.	1
Kaiser Cement Corp.	1
Levin Enterprises	1
Lotus Transportation Co., Ltd	1
Manubank Leasing Corp	1
Maru Shipping Co., Inc.	1
Morton-Thiokol, Inc.	1
Occidental Petroleum Corp.	1

(continued)

Parent Company	Number of ships
Seabourn Cruise Line	1
Sun Company, Inc.	1
Texas Commerce Bank N.A. (Trustee)	1
Total	**328**

Most Ships Are Tankers

Tankers (ships that carry liquid bulk products, such as crude and refined petroleum, natural gas, and chemicals) represent 71 percent of the U.S.-owned foreign flag ships and 91 percent of the total deadweight capacity. (See table I.2.) The remaining 29 percent (freighters, bulk carriers, and passenger ships) together total only 9 percent of capacity. Freighters are general cargo vessels, including refrigerated and containerized ships. Car and barge carriers also fall into this group. The bulk carriers transport dry bulk products, such as ore, cement, and salt. The number of passenger ships, totaling 11 in 1989, has increased in recent years with the growth of the cruise industry.

Table I.2: Types of U.S.-Owned Foreign Flag Ships

Type of ship	Number of ships	Percent	Deadweight tons	Percent
Tankers	234	71.3	28,057,351	91.2
Freighters	45	13.7	473,888	1.5
Bulk carriers	38	11.6	2,167,213	7.0
Passenger ships	11	3.4	79,108	0.3
Total	**328**	**100.0**	**30,777,560**	**100.0**

Liberian Registry Is Choice of Majority of Owners

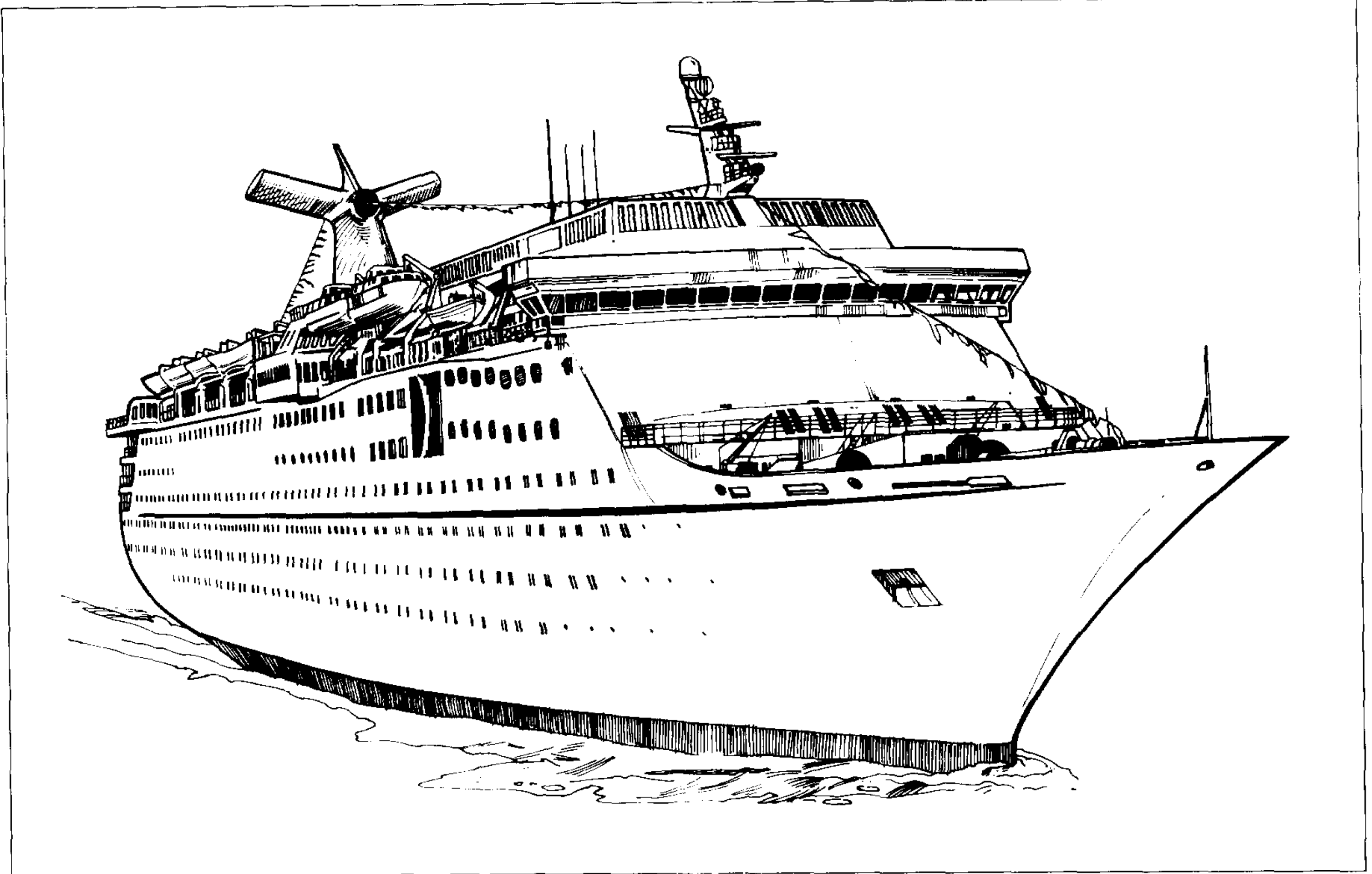
U.S.-owned ships registered in Liberia accounted for 167, or 51 percent, of the U.S.-owned foreign flag ships in January 1989. (See table I.3.) Another 14 percent were flagged in Panama. The overwhelming majority (80 percent) of U.S.-owned foreign flag ships are registered in Liberia, Panama, and other open registries. Only 20 percent fly flags of traditional maritime countries. The United Kingdom registers more than half of these with 37 ships.

Table I.3: Registries of U.S.-Owned Foreign Flag Ships

Country of registry	Number of ships
Liberia	167
Panama	47
United Kingdom	37
Bahamas	27
British Colonies	11
Singapore	8
Argentina	8
France	7
Norway	5
Australia	3
Netherlands	2
Honduras	2
Finland	1
Japan	1
South Africa	1
West Germany	1
Total	**328**

At the same time, U.S.-owned ships represent only small portions of the total Liberian and Panamanian registries. For example, in 1988, 13 percent of all oceangoing vessels flying Liberian flags were U.S.-owned. Less than 2 percent (58 of 3,208 ships) of Panamanian flag ships were U.S.-owned in 1988.

Figure I.3: Passenger Ship Capable of Carrying Military Personnel in an Emergency



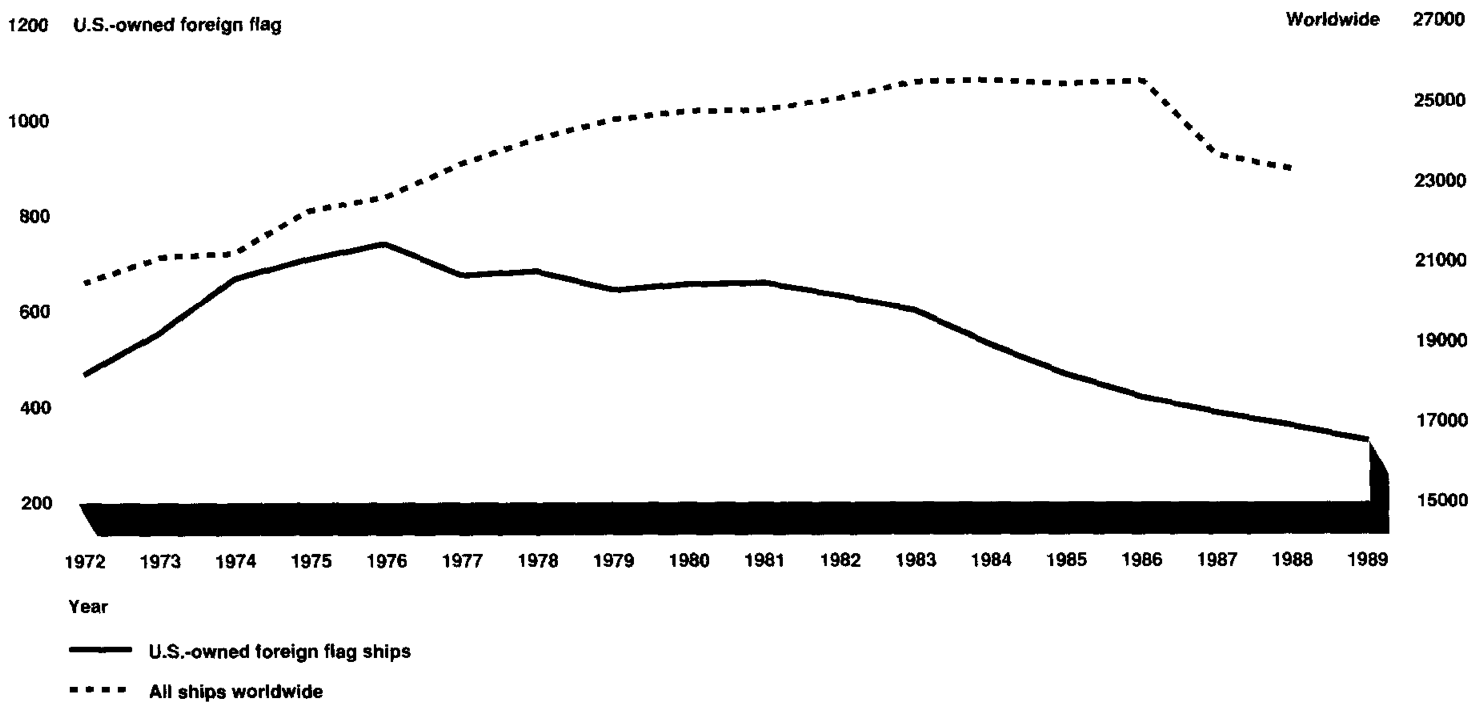
Trends in Foreign-Registered Vessels

After a rapid build-up in the early 1970s, the number of U.S.-owned foreign flag ships began declining steadily. However, total deadweight capacity did not begin to fall until 1981, reflecting the increased use of supertankers. Although U.S.-owned foreign flag ships declined through the 1980s, worldwide both the number of ships and their capacity continued to grow steadily until 1986.

The number of U.S.-owned foreign flag ships has fallen rapidly since the 1976 peak. (See figure I.4.) In 1976, U.S. owners controlled 739 ships, but by January 1989, they controlled only 328 vessels, less than 45 percent of the peak. Although the number of U.S.-owned foreign flag vessels was declining, total capacity continued to increase until leveling off between 1978 and 1980. (See figure I.5.) Since 1981, however, capacity

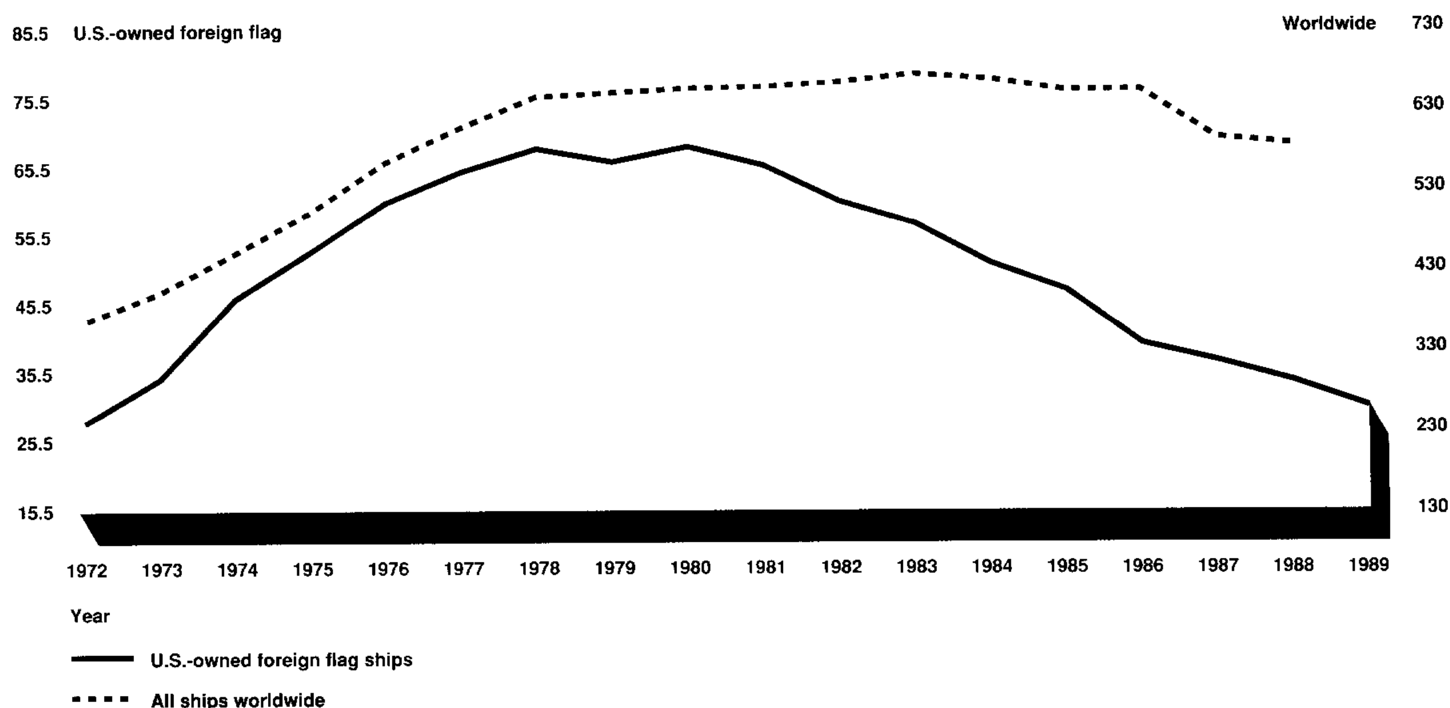
has fallen every year. In spite of the decline, current combined capacity of U.S.-owned foreign flag ships is still twice the 1968 level of 15.7 million deadweight tons.

Figure I.4: Number of Ships—Worldwide and U.S.-Owned Foreign Flag



Note: Worldwide number dropped between 1986 and 1987 largely because of data reconcilliation.

Figure I.5: Capacity of Ships—Worldwide and U.S.-Owned Foreign Flag



Note: Worldwide number dropped between 1986 and 1987 largely because of data reconcilliation.

While U.S.-owned foreign flag ships declined in number and capacity, the number of ships worldwide continued to expand until 1986. From fewer than 19,000 ships in 1968, the number of ships worldwide grew steadily each year to over 25,500 in 1986. (See figure I.4.) The capacity of merchant ships worldwide remained mostly stable in the 1980s, while the capacity of U.S.-owned foreign flag ships declined.

The continued growth in worldwide shipping through 1986 while U.S.-owned foreign flag ships declined is mostly attributable to the higher proportion of U.S.-owned foreign flag ships that are tankers. As a result, the U.S.-owned foreign flag vessels in total were hit harder than all ships worldwide by the build-up and later scrapping of oil tankers in the late 1970s and 1980s. Tankers represented 71 percent of the U.S.-owned foreign flag vessels in 1988 but only 22 percent of all ships worldwide.

The average capacities of ships worldwide and of U.S.-owned foreign flag ships also reflect the higher proportion of U.S.-owned tankers. Tankers generally have much larger capacities than other vessels. By

1988, the average capacity worldwide was 25,200 deadweight tons per ship. The comparable U.S.-owned foreign flag level was 96,000, almost four times the world average.

Objective, Scope, and Methodology

Our objective was to assess the impact of repealing the exclusion for reinvested shipping income in terms of tax revenues generated and, particularly, its impact on the U.S.-owned foreign flag ships that the U.S. military plans to use for strategic sealift. Our review also considered the availability of these ships for requisitioning by the United States in the event of war.

We analyzed available tax data for 1 year before and 1 year after the Tax Reform Act. With IRS assistance, we obtained the information returns for controlled foreign corporations engaged in water transportation for tax years 1984 and 1987. We coordinated our approach and analysis on several occasions with international tax experts at Treasury and IRS.

In order to evaluate the effect of the tax change on the number of militarily useful merchant vessels and their availability in wartime, we analyzed Maritime Administration (MarAd) data on U.S.-owned foreign flag ships, and we reviewed the Navy's plans for wartime use of these merchant vessels. We also contacted the Federation of American Controlled Shipping, an industry association that represents owners of ships registered in Liberia, Panama, Honduras, and the Bahamas; four of its shipowning member companies; and the Deputy Commissioner of Maritime Affairs for Liberia, under whose flag are registered half of the U.S-owned ships flagged abroad.

Our audit work was done between November 1988 and September 1989, and in accordance with generally accepted government auditing standards.

Tax Analysis Methodology

We reviewed IRS tax data to assess the impact of the repealed reinvestment deferral on the companies' tax burden and to determine whether the change would lead shipowners to give up ownership of their vessels. The data came from information returns filed by U.S. owners of foreign subsidiaries. We identified those returns for "water transportation," that is, shipping companies, for tax years 1984 and 1987.

IRS Form 5471 and Tax Years Used

IRS Form 5471 is the annual information return that documents financial data for U.S.-controlled foreign corporations. Filed as an attachment to the corporate (or individual) return, the form identifies the U.S. parent company or owners and contains extensive financial data on the foreign subsidiary, including an income statement and a schedule of subpart F income.

We used the 1984 data as our base year for assessing the taxation of foreign-earned shipping income before the deferral was repealed. We obtained a statistical summary and the supporting returns on a computer tape from IRS. Tax year 1984 is the most recent tax year summarized by IRS' Statistics of Income division, which summarizes Form 5471 for even-numbered tax years. Although IRS was able to provide us 1980 and 1982 data, these were not comparable to the 1984 data because 1984 was the first year Form 5471 was used. Before 1984, IRS data did not summarize subpart F income.

The repeal of the reinvestment deferral took effect for tax years beginning after December 31, 1986. In order to assess the effect of the repeal, we obtained tax returns for the tax year beginning on or after January 1, 1987. We manually identified these returns from those submitted to IRS' international returns processing center in Philadelphia.

Tax Data Constraints

IRS Form 5471 does not identify the key data element that we needed for our analysis—that is, the income reinvested in shipping assets and therefore excluded from taxable subpart F income. A supporting worksheet to Form 5471 contains the amount reinvested, but IRS instructions specifically direct that this worksheet is not to be filed with the return. The inability to isolate the exclusion for reinvested shipping income from other exclusions was a critical constraint and prevented us from concluding exactly how much was excluded for reinvestments in shipping assets before the repeal.

Another constraint is the accuracy of the available tax data. IRS had already reviewed the 1984 data and performed verification procedures to detect obvious errors and resolve inconsistencies. But tax data are only as accurate as the filers' reports to IRS and are subject to change upon audit. IRS had not reviewed and verified the 1987 data at the time we used them.

Deferral Benefited Others Beside Owners of Oceangoing Vessels

We obtained IRS Form 5471 for all foreign subsidiaries engaged principally in shipping—those designating "water transportation" as their principal business activity. We found tax returns for many more companies than the owners of oceangoing vessels tracked by MarAd. For example, of the 326 1984 tax returns found for shipping subsidiaries, only 94 companies were on MarAd's list as owning foreign flag ships that year. Apparently, some companies involved in this business activity do not own ships. They may be shipping agents or managers. Others owned ships, but not the oceangoing vessels monitored by MarAd or of use to the military in an emergency. The regulations define qualified shipping assets very broadly, so the deferral benefited owners of such shipping assets as barges, tugs, and smaller, nonoceangoing transport vessels. In our evaluation of tax data, we analyzed tax returns of all water transportation companies and did separate analyses of vessels tracked by MarAd.

Impact of Repealing the Deferral

A greater percentage of foreign-earned shipping income is subject to current taxation since enactment of the Tax Reform Act of 1986, which repealed the exclusion for reinvested shipping income. Although restriction of other exclusions by the act also contributes to this increased percentage, we believe the deferral's repeal is largely responsible for the observed effect. We also believe, however, that while the exposure to taxation has increased, changes in the corporate tax rate and in income levels may have prevented tax revenues from rising.

How shipowners will respond to the repeal of the deferral is not clear. Industry representatives argue that without the deferral's incentive shipowners will not reinvest in U.S.-controlled shipping assets as before. Instead, U.S. companies will charter ships from foreign owners rather than own them directly, or they will structure vessel ownership in order to reduce or avoid current taxation of profits. Either action could result in fewer U.S.-owned foreign flag ships.

We found no clear evidence that repealing the deferral has resulted in fewer ships to date. Furthermore, the increased exposure to taxation arising from the deferral's repeal appears minor relative to ship operating and construction costs. We recognize that shipping companies used the deferral to varying degrees and, as a result, its loss will affect some companies more than others.

1986 Act Increased the Proportion of Earnings Subject to Subpart F Taxation

Overall, a higher percentage of earnings and profits was subject to subpart F taxation after the Tax Reform Act of 1986. But declining profits reported for tax purposes and a lower corporate tax rate meant that the industry may have actually paid more in subpart F taxes before the 1986 repeal than after. Further, the act did not affect all foreign-controlled shipping corporations equally. Eligible companies used the deferral, before its repeal, to differing degrees and, therefore, some were affected more than others by its loss. Even after the 1986 act repealed the deferral and restricted other exclusions, about half of the companies were able to avoid subpart F taxation and reduce or avoid U.S. taxation on this shipping income.

Higher Percentage of Earnings and Profits Are Now Taxable

Our analysis of tax data showed that since the Tax Reform Act of 1986, the percentage of shipping income subject to immediate tax has risen. Industry and Treasury officials believe most of the increase is attributable to the repeal of the deferral for reinvested shipping income, which was the most significant subpart F exclusion for U.S. owners of foreign

ships. As table II.1 shows, with the deferral, income subject to subpart F taxation in 1984 represented 20.9 percent of the earnings and profits of the 134 profitable shipping subsidiaries. In contrast, the 145 profitable companies in 1987 had earnings and profits of $168 million, of which 70 percent was taxable subpart F income.

Table II.1: Tax Data for Foreign Subsidiaries, 1984 and 1987

Dollars in millions

	Number of foreign subsidiaries		Subsidiaries with profits		Subpart F as a percent of earnings
	Total	With profits	Earnings and profits	Subpart F income	
All water transportation					
1984	296	134	$521	$109	20.9
1987	277	145	168	118	70.0
On MarAd lists in both periods					
1984	42	11	284	9	3.0
1987	42	34	58	46	80.0
On MarAd lists and profitable in both periods					
1984	7	7	52	9	16.5
1987	7	7	37	37	99.2

An even higher proportion of taxable subpart F income to profits is evident after the Tax Reform Act for those subsidiaries that MarAd tracks as owning oceangoing foreign flag vessels. We found 1984 and 1987 tax data for 42 foreign subsidiaries that were on MarAd's list in both years. In 1984, 11 of the 42 subsidiaries reported profits of $284 million. These subsidiaries reported almost $9 million (or 3 percent of earnings) as subpart F income. By 1987, 34 of the 42 subsidiaries had profits totaling $58 million. In that year, they reported $46 million (80 percent of earnings) as subpart F income.

Only 7 of the 42 shipowning subsidiaries earned a profit in both 1984 and 1987. Although so few cases are not representative, they reflect the same result as our other analyses. In 1984, these seven had earnings of $52 million and declared $8.5 million (17 percent of earnings) as subpart F. The same seven subsidiaries had $37 million in profits in 1987. In that year, they reported just under $37 million in subpart F income, or 99.2 percent of earnings.

This analysis shows a sizable increase after the Tax Reform Act in the percentage of earnings and profits being declared as subpart F income. But our analysis attempts only to demonstrate the general trend. A few, particularly large, companies can affect the overall results. With fewer cases, as with the seven above, the results will be less precise.

Repeal Has Not Affected All Companies Equally

While the percentage of income subject to current taxation increased, the impact of repealing the deferral did not fall equally on all U.S.-controlled shipping companies. Some profitable companies reported all or most of their earnings as subpart F income in 1984 when the deferral was available. After the deferral was repealed, half of the profitable companies did not show any taxable subpart F income. Apparently, some companies had, and some still have, more favorable alternatives to subpart F taxation.

Even when the deferral was available in 1984, about one-fourth of the shipping subsidiaries did not use it fully. We believe this is because they chose either not to reinvest in shipping or they had other more favorable exclusions available at the parent level. For example, shipping and tax experts told us that many oil companies had excess foreign tax credits or loss carryforwards. These companies did not use the deferral but rather showed all their earnings and profits from shipping as taxable subpart F income, which was then offset on the parent company's return with the excess foreign tax credits or prior year losses.

Contrary to our expectation that without the benefit of the deferral most shipping companies would report all their earnings as taxable subpart F income, fewer than half declared 100 percent of their 1987 earnings as subpart F income. Companies that had been able to exclude their earnings with the deferral suffered the full impact of the repeal if they were unable to find other means of excluding subpart F income.

Virtually all the others in 1987 declared no taxable subpart F income. Apparently, these companies have other exclusions to avoid declaring subpart F income. IRS data are not sufficient to determine which exclusions are being used. But on the basis of discussions with IRS and others and the tax data available, we believe companies use the same country exclusion, which allows income to be excluded if derived in the country of incorporation; the exclusion for income subject to high foreign taxes; or the exclusion for U.S.-source trade or business income, which excludes income from immediate taxation to shareholders but leaves the foreign subsidiary subject to regular U.S. corporate tax. Furthermore,

some of the difference between earnings and profits and taxable subpart F income may be foreign-earned income derived from activities, such as manufacturing or trucking, that are not subject to subpart F taxation.

Significantly smaller reported earnings and profits in 1987 also suggest that affected subsidiaries have found ways to reduce their earnings and profits and, therefore, their taxable subpart F income. In 1984, 134 companies had profits totaling $521 million, while more (145) companies had profits of only $168 million in 1987. We considered several causes for this change. Economic conditions for the industry are not a likely explanation of the smaller profits because the shipping industry had improved by 1987. One factor possibly explaining the change is that we did not include 1987 tax data for returns that had not been submitted to IRS' Philadelphia Service Center by June 1989 when we completed our work there. Finally, our review of tax returns for the subsidiaries of one large parent corporation suggests that these subsidiaries, faced with higher tax without the deferral in 1987, found ways to delay recognition of income.

Total Tax Revenues Generated Are at Most $47 Million

Our analysis found $118 million in taxable subpart F shipping income in 1987. At a transitional corporate tax rate of 40 percent in 1987, total tax revenues generated on that income would be about $47 million. We believe most of the $47 million will be paid as tax by the parent company because the Tax Reform Act of 1986 also significantly restricted loss carryforwards and the foreign tax credits that U.S. companies had used in the past to offset their shipping profits.

In 1984, subpart F income for these foreign shipping subsidiaries was $109 million. Given the maximum corporate rate of 46 percent at that time, tax revenue of just over $50 million could have been generated—$3 million greater than the total in 1987. Thus, while the repeal of the deferral exposed a higher percentage of income to taxation, the combination of lower corporate tax rate and a decline in income may have resulted in a decline in 1987 tax revenue. However, if the deferral had not been repealed, 1987 tax revenues would have been even less.

From the available IRS data, we could not determine the actual amount of tax revenue generated from foreign-earned shipping income in either year because the parent corporation pays tax on its total operations. Further, government and industry officials believe that in 1984 subpart F income was generally recognized only when the parent corporation

had an offset available, so the parent corporation actually paid little or no tax in 1984 on this foreign-earned shipping income.

Impact of Deferral Loss on Shipowners Is Not Clear

The impact of the change in subpart F taxation on shipowners' decisions to maintain ownership of vessels is not clear. Although shipowners might consider increased taxation in their shipowning decisions, we could not determine any direct, measurable link occurring to date. A number of factors would indicate that the tax change will not necessarily lead to significantly fewer ships. First, the number of U.S.-owned foreign flag ships was declining even when the deferral was available. Second, as already discussed, companies appear to have other ways to reduce or avoid showing taxable subpart F income. Third, the additional tax paid is not significant compared with annual operating costs and purchase prices of new ships. Although repeal of the deferral no longer encourages reinvestment in shipping, it is not clear how significant its effect will be on the number of these ships in the future given these other factors.

Will Repeal of the Deferral Result in Fewer U.S.-Owned Foreign Flag Ships?

The reinvestment deferral served as an incentive for U.S. corporations with shipping income to reinvest in foreign shipping assets. Those companies that chose to use the deferral were able to reinvest in shipping with pre-tax dollars. With the repeal, that incentive to reinvest was eliminated, according to the industry. Reinvestment in shipping assets is now with after-tax dollars. At the current corporate tax rate of 34 percent, companies subject to tax on all their income need taxable income of $1.52 million in order to reinvest $1 million.

U.S. owners of foreign flag ships and the industry association believe that repeal of the deferral will result in fewer of these ships in the future. According to their position, chartering foreign-owned ships in the competitive shipping industry will be more cost effective than reinvesting in new assets with after-tax dollars. As an alternative to chartering, current U.S. shipowners may own a minority share of ships with a foreign partner. Income earned through such an arrangement would avoid current taxation because under subpart F provisions, non-U.S.-controlled foreign corporations' foreign-earned income is not taxable until repatriated. Thus, if current shipowners use these alternatives to escape taxation, fewer U.S.-owned foreign flag ships will be available.

Long-Term Decline of U.S.-Owned Foreign Flag Ships

The number of U.S.-owned foreign flag ships, however, was declining before the deferral was repealed. In fact, as shown in figure I.4 the decline began in 1977, soon after shipping income was included in subpart F and the deferral was introduced. As discussed in appendix I, this decline largely reflects demand and supply adjustments in the tanker market. The loss of the reinvestment deferral does not appear to have accelerated the decline in the number of ships. As shown in table II.2, the number of ships declined 13 percent from 1985 to 1986. The declines in 1987, 1988, and 1989 are not out of line with the declines in preceding years.

Table II.2: Yearly Change in Number of U.S.-Owned Foreign Flag Ships

Year	Number of ships	Change in number from previous year	Percentage change
1982	639	(27)	(4.0)
1983	602	(37)	(5.8)
1984	525	(77)	(12.8)
1985	485	(40)	(7.6)
1986	420	(65)	(13.4)
1987	394	(26)	(6.2)
1988	361	(33)	(8.4)
1989	328	(33)	(9.1)

Increased Tax May Be Small Relative to Other Financial Measures

The additional taxes generated by the deferral's repeal do not appear significant compared to the companies' total assets and gross receipts. In 1984, assets for these shipping subsidiaries totaled $9.1 billion, and gross receipts were about $3.1 billion. Taxes of $47 million in 1987 appear small by contrast.

Similarly, the tax burden per ship represents a small percentage of average operating and construction costs. We estimated an average per ship cost of the tax, assuming that only the 328 ships on MarAd's list were affected by the repeal and that 52 percent were profitable (as in 1987). Each of the 171 profitable ships would have a tax burden of $234,000 (based on a corporate tax rate of 34 percent and $118 million in subpart F income). MarAd estimated the construction cost of a new 100,000 ton foreign flag tanker to be $52 million and average operating costs to be about $10 million annually. So this average tax cost would be only about 2.3 percent of the annual operating cost. The tax burden calculated over the tanker's 20-year life represents about 5 percent of its construction cost.

These calculations are simplified average calculations. Such simplifications ignore the reality that the impact will not affect all companies equally. Some companies may suffer disproportionately because they do not have other exclusions with which to offset the loss of the deferral, and others may avoid any added costs because they do have exclusions.

Military Sealift Planning and Requisitioning Authority

Strategic sealift planning for a global conflict includes some 1,209 merchant ships, of which 124 are Effective U.S. Controlled (EUSC) ships. These 124 U.S.-owned foreign flag ships are registered under the flags of certain countries—currently Panama, Liberia, Honduras and the Bahamas—designated by the Joint Chiefs of Staff (JCS). Although their number appears small relative to the total sealift, EUSC ships provide critical sealift, especially tanker, capability. The U.S. legal right to these ships in wartime, however, is an unresolved issue.

Sealift Plans Include EUSC Ships

The U.S. Navy and MarAd plan to use U.S.-owned merchant ships in the event of war. The Navy is responsible for planning "strategic sealift" to transport troops, equipment, and supplies to the war effort. MarAd plans for "economic support shipping"—the merchant shipping capacity necessary to support the U.S. economy during the conflict. Although economic support shipping is a critical wartime requirement, we focused, as requested, on the militarily useful EUSC ships planned for strategic sealift.

Figure III.1: A Tank Driving Onto a Roll-On/Roll-Off Cargo Ship

Source: Military Sealift Command

Explanation of EUSC

In identifying vessels for its sealift needs, the Navy considers foreign-registered vessels that are more than 50 percent U.S. owned and registered under the flags of certain countries—now, Liberia, Panama, Honduras, and the Bahamas. Of the total 328 U.S.-owned foreign flag ships in January 1989, 243 were flagged under these countries and known as EUSC ships. Defense and maritime planners consider these ships to be under U.S. control by virtue of their ownership by U.S. citizens or corporations and to be available for requisitioning by the U.S. government in time of war or national emergency.

Section 1242(a) of the Merchant Marine Act of 1936 gives the Secretary of Transportation, following a presidential proclamation of emergency, the authority to requisition vessels owned by U.S. citizens. This authority to requisition civilian vessels for military use also requires that owners be compensated for the use of their property. DOD, MarAd, and industry officials regard this law as the authority for requisitioning EUSC vessels—U.S.-owned vessels registered under Liberian, Panamanian, Honduran, and Bahamian flags. Section 1242(a) authority, according to MarAd officials, was last exercised in World War II to requisition U.S. flag vessels. The United States has also used U.S.-owned foreign flag merchant vessels in wartime, but through charters, contracts, and agreements.

Explanation of Militarily Useful EUSC

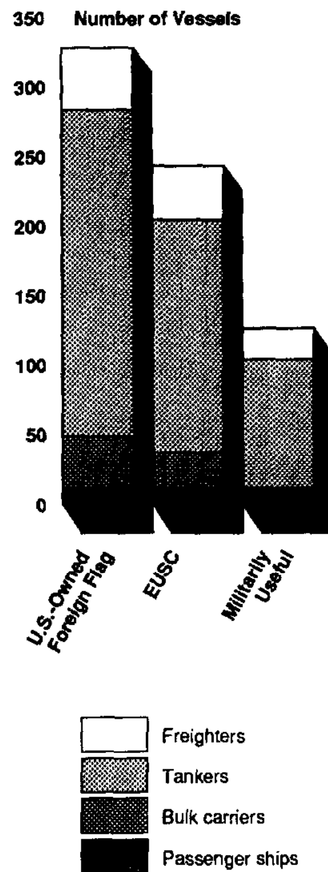
For wartime sealift, military planners select from an inventory of EUSC ships that MarAd maintains. Military sealift generally needs smaller oceangoing merchant vessels, which are more maneuverable in shallower ports. The current JCS plans define militarily useful merchant ships as follows:

- dry cargo ships that are oceangoing and have capacities of over 6,000 deadweight tons or that are under 6,000 tons with special features, such as heavy lift ships or float-on/float-off cargo ships;
- tankers with capacities between 6,000 and 100,000 deadweight tons, with a beam of less than 106 feet, that are capable (with modifications, if necessary) of handling refined petroleum products, and chemical tankers, excluding uniquely specialized tankers such as liquid natural gas tankers; and
- passenger ships that are oceangoing, excluding ferries.

On the basis of these criteria, the Navy has identified 124 militarily useful EUSC vessels. (Fig. III.2 shows the militarily useful, EUSC, and U.S.-owned foreign flag ships by type of ship.) Tankers make up 92 (or 74

percent) of the 124 militarily useful vessels, and freighters and bulk carriers (dry cargo ships) represent another 20 ships (or 16 percent). Although few in number, the 12 EUSC passenger ships provide an alternative to airlifting troops and are all militarily useful.

Figure III.2: U.S.-Owned Foreign Flag, EUSC, and Militarily Useful Ships, by Type of Vessel



Liberia has the largest number of U.S. ships flagged outside of the United States. Ships registered in Liberia constitute 165 (or 68 percent) of the 243 U.S.-owned ships flagged in the four countries as of January 1989. With 49 U.S.-owned ships, Panama trails as the next largest registrar, and the Bahamian registry has 27 ships to Honduras' 2 ships. Table III.1 shows the number of EUSC ships registered under these four flags.

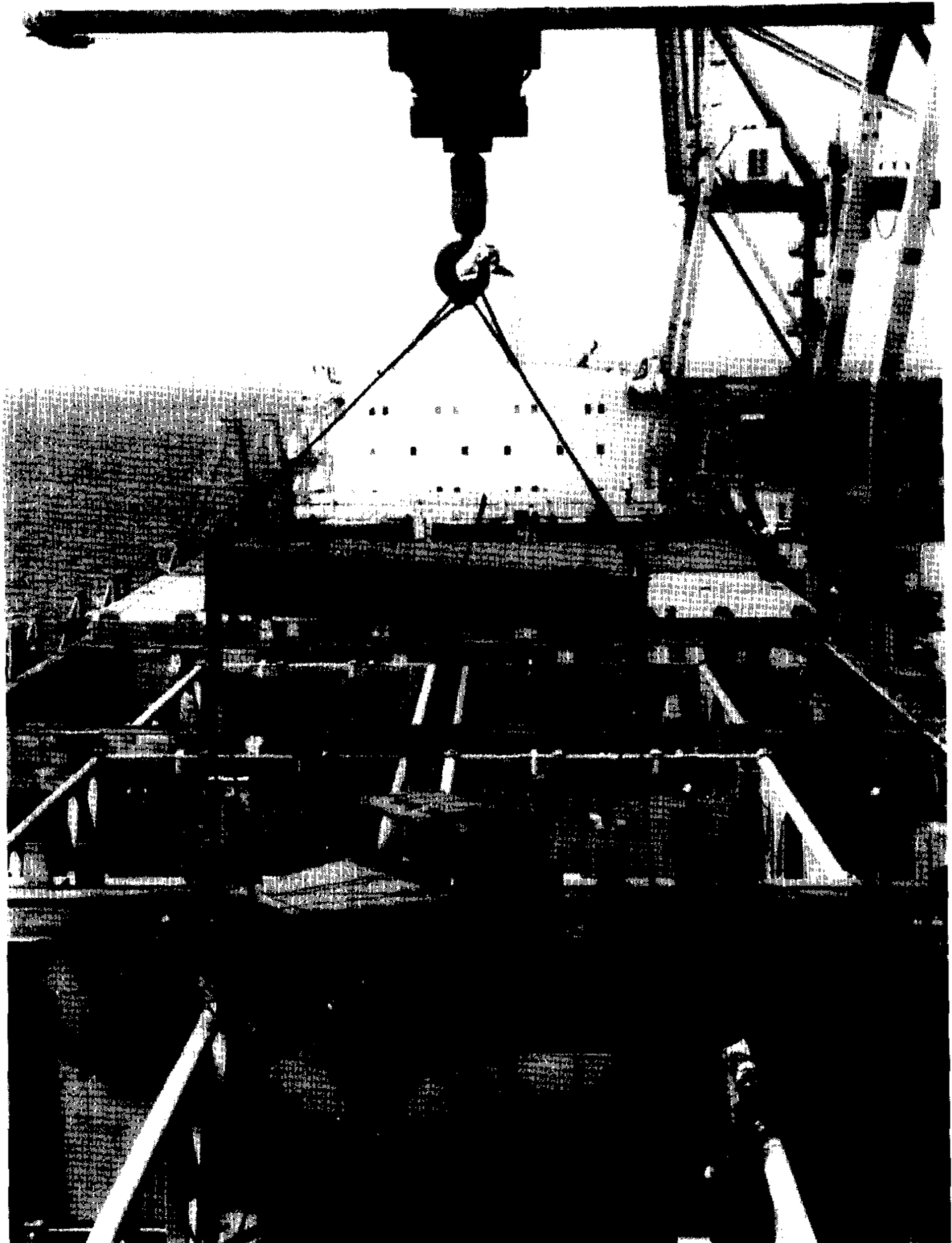
Table III.1: Total EUSC and Militarily Useful EUSC Ships by Country of Registry

Country of registry	Total EUSC	Militarily useful EUSC
Liberia	165	87
Panama	49	22
Bahamas	27	14
Honduras	2	1
Total	**243**	**124**

The Military Plans to Use EUSC Vessels for Strategic Sealift

Sealift, along with airlift and prepositioned reserves, provides the troops, equipment, and supplies in wartime. Militarily useful EUSC ships represent one seemingly small category from which the military plans to obtain emergency sealift capability. Navy officials stressed, however, that while EUSC ships are few relative to the other sources of sealift, they are a critical source of tankers for delivery of petroleum products to resupply the war effort.

Figure III.3: A Truck Tractor Lifted by Crane Into a Ship's Hold



Source: Military Sealift Command

Militarily useful EUSC vessels represent 124, or 10 percent, of the 1,209 total strategic sealift vessels planned to support U.S. forces in a global war scenario. Table III.2 shows how many merchant ships each strategic sealift source will provide, listed in order of the ships' availability. Ships

chartered to the Military Sealift Command at the outbreak of war will already be under the Military Sealift Command's operational control. The Ready Reserve Force is owned by the U.S. government and scheduled to activate within 5, 10, or 20 days after notification. The National Defense Reserve Fleet, a government-owned fleet of inactive merchant ships scheduled to activate in 60 or more days; U.S. flag merchant vessels; and EUSC ships all require presidential declaration of an emergency for military use. The final two sources of strategic sealift—commercial ships pledged by North Atlantic Treaty Organization (NATO) allies and Korea—are available with requisite authority in a global war scenario.

Table III.2: Strategic Sealift Sources

Source	Dry cargo	Passenger	Tanker	Total
Military Sealift Command	40	0	24	**64**
Ready Reserve Force	83	1	11	**95**
U.S. flag ships	145	5	134	**284**
EUSC	20	12	92	**124**
National Defense Reserve Fleet	44	10	21	**75**
NATO	471	12	58	**541**
Korea	26	0	0	**26**
Total	**829**	**40**	**340**	**1,209**

EUSC Requisitioning Authority

Two issues are debated regarding the authority of the United States to effectively requisition EUSC ships in the event of an emergency. The first is whether the country of registry or the United States has the legal right to requisition U.S.-owned ships in emergencies. The second is whether U.S. requisitioning authority extends to ships owned by foreign subsidiaries of U.S. corporations.

Does the Flag State Retain Control Over U.S.-Owned Foreign Flag Ships?

Under international law, a state that has attributed its nationality to a merchant vessel through registration has the right to control the ship's movements and activities. In addition, the flag state traditionally has the right to requisition that vessel in time of national emergency or war.

The rise of open registries or flags of convenience has called into question this traditional right of the flag state to control and to requisition vessels under its flag. Article 5 of the Convention on the High Seas (Geneva, 1958) recognized that the laws of the flag state govern the ships registered under its flag, if a "genuine link" exists between the flag state and the merchant ship. A 1977 United Nations Conference on

Trade and Development report that studied article 5 concluded that open registries "are generally regarded as lacking a genuine link with the vessels which fly their flag."[1]

On the other hand, the law of at least one open registry—Liberia, where about 70 percent of the militarily useful EUSC ships are flagged—asserts sovereign rights over vessels. Liberian maritime law retains the right to control ships in its registry and also prohibits agreements to make Liberian-flag vessels available for requisitioning by another country except with Liberian approval.

Under Liberian law, the Commissioner of Maritime Affairs may "when necessary prohibit or place restrictions upon the movement or operation of vessels...[and] it shall be unlawful to navigate or operate a Liberian vessel otherwise." According to historian Rodney Carlisle, Liberian Executive Order IV, issued during the Yom Kippur War in October 1973, prohibited Liberian flag vessels from supplying Israel. This order, while not enforced at that time, represents Liberian exercise of its legal authority over Liberian-registered vessels.

Another Liberian provision makes it unlawful, without written Liberian approval, to agree to make a Liberian flag vessel available for requisition by another country. Officials of Liberian Services, the registration agent for Liberia, told us that on a case-by-case basis, they do approve agreements with requisitioning clauses between U.S. owners and the U.S. government. This approval usually has been associated with the binders for U.S.-government sponsored war risk insurance. In the war risk insurance binder, the shipowner pledges to make the ship available to the United States in wartime.

We determined that of the 87 militarily useful Liberian-registered ships, the number subject to requisitioning by the United States with no objections from Liberia is at most 14 militarily useful EUSC ships registered in Liberia and covered by interim war risk insurance. In response to this finding, the Director of the Navy's Strategic Sealift Division informed us that he was arranging for written approvals from Liberia recognizing U.S. authority to requisition these vessels. He stated that he would pursue similar arrangements for the other EUSC vessels.

[1] Economic Consequences of the Existence or Lack of a Genuine Link Between Vessel and Flag of Registry, United Nations Conference on Trade and Development (Geneva: Apr. 12, 1977).

Does U.S. Requisitioning Authority Extend to Ships Owned by Foreign Subsidiaries of U.S. Corporations?

At the request of Senator Ernest F. Hollings, we provided an April 1988 legal opinion determining whether section 1242(a) requisitioning authority applies to a vessel owned by a U.S.-controlled foreign corporation.[2] We concluded that "if the foreign subsidiary of an American parent corporation owns a vessel, that vessel would not come within the scope of section 1242(a) unless there was a specific contractual arrangement to that effect." In order to eliminate uncertainty, we recommended that:

> "...either the requisitioning authority be amended to make clear whether ships owned through foreign subsidiaries are covered or that the Maritime Administration enter into contractual agreements providing for requisitioning in accordance with section 1242(a) with the owners of the vessels not specifically covered by the requisition provision."

MarAd, DOD, and the industry organization that represents U.S. owners of ships flagged in Liberia, Panama, Honduras, and the Bahamas strongly disagreed with our legal opinion. They said that section 1242(a) provides the U.S. government sufficient legal authority to requisition these ships and that the United States, as the country of beneficial ownership, can requisition these ships in a national emergency.

[2]B-229258, April 14, 1988.

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