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The Capital Construction Fund and How It Works

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Practice Areas

- Vessel Financing & Acquisition/Disposition

The Capital Construction Fund ("CCF") program is designed to encourage owners of U.S. flagged vessels to accumulate sufficient capital to acquire additional U.S. flagged vessels by offering tax incentives to do so. Under the CCF rules described below, a vessel owner may claim an income tax deduction for contributions to a CCF, pay no tax on CCF earnings and withdraw funds on a tax free basis to acquire new U.S. flagged vessels.

This memo summarizes the basic rules, restrictions and penalties associated with Capital Construction Funds.

I. Deposits into a CCF

United States citizens who operate U.S. flagged vessels are entitled to make deposits into a CCF. The maximum amount that may be contributed is the income attributable to the operation of "Eligible Agreement Vessels" [1] , limited by one's taxable income, together with the amount of depreciation allowed as a deduction on Eligible Agreement Vessels, the net proceeds from the sale or disposition of Eligible Agreement Vessels and the earnings from the investments in a CCF. Income from A Qualified Agreement Vessels (defined later) may also be deposited into a CCF. Deposits may be made up to the above limits, but CCF holders generally must make the minimum contributions provided in the CCF agreement. Unless a waiver is obtained from the Maritime Administration to make a lesser contribution, penalties can be imposed.

Vessel owners are entitled to an income tax deduction for the amount deposited into a CCF attributable to income from Eligible Agreement vessels. Deposits may be made into the fund up to the due date of the owner's income tax return for the taxable year to which the deposit relates (including extensions).

Deposits into a CCF are segregated into three separate accounts which must be maintained for bookkeeping purposes, an ordinary income account, a capital gain account and a capital account.

If a deposit is made from an amount that would otherwise have been taxed at ordinary income tax rates, it is credited to the ordinary income account. This includes contributions to a CCF out of ordinary income, short term capital gains, interest and other ordinary income earned on assets held in the CCF.

The capital gain account represents deposits that would otherwise be taxed at capital gains tax rates, such as gain from the sale of a vessel, the receipt of insurance proceeds resulting from the destruction of a vessel and long term capital gains earned on fund deposits. The capital account represents deposits from non-taxable sources such as depreciation.

II. CCF Withdrawals

"Qualified Withdrawals" can be made from a CCF for the acquisition and re-construction of United States flagged vessels and to satisfy acquisition indebtedness in connection therewith. Vessels acquired with Qualified Withdrawals are called "Qualified Agreement Vessels" and are subject to numerous restrictions. Within thirty (30) days after the execution of a contract to acquire a Qualified Agreement Vessel, a copy of the contract must be submitted to the Maritime Administration. Vessel reconstruction expenses must generally exceed $1 million and be of the nature that would be capitalized under the Internal Revenue Code to Qualified Withdrawals.

Withdrawals from a CCF for other purposes are called Non-Qualified Withdrawals and are effectively

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subject to penalties. Prior permission must be obtained from the Maritime Administration before a Non-Qualified Withdrawal can be made.

Qualified Withdrawals from a CCF are tax free. They are deemed to be made first from the capital account, until its balance is zero, then from the Capital Gain Account, and then from the Ordinary Income Account.

The portion of Qualified Withdrawals made from the Ordinary Income Account reduces the income tax basis in the vessel acquired by the withdrawal on a dollar for dollar basis. The portion of Qualified Withdrawals by partnership and L.L.C.'s made from the Capital Gain Account reduces the basis in the vessel by one-half of the withdrawal (corporations reduce the basis by 3/5 of the withdrawal). Acquisition indebtedness (vessel mortgages) cannot be prepaid with CCF dollars.

III. Qualified Agreement Vessels

Qualified Agreement Vessels are vessels acquired with the aid of Qualified Withdrawals and must be constructed or re-constructed in the United States, must be documented under the laws of the United States and must be operated in United States, Foreign, Great Lakes or Non-Contiguous Domestic Trade and must be engaged primarily in the waterborne carriage of men, materials, goods or wares. The term "Non-Contiguous Domestic Trade" includes transportation between the contiguous 48 states and the insular territories. Platforms and oil rigs attached to the sea bed of the outer continental shelf, beyond the three mile limit, are included as "insular territories". New Qualified Agreement Vessels must operate in this fashion for twenty (20) years from the date of acquisition. Used vessels must operate for ten (10) years from the date of acquisition.

The owner of a Qualified Agreement Vessel who sells the vessel within one year of acquisition is subject to a penalty equal to interest on the amount of the gain on the sale of the vessel attributable to the basis reduction and can only be done with a prior written approval of the Maritime Administration.

One difference between Eligible Agreement Vessels and Qualified Agreement Vessels is that Eligible Agreement Vessels can be operated in domestic trades on inland waterways, but Qualified Agreement Vessels cannot. The earnings from Qualified Agreement Vessels can also be deposited into a CCF even though not listed on schedule A to the CCF agreement.

IV. Penalties

The owner of a Qualified Agreement Vessel owes daily liquidated damages for each day that a Qualified Agreement Vessel is operated in violation of the geographic trading restrictions referred to above. The daily liquidated damage rate is based on a formula of the present value of the qualified withdrawals made to acquire that vessel plus the amount of any outstanding indebtedness on that vessel which may be paid in the future from a CCF times thirty percent (30%) divided by the duration of the trading restrictions on the vessel.

Non-Qualified Withdrawals are subject to income tax to the extent that the CCF deposits were made from a taxpayer's ordinary income and to the extent of the capital gain account of the fund. Non-Qualified Withdrawals are deemed to be made from the ordinary income account, then from the capital gain account. Simple interest is charged on the tax attributable to Non-Qualified Withdrawals from the year of deposit through the year of withdrawal.

Penalties can also be imposed for failure to fulfill a substantial obligation under the CCF Agreement.

V. Investment Restrictions

Earnings on investments in a CCF are tax free. CCF's are subject to detailed investment restrictions. In sum, no more than 60% of the value of the total assets of the fund can be invested in common or preferred stock of publicly traded companies. No more than 25% of the fund's value can be invested in the security of one issuer. Funds cannot be invested in securities of entities related to the fund owner. Interest in debt

instruments must either be issued by the United States Government or have obtained specified ratings from Standard and Poors or Moody's rating services. Margin transactions are not permitted.

VI. Reporting Requirements

Each year a report must be filed with the Maritime Administration updating the schedules attached to your CCF application and containing other information.

VII. Termination

A CCF may be terminated at any time upon mutual consent of the parties or upon completion of the objectives set forth on Schedule B unless modified to add future objectives. At termination, all remaining amounts in a CCF are treated as being withdrawn in a non-qualified withdrawal.

There are numerous other technical CCF rules. Please call me anytime to discuss your questions about the CCF program.

[1] Eligible Agreement Vessels are vessels constructed in the United States and operated in United States, Foreign or Domestic Commerce, which means operated by and between two points in the United States, a point in the United States and in a point in a foreign country, two points in the same foreign country or points in two different foreign countries. The Maritime Administration must be notified within ten (10) days of the sale of an Eligible Agreement Vessel.

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