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The Construction Reserve Fund

By: Leon H. Rittenberg, III

Practice Areas
- Admiralty & Maritime

This letter summarizes the basic rules, restrictions, and penalties associated with Construction Reserve Funds.

The Construction Reserve Fund ("CRF") is a United States Maritime Administration program that provides tax deferral benefits to owners and operators of U.S.-flagged vessels. The CRF permits eligible parties to defer the tax on gains from the sale or exchange of these vessels, as long as the proceeds are then reinvested in new vessels within approximately a three year period. It is similar to an extended 1031 exchange. In doing so, the CRF seeks to promote the construction, reconstruction, reconditioning, or acquisition of U.S. flagged vessels.

I. Eligibility Requirements

A CRF may be established by any citizen of the United States who owns, in whole or in part, a vessel or vessels operating in the foreign or domestic commerce of the United States or in the fisheries. The foreign commerce of the United States includes trades between the United States (including the District of Columbia), its territories and possessions, and a foreign country or other territories and possessions of the United States . The domestic commerce of the United States includes trade between ports of the United States and its territories and possessions contained within the coastwise laws, on the Great Lakes , and on inland rivers. Fisheries include the fisheries of the United States and its territories and possessions. In addition, any citizen who is operating such vessel or vessels owned by another individual may establish a CRF. However, the benefits available to the non-owner operator are limited.

II. Application Guidelines and Establishing a CRF

Any individual claiming to be eligible to the benefits of the CRF may make an application in writing, to the Maritime Administration of the Department of Transportation (Administration) for permission to establish a Construction Reserve Fund. Regulations specify the details of this application, and a small filing fee is required. In addition, an election must be filed with the individual's tax return in the year each vessel is sold.

III. Benefits

The principal tax benefit is the non-recognition of gain on the sale or actual or constructive total loss of a vessel when the net proceeds are timely deposited into a CRF and spent on a new vessel. However, earnings on funds deposited in a CRF are taxable in the year of receipt and are not deferred. Further, losses on investments in a CRF must be replaced. Therefore, it is important that securities purchased with CRF must be conservative. The cost basis in new vessels purchased with CRF deposits is reduced by the amount of non-taxable CRF deposits used for the purchase of the vessel.

An individual may be reimbursed from a CRF for payments prior to the establishment of the fund, or for payments subsequent to the establishment of the fund, provided that he has made necessary payments under a contract which satisfies the provisions of the regulations the Act for the construction or acquisition of a new vessel.

In determining "net proceeds," mortgage payoffs and brokers' commissions are deducted from the gross amount of the sales price.

Both ordinary income gain and capital gain may be deferred in this manner. The ability to defer gain under this provision applies only to vessel owners. Citizens operating a vessel owned by another individual cannot benefit from the provisions relating to the non-recognition of gain from the sale or loss of a vessel. A vessel owner or operator is also allowed to deposit into the CRF earnings from the operation of vessels documented under United States laws and earnings from the investment of the fund, unlike a Capital Construction Fund. These deposits of operating earnings are not tax deductible, and they do not delay the time such earnings can be included in gross income.

IV. Requirements for New Vessels/New Vessel Defined

The non-recognition gain of provisions applies only when money deposited in the CRF is allocated towards the construction, reconstruction, or acquisition of a new vessel or vessels. The Act requires that the new vessel be constructed or reconstructed in the United States and documented under the laws of the United States . Specifically, the vessel must either be greater than 2000 gross tons or have a speed more than 12 knots, unless a vessel in question has been determined and certified by the Administration as being useful to the United States in case of war or emergency.

V. Time Limits

Upon establishment of the fund, in order for an individual to be eligible for the benefits of the CRF, that person should , in the case of the sale or actual or constructive total loss of a vessel, deposit an amount equal to the net proceeds of the sale or to the net indemnity with respect to the loss into the CRF. This amount must be deposited into the CRF within sixty (60) days after it is received by the taxpayer.

Within three (3) years from the date of any deposit into a CRF, the money deposited must be obligated under contract toward the construction or acquisition of a new vessel. Within that time frame, not less than 12 ½ percent of the price of the vessel must be expended or irrevocably obligated. In addition, not less than five percent of the work on such vessel must be completed. Time extensions are possible, but are subject to final determination by the Secretary of Treasury.

VI. Penalties

Any deposited gain that is not expended or obligated within the period provided, or that is withdrawn before the expiration of such period for purposes other than: (1) the construction, reconstruction, reconditioning, or acquisition of a new vessel, or (2) the liquidation of existing or subsequently incurred purchase-money indebtedness to persons other than a parent company of, or a company affiliated or associated with, the mortgagor on a new vessel or vessels, shall be included in the taxpayer's gross income for such taxable year for income or excess-profits tax purposes.

Any additional tax due on account of withdrawal from a CRF, or failure to comply with section 511 of the Act or the regulations in this part, is collectible as a deficiency.

VII. Reporting Requirements

With each income tax return filed for a taxable year during any part of which a construction reserve fund is in existence, the taxpayer shall submit a statement setting forth a detailed analysis of such fund.

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