Construction Reserve Fund vs. Capital Construction Fund

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In times like this when business is great in the Marine Transportation Industry, vessel owners are always looking for ways to limit their tax obligations. The United States Maritime Administration ("MARAD") offers two great programs which allow vessel owners to limit their tax burden. These programs are called the Construction Reserve Fund and the Capital Construction Fund. They are not "tax shelters" but are government sponsored programs by which a vessel owner signs an agreement with MARAD which offers significant, legal, tax deferral opportunities. The professionals at MARAD do a spectacular job administering these and other programs, such as the Title XI ship finance program.

The Construction Reserve Fund ("CRF") program offers less tax deferral opportunities than the Capital Construction Fund ("CCF") program, but has fewer strings attached.

In a CRF, a vessel owner is allowed to defer income tax due from the sale of one or more vessels by committing to reinvest the net proceeds in a new vessel. If all of the net proceeds are deposited, no tax is due in the year of the sale of the vessel. The deposit must generally be obligated under a contract for the construction or acquisition of a new vessel within three years from the date of a deposit in a CRF. Withdrawals for the construction or acquisition of new vessels are tax free. New vessels built under a CRF must be United States flagged. There are no restrictions on the operation of a vessel under this CRF Program. Although profits from vessel trading operations and earnings on funds deposited in a CRF are subject to tax in the year earned, both may be deposited in a CRF. CRF deposits must be used for the construction or acquisition of new vessels. The cost basis in a new vessel is reduced by the amount of the CRF deposits for which taxes were deferred. Thus, a lower depreciation deduction is available for a vessel built under the CRF program. A CRF application must be filed and tentative approval granted by MARAD within sixty (60) days of the date a vessel is sold for the proceeds to be deposited to a fund on a tax deferred basis.

Under the CCF program, a vessel owner may obtain a tax deferral not just for the sales proceeds of a vessel, but also for all net operating profit attributable to eligible vessels and for earnings on funds deposited in a CCF account. Further, CCF deposits can be used both for the acquisition of new vessels and for the acquisition and reconstruction of used vessels. Deposits in a CCF may be held for up to 25 years. Withdrawals are tax free if used as set forth herein. A CCF application must be filed and approved by the due date of the taxpayer's income tax return for the year in which the initial tax benefits are sought.

There are substantial trading restrictions on vessels built under a CCF program. Specifically, new vessels must trade in the United States Foreign or Non-Contiguous Domestic Trade for a period of twenty years after they are constructed. Reconstructed (used) vessels must trade in this manner for ten years. In essence, vessels must travel from a United States port to a foreign port (or a offshore point in the Gulf of Mexico such as an oil rig) and back. Vessels built with CCF deposits may engage in foreign to foreign trade with advance permission of MARAD. There is a daily penalty for vessels built under the CCF which trade between two U.S. Ports. There is also a large penalty for funds withdrawn from the CCF

that are not used for the purchase of a new or used U.S. Flagged vessel. The cost basis in a new vessel is reduced by the amount of the CCF deposits for which taxes are deferred. Thus, a lower depreciation deduction is available for a vessel built under the CCF program.

Both CCF and CRF deposits can be used to pay the up front deposit or the full price of a vessel. They can also be used to pay a first preferred mortgage or other acquisition indebtedness incurred to acquire a vessel. For example, an owner can sell a vessel for $2,000,000 and apply the entire $2,000,000 as a down payment on a $10 million vessel and use subsequent qualified CCF or CRF deposits to pay off the ship mortgage on a tax deferred basis. Effectively, a vessel owner obtains a tax deduction not just for the interest portion of the debt but also for the principal.

Periodic reports and qualified trade affidavits must be filed with MARAD under each program.

The deferral of vessel sales proceeds under a CRF is respected both for income and alternative minimum tax purposes. CCF contributions are a corporate (but not individual) alternative minimum tax preference item. As a result, traditional “C” corporations have fewer benefits from a CCF than “S” corporations and LLC’s.

Although each program has strings attached for vessel operators who are committed to the industry long-term, the benefits typically far outweigh the costs.