



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

August 3, 2012

Number: **INFO 2012-0056**
Release Date: 9/28/2012

CONEX-128376-12

UIL: 9999.98-00

The Honorable Rick Larsen
Ranking Member
Subcommittee on Coast Guard and Maritime Transportation
Committee on Transportation and Infrastructure
U.S. House of Representatives
Washington, DC 20515

Dear Mr. Larsen:

Thank you for your letter to Commissioner Shulman dated June 26, 2012, regarding the tax effects of certain proposed changes to the Capital Construction Fund (CCF) program that the Maritime Administration administers (Title 46 of the United States Code chapter 535).

The CCF program assists owners of U.S.-flag vessels in accumulating capital to construct, reconstruct, or acquire vessels. You said that competent individuals suggested that the Maritime Administration could enhance the CCF program's effectiveness if it were to authorize using CCF funds to lease a vessel when the lease is the functional equivalent of a purchase. You also asked about the federal income tax consequences, including the effect on federal tax revenues that would result from this policy change.

On July 10, 2012, we discussed this matter with

. As we

understand it, your primary concerns are whether:

- A taxpayer can make qualified withdrawals from a capital construction fund for long-term lease payments

- A long-term lease is treated as a sale for federal income tax purposes.

Section 7518(e)(1) of the Internal Revenue Code (the Code) provides that a qualified withdrawal from a capital construction fund is one made under the terms of the agreement with the Maritime Administrator of the Department of Transportation, but only if it is for:

- The acquisition, construction, or reconstruction of a qualified vessel
- The acquisition, construction, or reconstruction of barges and containers that are part of the complement of a qualified vessel
- The payment of the principal on indebtedness incurred with the acquisition, construction, or reconstruction of a qualified vessel or a barge or container that is part of the complement of a qualified vessel.

Section 7518 does not address whether a long-term lease is treated as an “acquisition” in determining whether an amount withdrawn from a capital construction fund is a qualified withdrawal.

Our understanding is that the Department of Transportation’s regulations provide that withdrawals from a capital construction fund used to make operating lease payments cannot be qualified withdrawals because taxpayers must only use qualified withdrawals for costs that are capitalized for federal income tax purposes. See Title 46 of the Code of Federal Regulations sections 390.9(b)(1) and (c)(1). Generally, for a taxpayer to have capitalized costs in a leased vessel for federal income tax purposes, the lease must be treated as a sale.

Whether a lease is treated as a sale for federal income tax purposes is a highly factual inquiry, and a transaction can possibly be a lease for state law purposes and a sale for tax purposes, or vice-versa. The test for determining whether a transaction is a sale or lease is whether the benefits and burdens of ownership pass to the lessee. Numerous factors determine if the benefits and burdens of ownership pass to the lessee, including whether the lessee:

- Has acquired an equity interest in the property
- Bears the risk of economic loss or physical damage to the property
- Receives the profit from the operation, retention, and sale of the property
- Has an option to purchase the property for a nominal price. See *Grodts & McKay Realty, Inc. v. Commissioner*, 77 T.C. 1221, 1237-38 (1981); Revenue Ruling 55-540, 1955-2 C.B. 39.

The transfer or retention of title to the underlying property is not determinative.

Because of the factual nature of the inquiry, the issue of whether a long-term lease is treated as a sale for federal income tax purposes has resulted in substantial controversy

between taxpayers and the Internal Revenue Service. For the same reason, the Internal Revenue Service has a policy of not providing private letter rulings to taxpayers who ask whether a particular lease constitutes a sale for tax purposes. See Revenue Procedure 2012-3, 2012-1 C.B. 113. Accordingly, we think a policy that permits the use of CCF funds for “*leases that are treated as sales for federal tax purposes*” or for “*leases that are the functional equivalent of a purchase*” has the potential to create significant uncertainty and controversy for taxpayers. Ideally, any legislative change to the CCF program to extend it to leases would include a clear statement of whether a withdrawal from a CCF to make a payment on a lease is a qualified withdrawal for purposes of section 7518 of the Code.

Finally, as we explained to _____, the Internal Revenue Service does not calculate the revenue effects of proposed legislation. Therefore, we are unable to respond to your question about the effect on federal tax revenues of extending the use of CCF funds to leases.

I hope this information is helpful. If you have further questions, please call me at _____ or _____ at _____.

Sincerely,

Andrew J. Keyso
Associate Chief Counsel
(Income Tax & Accounting)