Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:CTM:SEA:TL-N-3770-01
CAGoodson

date:

to: Barbara Knight, Team Manager
Internal Revenue Service, LMSB
Seattle, Washington

from: Associate Area Counsel, LMSB
Seattle

---

subject: [redacted]
Pre-Filing Agreement Request
Capital Construction Funds Issues

Non-Precedential Statement

This memorandum should not be cited as precedent.

This memorandum concerns [redacted]'s request to enter into a pre-filing agreement (PFA). More specifically, we address [redacted]'s arguments with respect to how sections 41 (research credit provisions) and 7518 (capital construction fund provisions) interact. (See [redacted]'s paper titled "Interaction of Capital Construction Fund Provisions of the Merchant Marine Act of 1936 with the Research Credit Provisions (hereafter "[redacted]'s CCF Mem.")). We also discuss issues raised by the Service's PFA team.

ISSUES

1. Whether, as [redacted] claims, "qualified withdrawals from capital construction funds for the acquisition or construction of qualified vessels may also include research, development, and design costs."

2. Whether [redacted] is entitled to benefit from both the capital construction fund (CCF) provisions and the research credit provisions.

3. Whether the research credit should be reduced by [redacted]'s CCF withdrawals.

BRIEF ANSWERS

Contrary to [redacted]'s arguments, section 7518 treats capital construction fund withdrawals for "research, development, and design" unfavorably; the statute does not treat such withdrawals differently if a vessel is ultimately constructed.

Section 280C(c) will reduce the amount by which [redacted] will benefit from both the CCF provisions and the research credit provisions. Additionally, [redacted] may properly calculate the research credit without first reducing qualified research expenses by its CCF withdrawals.

FACTS

Section 7518 provides tax incentives relating to merchant marine capital construction funds (CCF funds). The Department of Transportation, Maritime Administration ("MARAD") administers the capital construction program, and determines whether shipping companies involved in the program comply with the program's objectives.

In [redacted], [redacted] asked MARAD to allow it to use its CCF funds to construct (not to "research" or "design") [redacted] vessels. It stated that the vessels would cost $[redacted] each, for a total of $[redacted]. MARAD approved [redacted]'s request.

On [redacted], [redacted]'s subsidiary, [redacted][1], entered into a contract with [redacted] to "construct, outfit, test, and deliver" the [redacted] ships. In the contract, [redacted] agreed to pay [redacted] $[redacted] for the [redacted] ship and $[redacted] for the [redacted] ship. Pursuant to the contract, [redacted] paid $[redacted] to [redacted] in [redacted], of which $[redacted] came from [redacted]'s CCF fund. (Contract Payment Schedule, Line [redacted] less Line [redacted] and Line [redacted].

[redacted] asserts that the entire $[redacted] it will pay for the [redacted] vessel over the next several years constitutes a qualified research expense. At issue for purposes of the PFA is the $[redacted] paid in [redacted].

[redacted] described its activities as:

> [D]esigning, research[ing] and developing an experimental vessel for ultimate use in the transportation of cargo between [redacted], Washington, and [redacted], Alaska.

---

[1] For ease of discussion, we hereafter use "[redacted]" to refer to [redacted], [redacted] and [redacted].

> The research and experimentation process covers the period from the start of the concept and feasibility stage through the fabrication stage and the validation testing stage. The vessel's component parts will be used as qualified supplies during the fabrication stage and the vessel itself will be utilized as a qualified supply during the basic sea trials and the ultimate performance validation testing in the harsh conditions of the [redacted] passage that the vessel is intended to operate. Accordingly, the vessel and its component parts are used as supplies for research purposes from the start of fabrication through final validation testing.

([redacted] Post Launch Mem. § II).

DISCUSSION

Section 7518 generally encourages construction or reconstruction of merchant vessels in U.S. shipyards. It allows taxpayers to establish a tax-deferred reserve fund, called a capital construction fund, for the replacement or addition of qualified vessels. I.R.C. § 7518(a).

Amounts deposited in a CCF are deductible from taxable income and investment earnings are generally excluded from income. I.R.C. § 7518(c). When a taxpayer withdraws funds to acquire, construct, or repair a qualified vessel, the withdrawal will be considered "qualified" and the taxpayer will not be required to recognize income. I.R.C. § 7518(f). If, however, the taxpayer withdraws funds for other, "nonqualified" purposes, the taxpayer will be required to recognize income. Moreover, the resulting tax liability is subject to interest payable from the time the amount withdrawn was originally deducted. I.R.C. § 7518(g)(3). In the next section, we discuss [redacted]'s view of whether withdrawals for "research" are qualified withdrawals.

1. **Whether, as [redacted] claims, "qualified withdrawals from capital construction funds for the acquisition or construction of qualified vessels may also include research, development, and design costs."**

[redacted] asserts that section 7518 treats withdrawals for "research, development, and design" as qualified withdrawals as long as a ship is eventually constructed. [redacted]. (stating "[w]here withdrawals are made for research, development, and design expenses associated with the construction, reconstruction, or acquisition of a vessel such withdrawals are qualified withdrawals"); [redacted] (stating withdrawals will be treated as nonqualified withdrawals if "there is no construction, acquisition or reconstruction and research expenditures are made"); [redacted]. (stating "qualified withdrawals from capital construction funds ... may include research, development and design costs")).

Neither the statute nor its legislative history support [redacted]'s position. Section 7518(e)(1)(A) states that "qualified withdrawals" include those for acquisition, construction or reconstruction of qualified vessels. Qualified withdrawals may also be made to acquire, construct, or reconstruct barges and containers, and to make payments on debt incurred (principal only) to acquire, construct, or reconstruct qualified vessels, barges, and containers. I.R.C. §§ 7518(e)(1)(A), (B). The statute does not specifically include "research and design"; by implication, withdrawals for other purposes--including researching, developing, and designing--are nonqualified withdrawals.

Section 7518(g) supports this view. It states that "any nonqualified withdrawal for research, development, and design expenses incident to new and advanced ship design, machinery and equipment" shall be treated in a special manner. I.R.C. § 7518(g) (flush language). This special treatment implies such withdrawals are nonqualified See also Richard E. Madigan, Taxation of the Shipping Industry 35 (2d ed. 1983) (stating that nonqualified withdrawals will be authorized when "the party desires to make a research development and design expenditure incident to a new and advanced ship design").

Section 7518's legislative history expressly provides that withdrawals for research are nonqualified:

> Section 607(b)(A) of present law authorizes withdrawals for "research and design expenses incident to new and advanced ship design machinery and equipment." Under this bill's revision of section 607, such an expenditure will be treated as a non-qualified withdrawal, which usually will be added to taxable income.

S. Rep. No. 91-1080 at 49 n.10 (1970); H.R. Rep. No. 91-1073 at 53 n.10 (1970) (emphasis added). The relevant portions of the statute have not changed since 1970. Congress did not include any exception for instances where the research, development, and design expenses were associated with constructing or acquiring a new ship.

In short, we believe [redacted]'s view of section 7518 is incorrect. Section 7518 and its legislative history provide that withdrawals for research, development, and design expenses incident to ship design are nonqualified withdrawals. Contrary to [redacted]'s argument, neither the statute nor the legislative history treat research, development, and design expenses as qualified as long as the expenses are associated with acquiring or constructing a ship.

A related topic is that it appears [redacted] has been inconsistent with respect to sections 7518 and 41. For purposes of section 7518, [redacted] represented to MARAD that it intended to construct [redacted] vessels; it did not use the word "research." For purposes of claiming the research credit, however, [redacted] stated it was "designing, researching and developing an experimental vessel." [redacted].

As stated in other memorandums, we do not believe [redacted] is entitled to section 41's research credit on amounts it paid [redacted] to construct a vessel. If it is, the Commissioner should consider whether such amounts constitute section 7518 nonqualified withdrawals. We caution you, however, that [redacted] may be entitled to have it both ways: "qualified research" for purposes of section 41 may not be the same as "research, development, and design" for purposes of section 7518.

2. Whether [redacted] is Entitled to Benefit From Both the CCF Provisions and the Research Credit Provisions.

Another question is whether [redacted] is entitled to two tax benefits. [redacted] obtained the first tax benefit via the CCF provisions: [redacted] deducted its contributions to its CCF fund from income and did not recognize gains on the fund's growth. If the Service enters into a PFA with the taxpayer and allows research credits, the research credits would provide the second benefit: [redacted] believes it is entitled to the research credit on amounts it paid to construct a ship, even though it obtained the amounts from its CCF fund.

[redacted] argues that the investment tax credit is analogous to the research credit and that the Court of Claims decided the issue in the taxpayer's favor (the taxpayer was entitled to the investment tax credit even though it had used CCF funds). ([redacted] CCF Mem. § B.4., citing Ogelebay Norton Company v. United States, 610 F.2d 715 (Ct. Cl. 1979)).

Although the Commissioner lost the issue in several claims court cases, the Commissioner won the issue in the Tax Court. Zuanich v. Commissioner, 77 T.C. 428 (1981) (disallowing the investment tax credit because the taxpayer reduced its basis in the asset to zero when it used CCF funds). The Service is not, however, pursuing this issue. Rev. Rul. 91-54, 1991-2 C.B. 15.

The investment tax credit and the research credit are computed differently. The investment tax credit is computed on the basis of qualified investment in certain property placed in service during the year. I.R.C. §§ 46(a)(1) and (c)(1). The research credit, on the other hand, is computed by determining a taxpayer's qualified research expenses. I.R.C. § 41(a). Thus, analogizing investment tax credit cases with research credit issues may not be helpful.

More importantly, section 280C(c) applies. Section 280C(c) requires taxpayers to reduce their deductions by the amounts of the research credit. Specifically, it provides:

> No deduction or credit shall be allowed for that portion of the qualified research expenses (as defined in section 41(b)) or basic research expenses (as defined in section 41(e)(2)) otherwise allowable as a deduction or credit for the taxable year which is equal to the amount of the credit determined for such taxable year under section 41(a).

I.R.C. § 280C(c)(1). Alternatively, taxpayers may elect to reduce the research credit. I.R.C. § 280C(c)(3).

Here, under section 7518(c), [redacted] deducted CCF contributions from income when it made the deposits. It asserts that the entire $[redacted] paid to [redacted] in [redacted] qualifies as a section 174 expense and for the section 41 credit. [redacted] will claim a $[redacted] section 174 deduction ($[redacted] less the amount of its CCF withdrawals, $[redacted] in [redacted]).

If [redacted] is entitled to the research credit, it must further reduce the $[redacted] section 174 deduction by the research credit. I.R.C. § 280C(c). If the $[redacted] section 174 deduction is not sufficient to absorb the research credit, [redacted] must reduce its section 7518(c) deductions by the research credit amount.[2]

3. Whether the Research Credit Should be Reduced for [redacted]'s CCF Withdrawals.

Generally, "qualified research" is research "with respect to which expenditures may be treated as expenses under section 174." Sections 7518(f)(2) and (3), however, require taxpayers to adjust the vessel's basis by the amount of the qualified withdrawals. Here, [redacted] must reduce its $[redacted] basis by the $[redacted] in CCF withdrawals. The question is therefore whether to compute the research credit on the whole amount (approximately $18 million) or on only the net amount ($[redacted] (excluding the $[redacted] basis reduction).

We believe the research credit should be computed on the entire $[redacted]. Specifically, section 41(d)(1)(A) requires

---

[2] If the Service enters into a PFA with [redacted], we will further investigate section 280C's mechanics (e.g., whether [redacted] must file amended returns for years it originally deducted its CCF contributions).

only that eligible "expenditures may be treated as expenses under section 174." The statute does not require the taxpayer actually deduct the expenses; [redacted] may calculate its research credit on the entire $[redacted].

CONCLUSION

Section 7518 treats withdrawals for research, development, and design expenses incident to new and advanced ship design as nonqualified withdrawals. Contrary to [redacted]'s position, neither the statute nor its legislative history treat these expenses as qualified if the research, development and design expenses result in a vessel. Further, the taxpayer has taken inconsistent positions with respect to obtaining the benefits of sections 41 (research credit) and 7518 (capital construction fund). The Service should not sanction [redacted]'s inconsistent approach.

Section 280C lessens section 41's inherent double tax benefit (section 7518's deduction and section 41's credit). Further, if [redacted] is entitled to the research credit, it is entitled to compute the credit on the entire amount; section 41 does not require [redacted] to net out its CCF funds.

If you have any questions or if you should need any additional information, please contact us at 206-220-5951.

Disclosure Statement

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney-client privilege. If disclosure becomes necessary, please contact this office for our views.

ROBERT F. GERAGHTY
Associate Area Counsel
(Large and Mid-Size Business)

By:_____
CATHY A. GOODSON
Attorney (LMSB)