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October 20, 1995

The Honorable Walter Dellinger
Assistant Attorney General
Office of Legal Counsel
United States Department of Justice
10th & Constitution Avenue, N.W.
Washington, D.C. 20530

Dear Mr. Dellinger:

The enclosed Memorandum of Law, which analyzes the jurisdictional issues that were recently submitted to the Office of Legal Counsel in connection with the capital construction funds program administered by the Maritime Administration and the National Oceanic and Atmospheric Administration, is respectfully submitted by the Morrison Knudsen Corporation.

The Memorandum of Law is devoted to an analysis of the legal issues raised by this jurisdictional dispute. We also enclose an appendix detailing the ongoing efforts by the Internal Revenue Service to exert against Morrison Knudsen an authority that we believe the IRS does not possess. Finally, for the convenience of OLC, we enclose copies of the most important authorities on which our legal analysis rests.

For the reasons set out in detail in our Memorandum, Morrison Knudsen strongly supports the positions taken by the Departments of Transportation and Commerce in their disagreements with the Department of the Treasury.

Morrison Knudsen and its attorneys will be happy to respond to any inquiries that OLC may have about the enclosed documents or the matters to which they relate.

Yours sincerely,

H. C. Cook Jr.

H. Clayton Cook, Jr.

Enclosures

cc: Rosalind Knapp
Acting General Counsel
Department of Transportation

Edward S. Knight
General Counsel
Department of the Treasury

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General Counsel
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Recieved by Lawon Robinson
Date 10/20/95

MEMORANDUM OF MORRISON KNUDSEN CORPORATION

IN SUPPORT OF THE JOINT BRIEF OF THE UNITED STATES DEPARTMENT OF TRANSPORTATION AND DEPARTMENT OF COMMERCE

IN THE MATTER OF

AUTHORITY TO ADMINISTER THE CAPITAL CONSTRUCTION FUNDS ESTABLISHED UNDER THE MERCHANT MARINE ACT OF 1936

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MEMORANDUM OF MORRISON KNUDSEN CORPORATION

IN SUPPORT OF THE JOINT BRIEF OF THE UNITED STATES DEPARTMENT OF TRANSPORTATION AND DEPARTMENT OF COMMERCE

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MEMORANDUM OF MORRISON KNUDSEN CORPORATION

IN SUPPORT OF THE JOINT BRIEF OF THE UNITED STATES DEPARTMENT OF TRANSPORTATION AND DEPARTMENT OF COMMERCE

INTRODUCTION

From the time it was first enacted, section 607 of the Merchant Marine Act of 1936 has included tax incentives to encourage the construction in the United States of U.S.-flag merchant vessels.[1] In 1970, Congress added the Capital Construction Fund ("CCF") Program to the Merchant Marine Act in order to provide tax deferral benefits for domestic shipbuilding on an expanded basis.[2] At that time, Congress specifically and expressly provided that the tax benefits would be made available through contracts with private parties administered by the Department of Commerce (and, later, the Department of Transportation).[3] In doing so, Congress deliberately removed the Department of Treasury from the administrative role that it had assumed immediately after World War II through the negotiation of taxpayer "closing agreements."

This congressional reassignment of administrative responsibilities generated the controversy that has evolved into the dispute that is now before OLC. The Department of the Treasury tried and failed to secure repeal of the CCF Program in 1986. It then tried and failed to secure the transfer of administrative responsibility back to Treasury in 1992. Having failed to achieve its legislative goals, Treasury now seeks to accomplish those same goals by challenging the right of individual taxpayers to rely on statutorily authorized decisions made by DOT and

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[1] Merchant Marine Act of 1936 (the "1936 Act" or the "Act"), Pub. L. No. 74-835, § 607, 49 Stat. 1985, 2005 (1936) (codified as amended at 46 U.S.C. app 1177 (1988)). All references herein to section 607 or § 607, or to subsections thereof, refer to section 607 of the Merchant Marine Act of 1936, as amended.

The 1936 Act, along with the other authorities principally relied on in this Memorandum, are collected in Appendix I to the Memorandum.

[2] Merchant Marine Act of 1970 (the "1970 Act" or the "1970 Amendments"), Pub. L. No. 91-469, § 21, 84 Stat. 1018, 1026-32 (codified as amended at 46 U.S.C. app. 1177 (1988)).

[3] Actual administration of CCF contracts is carried out by the Maritime Administration at Transportation ("MARAD") and the National Oceanic and Atmospheric Administration at Commerce ("NOAA"). *See, e.g.*, 49 CFR § 1.66 (delegation of 1936 Act functions to MARAD, except for CCF functions delegated to NOAA). MARAD was situated in the Commerce Department in 1970, but was moved to Transportation in 1983. *See* Pub. L. No. 97-449, 96 Stat. 2414 (1983), codified as amended at 49 U.S.C. §§ 101-102 (1988 & West Supp. 1995).

Commerce.[4]

Morrison Knudsen Corporation ("MK") is a former CCF holder who—like many other companies in the maritime and fishing industries—is being adversely affected by this interagency dispute.[5] Despite its interest in the outcome of the dispute, however, MK does not seek either to involve OLC directly in a specific taxpayer dispute or to become a party to the OLC proceedings. Rather, the purpose of this Memorandum is to demonstrate the incompatibility of Treasury's jurisdictional arguments with the applicable statutes and regulations, and to clarify the implications of the Treasury's current course of action.

A full appreciation of the nature of Treasury's position, and of its potential impact on taxpayers like MK who are parties to binding CCF agreements with the United States, is vital to an informed decision in the dispute now under consideration by OLC.

HISTORICAL BACKGROUND

The 1936 Act was one of several congressional enactments in the first half of the twentieth century intended to foster the development and continued maintenance of a modern United States merchant marine and a vigorous domestic shipbuilding industrial infrastructure.[6] Section 101 of the 1936 Act sets out its purposes and policy:

> It is necessary for the national defense and development of its foreign and domestic commerce that the United States shall have a merchant marine (a) sufficient to carry its domestic water-borne commerce and a substantial portion of the water-borne export and import foreign commerce of the United States and to provide shipping service essential for maintaining the flow of such domestic and foreign water-borne commerce at all times, (b) capable of serving as a naval and military auxiliary in time of war or national emergency, (c) owned and operated under the United States flag by citizens of the United States insofar as may be practicable, (d) composed of the best-equipped, safest, and most suitable types of vessels,

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[4] Treasury apparently maintains that Congress intended, through section 261 of the 1986 statute that revised and recodified the Internal Revenue Code, Tax Reform Act of 1986, Pub. L. No. 99-514, § 261, 100 Stat. 2085, 2208 (1986) (codified as amended at 46 U.S.C. § 1177, 26 U.S.C. §§ 26, 7518 (1988)), to transfer responsibility for the administration of this Program from the Departments of Commerce and Transportation to the Treasury Department. For the reasons set out in detail in this Memorandum, MK joins DOT and Commerce in challenging Treasury's claims.

[5] MK's interest in this matter is illuminated by the detailed factual history set out in Appendix II, at Tab A. The supporting documents relevant to that history are found in Appendix II, at Tab B.

[6] Earlier related expressions of this policy include the Cargo Preference Act of 1904, ch. 1766, 33 Stat. 518 (1904); the Shipping Act of 1916, Pub. L. No. 64-260, 39 Stat. 728 (1916); and the Merchant Marine Act of 1920, Pub. L. No. 66-250, § 23, 41 Stat. 997-98 (1920). The current CCF Program is only the most recent example of the longstanding congressional use of tax policy to promote maritime interests.

> constructed in the United States and manned with a trained and efficient personnel, and (e) supplemented by efficient facilities for shipbuilding and ship repair. It is hereby declared to be the policy of the United States to foster the development and encourage the maintenance of such a merchant marine.[7]

The statutory basis for the current CCF Program, which was established by the 1970 Amendments to the 1936 Act, is related to that of prior "capital reserve" and "special reserve" tax deferral programs authorized under the 1936 Act. The CCF Program established in 1970 shares the objectives of its predecessors. It was, however, intended to be much more ambitious; to serve a much larger constituency; and to do so in a fashion that would be more efficient than these predecessors. Congress placed responsibility for the Program's implementation in the Department of Commerce (where both MARAD and NOAA were then located).

Congress has provided special tax treatment to the merchant marine and shipbuilding sectors of our economy almost from the founding of the Republic.[8] In this century, shipbuilding tax incentives first appeared in the Merchant Marine Act of 1920. The 1920 Act exempted United States citizen vessel owners from the income tax imposed under the Revenue Act of 1918 on vessel earnings and sale proceeds used for construction in the United States of vessels to be operated under the U.S. registry.[9] The 1936 Act, which exempted vessel operating and sales proceeds from tax in a more detailed fashion, also required contracting vessel owners to assure fleet renewal by setting aside sufficient monies in reserve funds to finance new vessel construction.[10]

Subsequent Congresses and Administrations have recognized the importance of U.S.

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[7] 46 U.S.C. app. § 1101.

[8] The first act of the First Congress, which imposed duties on imported goods, allowed a 10% reduction in duty on goods arriving in U.S. ships. H. D. Bress & M.T. Farris, *U.S. Maritime: Policy History and Prospects* 14 (1981). *See also* I.M. Heine, *The United States Merchant Marine: A National Asset* 3-4 (1976); S. A. Lawrence, *United States Merchant Shipping: Policies and Politics* 7-8 (1966).

[9] Merchant Marine Act of 1920, Pub. L. No. 66-250, § 23, 41 Stat. 997-98 (1920) (codified at 46 U.S.C. §§ 878-879) (repealed, Pub. L. No. 100-710, § 202(4), 102 Stat. 4753 (1988)).

[10] Merchant Marine Act, ch. 858, § 607(f), 49 Stat. 1985 (1936) (redesignated § 607(h) by the 1938 amendments to the Merchant Marine Act, ch. 600, § 28, 52 Stat. 953, 961) (1938) ("The earnings of any contractor receiving an operating differential subsidy under authority of this chapter, which are deposited in the contractor's reserve funds as provided in this section . . . shall be exempt from all Federal taxes."). The 1936 Act provisions exempted all capital reserve fund deposits from taxation at a then maximum corporate rate of 15%. The IRS unsuccessfully challenged the application of the provision in *Seas Shipping Co. v. Comm'r,* 1 T.C. 30 (1942), where the court rejected the contention that IRS' interpretation of section 607(h) language should override that of the United Stated Maritime Commission.

shipyard capability to the national defense and national industrial infrastructure.[11] When the current CCF provisions were enacted in 1970, Congress extended the capital formation benefits of tax deferral beyond the thirteen subsidized operators then under 1936 Act contracts.[12] Dissatisfied with the IRS practice of negotiating closing agreements with individual participants in the 1936 Act Program, Congress also deliberately replaced this existing practice with a more specific statutory framework for determining the tax status of deposits into and withdrawals from the fund.[13]

In both the Senate and the House, the responsible Committees viewed the CCF provisions as the most important single element of the 1970 Act effort to revitalize our domestic shipyards and the U.S. flag merchant fleet. The Senate Report stated that this expansion of tax deferral benefits "will do more than any other provision of this bill to build ships in the United States shipyards to be operated under the American flag."[14] Continuing concern for the importance of the Federal government's role in assuring a vigorous domestic shipbuilding capacity is reflected in the 1993 National Defense Authorization Act, and in the National Shipbuilding and Shipyard

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[11] These concerns found expression in the Merchant Ship Sales Act of 1946, Pub. L. No.79-321, 60 Stat. 41 (1946); the Agricultural Trade Development and Assistance Act of 1954, Pub. L. No. 83-480, 68 Stat. 454 (1954), which was subsequently amended by the Food for Peace Act of 1966, Pub. L. No. 89-808, 80 Stat. 1526 (1966); and the Cargo Preference Act of 1954, Pub. L. No. 83-664, 68 Stat. 832 (1954), which was subsequently amended by the Act of September 21, 1961, Pub. L. No. 87-266, 75 Stat. 565 (1961).

[12] The provisions were intended to "expand the scope of the tax deferral system for merchant ship construction to include all qualified operators." 116 Cong. Rec. 16,592 (May 21, 1970) (remarks of Mr. Mailliard).

[13] As the minority floor manager observed:

> [While] H.R. 15424, as introduced, simply expanded the existing tax deferral provision . . . . your committee determined that section 607 should be completely rewritten to eliminate the need for Internal Revenue Service closing agreements . . . . [T]he staff of the Joint Committee on Internal Revenue Taxation assumed the principal role in this undertaking. The bill, as reported, sets forth the technical revisions to the tax deferral system as recommended by the staff of the joint committee. This revision will permit the administration of the tax deferral system by the Secretary of Commerce in conjunction with the Secretary of the Treasury without the need for individual closing agreements.

Id. (remarks of Mr. Mailliard).

[14] S. Rep. No. 1080, 91st Cong., 2d Sess. 39 (1970), *reprinted in* 1970 U.S.C.C.A.N. 4188, 4213 ("1970 Senate Report"). Similarly, the Committee emphasized:

> It is believed that these provisions will do more than anything else in the bill to help the ship operating, and therefore the shipbuilding industry to build ships in United States yards which are so urgently needed to modernize the United States merchant marine.

Id. at 43, 1970 U.S.C.C.A.N. at 4216-17.

Conversion Act of 1993.[15]

Despite Congress' repeated reaffirmation of this specialized program of tax incentives, it has been a repeated and continuing target of IRS attacks. Beginning at least as early as the IRS' unsuccessful *Seas Shipping Co.* challenge to the United States Maritime Commission administration of the original 1936 Act tax provisions, for example, Treasury and the IRS have sought to void fundholder tax benefits.

In *Seas Shipping*, the IRS urged denial of a taxpayer's reduction of its 1938 income by the amount of deposits pursuant to the taxpayer's contract with the United States Maritime Commission.[16] IRS justified denial on the basis that the deposited earnings were not "earnings" within the meaning of the contract.[17] The Tax Court rejected the IRS position.[18] The court found that the language of the statute was unambiguous,[19] and upheld the contracting taxpayer's rights to its contract benefits on the basis of the Maritime Commission's congressionally conferred authority to fix and interpret contract terms binding on the United States.[20]

In a set of post-World War II forays, the IRS disallowed taxpayer exemptions claimed on wartime earnings and vessel disposition proceeds by 1936 Act contract holders. In these instances,

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[15] The present Administration's position is set forth in the President's October 1, 1993, transmittal to Congress of the Administration's "Strengthening America's Shipyards: A Plan For Competing In the International Market":

> The U.S. Shipbuilding industry is unsurpassed in building the finest and most complex naval vessels in the world. Now that the Cold War has ended, these shipyards, like many other defense firms, face a new challenge—translating their skills from the military to the commercial market. Individual shipyards already have begun to meet this challenge. The enclosed report describes steps that the Government is taking and will take to assist their efforts. I look forward to working with Congress and the industry to ensure a successful transition to a competitive industry in a truly competitive market place.
>
> William J. Clinton,
>
> The White House,
> October 1, 1993

[16] *Seas Shipping Co. v. Comm'r*, 1 T.C. 30, 37 (1942), *Commr's appeal dismissed*: unpublished op. (2d Cir. 1944).

[17] IRS argued that section 607(h) could not be construed to allow "a wholesale exemption from tax with respect to any and all earnings that might be deposited in a reserve fund provided for by an agreement . . ." *Id.*

[18] *Id.* at 40 (holding that "the [taxpayer] is not liable to income tax for 1938 upon any part of its earnings for that year deposited in the capital reserve").

[19] *Id.* at 39 ("earnings . . . deposited in the contractor's reserve funds . . . shall be exempt from all Federal taxes").

[20] *Id.*

the IRS was more successful than it had been before: IRS achieved a substantial voice in the administration of the program's tax aspects through taxpayer "closing agreements" negotiated separately between the IRS and each program participant.

From 1947 to 1970, the tax aspects of the 1936 Act fund contracts were ostensibly administered by the IRS through these closing agreements.[21] However, despite these agreements, the IRS continued to challenge the tax deferral benefits that the 1936 Act provided. Frequently, IRS persisted in revisiting issues despite prior court decisions indicating that IRS positions were untenable under the governing statute. In *Pacific Transport*, for example, the Tax Court pointed out that the IRS theory was "squarely contrary to the reasoning and holding in *Seas Shipping* [and] clearly contrary to the provisions of section 607(h) of the Merchant Marine Act."[22] The closing agreement, the Tax Court held, "did not and could not have the effect of modifying a statute."[23] While IRS accepted the Tax Court holding in *Pacific Transport* in 1971,[24] it refused to accept the Claims Court's en banc 1976 decisions in *Pacific Far East Line* and two companion cases until 1991.[25] The three 1976 en banc decisions followed IRS defeats in two companion Claims Court cases involving the same general issue in 1975,[26] and were followed by three more IRS challenges on the same subject, in the same court.[27]

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[21] The closing agreements apparently succeeded in freezing new benefits generally at the reduced levels, since contracts concluded after 1947 were required to be consistent with the terms of existing closing agreements. *See Pacific Far East Line, Inc. v. United States*, 544 F.2d 478, 481 (Ct. Cl. 1976) (en banc), *aff'g on other grounds* 513 F.2d 1355 (Ct. Cl. 1975).

[22] *Pacific Transport Co. v. United States*, 29 T.C.M. (CCH) 133 (1970) (direct IRS challenge to tax benefits for deposits into MARAD reserve funds, based on IRS interpretation of a closing agreement).

[23] *Id.* at 178.

[24] Rev. Rul. 71-349, 1971-2 C.B. 155; G. C. M. 34455 (March 12, 1971).

[25] *See Pacific Far East Line, Inc., v. United States*, 544 F.2d 478 (Ct. Cl. 1976) (en banc) (rejecting IRS argument that to the extent vessels were acquired with tax-exempt amounts from CCF funds, no investment tax credits could be allowed under a closing agreement); *Pacific Transport Co. v. United States*, 544 F.2d 493 (Ct. Cl. 1976) (en banc) (same); *Delta Steamship Lines, Inc. v. United States*, 544 F.2d 496 (Ct. Cl. 1976) (en banc) (same). Two years later, the IRS refused to consider these cases controlling with respect to 1970 Act withdrawals from CCFs. A.O.D. 1978-91 (Apr. 10, 1978). Not until fifteen years after the three en banc decisions did IRS finally accept the Claims Court's position. Rev. Rul. 91-54, 1991-2 C.B. 15 (suspending two late 1960's rulings that denied investment tax credits with respect to CCF-financed vessels).

[26] *Pacific Far East Line, Inc. v. United States,* 513 F.2d 1355 (Ct. Cl. 1975); *Lykes Bros. Steamship Co. v. United States*, 513 F.2d 1342 (Ct. Cl. 1975).

[27] *Oglebay Norton Co. v. United States,* 610 F.2d 715 (Ct. Cl. 1979) (reaffirming the court's position in its 1976 *Pacific Far East Line* opinion); *O. L. Schmidt Barge Lines, Inc. v. United States*, 610 F.2d 728 (Ct. Cl. 1979) (a companion case to *Oglebay Norton* decided the same way); *Moore McCormack Resource, Inc. v. United States*, 224 Ct. Cl. 672 (1980) (again rejecting IRS challenge to investment tax credit for monies deposited into a CCF).

IRS' ability to generate so much litigation, over the same persistently court-disapproved theories, concerning so few (thirteen) fundholders, at a time when IRS had partial control over program benefits through closing agreements, demonstrates the depth of IRS' hostility. As the Tax Court first recognized, in focussing on allegedly unauthorized taxpayer benefits, the IRS had lost sight of the congressionally mandated maritime program goals.

> By the Merchant Marine Act, . . . Congress was principally concerned in building up a merchant marine. The act was not primarily for the benefit of the operator. It was for the benefit of the United States.[28]

The current CCF provisions were adopted by Congress in 1970 in order to effect a continuation of the 1936 Act policies on an expanded basis, and to eliminate the IRS-inspired obstacles that the 1936 Act program had encountered. The 1970 Amendments followed the pattern of the 1936 Act in placing Program control over the availability of tax deferral benefits in the cabinet department where the agencies with maritime knowledge resided, not in Treasury. The 1970 Amendments provided a highly detailed statutory specification of the rules that were to govern tax deferral, and restored maritime agency responsibility for maritime program tax administration. Congress believed that only the maritime agencies would administer the Program consistent with congressional purposes. And, Congress believed that it had taken the steps necessary to safeguard the integrity of Program administration.

As revised, Section 607 assigned complete and exclusive authority for Program administration to the Department of Commerce (where both MARAD and NOAA were then situated). Section 607 gave Treasury no role in the Program, except to the extent that subsection (*l*) authorized Commerce and Treasury *jointly* to issue "rules and regulations not inconsistent with the foregoing provisions of this section, as may be necessary or appropriate to the determination of tax liability under this section." Subsequent legislative enactments, including those adopted in 1986, have not modified the jurisdictional divisions which Congress established between Commerce and Treasury in 1970.

All this notwithstanding, Treasury and IRS opposition to the use of tax deferral as a means of encouraging fleet renewal has continued. In 1984 and 1985, the Treasury proposed to terminate the CCF Program. In 1992, Treasury sought to have control over the Program transferred to

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[28] *Seas Shipping Co.*, 1 T.C. at 39, *quoted in Pacific Transport Co.*, 29 T.C.M. (CCH) at 177-78. *See also Pacific Transport Co.*, 29 T.C.M. (CCH) at 174 ("[A CCF deposit] is a contractual deposit required or necessitated to serve the purposes of the [Act], namely, to foster the development of a modern efficient merchant marine which is capable of carrying our domestic commerce and a substantial part of our foreign commerce, and capable of serving as a naval auxiliary in times of war or national emergency."). Even after passage of the 1970 Act, the Tax Court continued to find itself reviewing cases brought by IRS in disregard of the policies and purposes of 1936 Act reserve funds. *See Eades v. Commissioner*, 79 T.C. 985, 992 (1982) (reaffirming that the 1970 Act "exhibits the clear congressional intent to allow a deferral of the ordinary income tax and capital gains tax" on amounts deposited into a capital construction fund, though denying such deferral for the self-employment tax).

Treasury. Congress rejected each such effort. In 1993, one year after congressional rejection of the 1992 Treasury proposal, the IRS commenced its audit challenges to MK/NASSCO, and Treasury acted to block publication of NOAA Program regulations.

The MARAD CCF Program now embraces 111 contract agreements, with aggregate deposits of approximately $1.2 billion. NOAA administers approximately 3,300 Program contracts with deposits which aggregate approximately $241 million.

STATUTORY FRAMEWORK

The CCF Program achieves its policy goals by means of contracts. In order to implement the Program, NOAA (for fishing vessels) or MARAD (for other vessels) must let and oversee CCF contracts. MARAD and NOAA induce eligible U.S. citizens to commit to undertake activities that further CCF policies by committing the United States to defer tax on monies deposited to finance these activities. CCF tax deferral benefits constitute contract consideration.[29] They are therefore unlike any other deferral benefits provided for in the Internal Revenue Code. In accord with the section 607 statutory requirements, MARAD and NOAA negotiate the contracts that determine which private parties will receive these tax benefits, and what the terms will be for receiving and retaining those benefits.

The tax benefit—deferral of tax on deposits—begins when a deposit of a type and in an amount allowed under the Program contract is deposited in an approved fund.[30] The tax deferral ends when the money in a CCF is withdrawn to finance the contract-approved vessel renewal. The fundholder begins to repay the deferred tax during the first year of such a "qualified withdrawal."[31]

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[29] A U.S. citizen who owns or leases at least one "eligible vessel" may enter a CCF agreement. § 607(a). An eligible vessel is a U.S.-flag, U.S.-built vessel operated in the foreign or domestic commerce of the U.S. § 607(k)(1). A CCF may be used for replacing, adding or reconstructing "qualified vessels": U.S.-built, U.S.-flag vessels, for operation in the U.S. foreign, Great Lakes or noncontiguous domestic trade or in U.S. fisheries. §§ 607(a), (k)(2). The agreement identifies the eligible and qualified vessels involved in the program (the "agreement vessels"), § 607(k)(3), in Schedules A and B of the agreement, respectively. 46 CFR § 390.4(b), (c).

[30] § 607(d). Deposits by parties to CCF agreements may be approved and therefore permitted under the contract if they come from one of four sources: (1) operating income from agreement vessels; (2) amounts equal to the depreciation deduction allowed for agreement vessels; (3) net proceeds from the sale or other disposition of any agreement vessel or from insurance or indemnity proceeds with respect to it; and (4) receipts from the investment or reinvestment of amounts held in the fund. These deposit subceilings are specified in section 607 (b)(1).

[31] § 607(f), (g). Because the cost basis of a financed vessel is reduced by the amount of its CCF financing, the government recoups a corresponding part of the deferred tax due to reduced depreciation deductions. Reduced deductions increase the vessel owner's taxable income and therefore the amount of tax paid each year in later years. Basis reduction also causes the vessel owner to realize increased gain upon sale of the vessel. As a result, the

(continued...)

The Act vests authority to set the conditions for CCF deposits and withdrawals exclusively in the contracting agency: Commerce (for fishing vessels) or DOT (for other vessels). Under section 607(a) of the Act, DOT and Commerce set such conditions by entering into contracts, and through rules and regulations that are incorporated in such contracts.[32] Since CCF deposits and withdrawals determine the flow of CCF tax benefits, the exercise of these powers fully controls the flow of the tax benefits.

Tax deferral may also be terminated as the result of a "nonqualified withdrawal"—one that is not for a Program-specified purpose.[33] Discretion to treat all or part of a fund as withdrawn in a nonqualified withdrawal resides solely with the Secretary of Transportation or Commerce. Generally, such treatment follows a determination by the Secretary that a substantial obligation under an agreement is not being fulfilled.[34] When a nonqualified withdrawal is deemed to have occurred, the fundholder pays back the full amount of the deferred tax in the year of the withdrawal at the highest marginal rate, with interest.[35]

SUMMARY OF ARGUMENT

Summary of Part I

The 1970 Amendments, which established the CCF Program in its current form, entrusted

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[31](...continued)
government usually recoups the rest of the deferred tax when it collects an increased amount of tax on such gain. Subject to joint regulations, tax on such additional gain may be deferred by redeposit of an amount that, "insofar as practicable, restore[s] the fund to the position it was in before the withdrawal" used to finance the vessel that was sold. § 607(g)(5). In recent years, however, little use has been made of this provision.

[32] Pursuant to their authority to prescribe all deposit and withdrawal conditions through contracts or regulations, MARAD and NOAA have issued regulations governing eligibility for CCF agreements, the sources and amounts of deposits, the use and timing of withdrawals and related deposit and withdrawal matters. *See, e.g.*, 46 CFR Part 390 (MARAD regulations). Under the authority granted in section 607(*l*), MARAD and NOAA have also agreed to joint regulations with IRS, which appear at 46 CFR Part 391 and 26 CFR Part 3. As required by subsection (*l*), these regulations are "not inconsistent" with the contracting agencies' authority, as specified in preceding subsections of section 607.

[33] § 607(h).

[34] Any such determination must be preceded by notice and a hearing. § 607(f)(2). Nonqualified withdrawals may be declared in a limited number of other situations. These include: § 607(h)(5)(A) (amount remaining in CCF after 25 years from deposit); § 607(h)(5)(D) (amounts determined by the Secretary of Transportation or Commerce to exceed the amount appropriate to meet the fundholder's vessel program construction objectives); and § 607(i) (non-qualifying corporate and partnership changes).

[35] § 607(h)(1), (3), (4), (6)(A).

the maritime agencies with control of CCF Program tax benefits. The maritime agencies exercise this control by setting and administering all conditions for CCF deposits and withdrawals through contracts and regulations. Section 607 protects the maritime agencies' authority by carefully limiting the role of Treasury to regulatory authority that can only be exercised jointly with DOT or Commerce. Such joint regulations, moreover, must be "not inconsistent" with the statutory provisions vesting full control over contract administration in the maritime agencies.

Summary of Part II

In 1986, Congress rejected a Reagan Treasury proposal to terminate the CCF Program. Instead, Congress kept the pre-existing structure in place and reaffirmed the congressional policies that dictated that structure. Neither the language nor the legislative history of section 261 of the 1986 tax reform statute reveals any evidence of any intent to transfer responsibility for any part of the Program's administration to Treasury. Rather, the legislative history suggests that the new statute added section 7518 to the Internal Revenue Code because the Ways and Means Committee wished to expand its own oversight jurisdiction.

Summary of Part III

MARAD and NOAA are authorized to enter CCF Program contracts on behalf of the United States, with tax deferral benefits serving as the consideration for Program commitments made by private fundholders. Under these contracts, the private parties are entitled to retain their tax deferral benefits subject only to one condition: that they comply with the terms of the contract. Contracting fundholders have vested rights, as well, to all the procedural protections promised in CCF contracts. Under the statute and the contracts, only the contracting agency may decide if there has been noncompliance, and if so, whether it should result in termination of some or all deferral benefits. If the IRS disallows tax benefits in contravention of these substantive and procedural provisions, it will force the United States to breach CCF Program contracts. The net effect of such breaches will deplete rather than enrich the federal fisc, and the costs will fall on the United States rather than on IRS/Treasury.

ARGUMENT

I. SECTION 607 GIVES TRANSPORTATION AND COMMERCE SOLE AUTHORITY TO CONTROL THE FLOW OF CCF TAX BENEFITS

As we demonstrate in detail below, comprehensive control over CCF tax benefits was lodged by Congress in the Departments of Transportation and Commerce. Under the express authority of section 607(a), DOT and Commerce set conditions for CCF deposits and withdrawals through contracts and regulations. Since CCF deposits and withdrawals determine the flow of CCF tax benefits, DOT and Commerce necessarily control the administration of those tax benefits.

In order to discharge their section 607(a) mandate to set all deposit and withdrawal conditions, Transportation and Commerce must interpret and apply all parts of section 607, including the portions that address tax issues. Similarly, since contractually permitted deposits and withdrawals remain "subject to" all the conditions set by Transportation and Commerce, these agencies must continue to interpret all parts of the statute throughout the administration of the contracts. The language of section 607(a) dictates this understanding, which is also reflected in the existing agency regulations and contracts (which are themselves authorized under section 607(a)).

Treasury and the IRS err when they suggest that section 607 may be bifurcated into tax-related and non-tax subsections. The language of section 607 attests to just the reverse. The "tax" and "non-tax" parts of section 607 are inextricably connected and could not be separately administered. If Treasury succeeds in seizing control of what it considers the "tax-related" provisions, it will necessarily oust Commerce and Transportation from the comprehensive contractual and administrative authority expressly entrusted to them by section 607(a).

Aware of the potential for just such challenges to the DOT/Commerce role, Congress sought to head them off through the safeguards built into section 607(*l*) of the statute. Section 607(*l*) protects the DOT/Commerce authority over deposits and withdrawals granted in section 607(a). It does this by limiting IRS/Treasury to certain rulemaking and regulating functions that can only be undertaken jointly with DOT or Commerce, and that must be exercised in a manner "not inconsistent" with subsections (a) through (k) of section 607.

Because regulations concerning CCF-related tax liability are subject to section 607(*l*), the IRS has no authority to regulate any portion of the Program independently, or without regard to the consistency requirement. Nor can Treasury claim a right to participate in any minimum amount of regulation. Unless DOT or Commerce agrees to a regulation, Treasury has no role. By giving DOT and Commerce this veto over Treasury proposals, Congress ensured that the maritime agencies would have the power to enforce the consistency requirement of section 607(*l*).

A. Section 607 Gives DOT and Commerce the Authority to Establish and Interpret All CCF Deposit and Withdrawal Conditions

Section 607(a) establishes that DOT and Commerce control all determinations concerning deposits and withdrawals, through their authority to set all relevant conditions and requirements by means of regulations, contracts and the administration thereof:

> Any citizen of the United States owning or leasing one or more eligible vessels (as defined in subsection (k)(1)) may enter into an agreement with the Secretary[36]

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[36] "Secretary" is defined to mean the Secretary of Commerce with respect to eligible or qualified vessels operated (continued...)

> under, and as provided in, this section to establish a capital construction fund (hereinafter in this section referred to as the "fund") with respect to any or all of such vessels. Any agreement entered into under this section shall be for the purpose of providing replacement vessels, additional vessels, or reconstructed vessels, built in the United States and documented under the laws of the United States for operation in the United States foreign, Great Lakes, or noncontiguous domestic trade or in the fisheries of the United States and shall provide for deposit in the fund of the amounts agreed upon as necessary or appropriate to provide for qualified withdrawals under subsection (f). *The deposits in the fund, and all withdrawals from the fund, whether qualified or nonqualified, shall be subject to such conditions and requirements as the Secretary may by regulations prescribe or are set forth in such agreement; . . .*[37]

This controlling statutory language is in perfect agreement with the legislative history.[38] In 1970, Congress deliberately designated Commerce (which then housed both MARAD and NOAA) as the sole contracting agency administering tax-benefitted funds dedicated to vessel fleet renewal. It thereby unseated IRS from the position it had acquired over reserve fund benefits through the closing agreements that the IRS had negotiated with affected taxpayers after World War II.[39]

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[36](...continued)
or to be operated in the fisheries in the United States, and the Secretary of Transportation with respect to all other vessels. § 607(k)(9).

[37] 46 U.S.C. app. § 1177(a) (emphasis added).

[38] "The starting point for interpretation of a statute 'is the language of the statute itself. Absent a clearly expressed legislative intention to the contrary, that language must ordinarily be regarded as conclusive.'" *Kaiser Aluminum & Chem. Corp. v. Bonjorno*, 494 U.S. 827, 835 (1990) (quoting *Consumer Product Safety Comm'n v. GTE-Sylvania, Inc.*, 447 U.S. 102, 108 (1980). *Accord, Whether Members of the Sentencing Commission Who Were Appointed Prior to the Enactment of a Holdover Statute May Exercise Holdover Rights Pursuant to the Statute*, 18 Op. Off. Legal Counsel 24, (1994) (available at 1994 WL 813352 (O.L.C.) (April 5, 1994)); *Application of the Cargo Preference Act to the Transportation of Alaskan Oil to the Strategic Petroleum Reserve*, 7 Op. Off. Legal Counsel 139, 144 (1983); *Damage Claims Under the Atomic Energy Act*, 1 Op. Off. Legal Counsel 157 (1977). Difficult problems of interpretation (and accompanying controversies about the principles of statutory construction) may arise when the plain meaning of a statute seems to conflict with Congress' apparent intent as reflected in legislative history. No such problem exists in this case, however, where the statutory language and the legislative history are perfectly consonant.

[39] *See* 1970 Senate Report at 43-44, 1970 U.S.C.C.A.N. at 4217; 116 Cong. Rec. 16,592 (May 21, 1970) (remarks of Mr. Mailliard); *id* at 16,598 (remarks of Mr. Lennon). As introduced, H.R. 15424 extended and expanded the tax deferral provisions. The Committee on Merchant Marine and Fisheries worked with the Committee on Ways and Means to eliminate the need for Internal Revenue Service closing agreements:

> [Y]our committee determined that section 607 of the act should be completely rewritten to eliminate the need for Internal Revenue Service Closing Agreements. In order to accomplish this, we turned

(continued...)

The grant of authority in section 607(a) applies to the scheme of deposit and withdrawal conditions Congress detailed throughout section 607.[40] The breadth of DOT and Commerce authority in section 607 is consistent with the scope of their powers under the Act as a whole. The exclusive authority of DOT and Commerce to govern CCF deposits and withdrawals, by setting and administering contract terms and regulatory provisions, in turn reflects the broad regulatory and contracting authority of these agencies with respect to 1936 Act programs.[41]

DOT and Commerce necessarily control interpretive functions ancillary to their roles in

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[39](...continued)

> to our colleagues, the distinguished chairman of the Ways and Means Committee (Mr. Mills), and the distinguished ranking minority member of that committee (Mr. Burns). Through their cooperation, the staff of the Joint Committee on Internal Revenue Taxation assumed the principal role in this undertaking. The bill, as reported, sets forth the technical revisions to the tax deferral system as recommended by the staff of the joint committee. This revision will permit the administration of the tax deferral system by the Secretary of Commerce in conjunction with the Secretary of the Treasury without the need for individual closing agreements.
>
> The principal element in the new tax deferral system will be the vessel acquisition or modernization agreement which each carrier will enter into with the Secretary of Commerce. This agreement will simply set forth the building program which the carrier hopes to achieve and will provide for the orderly deposit of earnings into the fund. We have deliberately left the terms of this agreement flexible, so that it may be fitted to the needs of each carrier.

Id. at 16,592 (remarks of Mr. Mailliard).

[40] With the exception of the reporting requirements and joint regulatory authority contained in subsections (*l*) and (m), and the provision for transfer of 1936 Act funds in subsection (j), all subsections of the statute spell out conditions and requirements for deposits and withdrawals. Subsections (f) through (i) concern withdrawals: purposes of qualified withdrawals, their tax treatment, the tax treatment of nonqualified withdrawals and authority to waive nonqualified withdrawal treatment of funds transferred in certain corporate reorganizations and partnership transactions. Subsections (b) through (e) concern deposits: ceilings, permissible investments of deposited amounts, requirements for tax deferral, and the allocation of deposits into separate fund accounts. Subsection (j) defines terms that appear throughout section 607.

[41] The Supreme Court has confirmed the broad scope of this statutory authority. *See Seatrain Shipbuilding Corp. v. Shell Oil Co.*, 444 U.S. 572, 585 (1980) (stating that "[t]he Secretary of Commerce was given broad authority to oversee administration of the [1936] Act."). The Court has also specifically noted the discretionary powers of the Secretary of Commerce to implement 1936 Act programs through contracts. *Id.* (citing § 207 of the 1936 Act).The regulatory powers of the Secretaries are similarly sweeping:

> [T]he Secretary of [Transportation] [is] hereby authorized to adopt *all* necessary rules and regulations to carry out the powers, duties, and functions vested in [him/her] by this Act.

46 U.S.C. app. § 1114 (emphasis added). *See also States Marine International v. Peterson*, 518 F.2d 1070, 1079 (D.C. Cir. 1975), *cert. denied* 424 U.S. 912 (1976).

contract entry and administration.[42] They could not otherwise discharge their statutory responsibilities to enter and administer the contracts in a manner designed to ensure that the funds are used (and therefore the incentive tax benefits are conferred and retained) for the purposes intended by Congress. Section 607(a) makes it plain that Congress understood this logic. Congress made all deposits and withdrawals "subject to such conditions and requirements" as the Secretaries of Transportation or Commerce "may" prescribe through regulations or contract terms.[43] "Such" conditions or requirements manifestly refers to all those that the Secretaries, in their discretion, choose to prescribe.[44]

It is the approval of deposits and withdrawals that determines tax benefits under the CCF Program. Section 607(a) requires that deposits and withdrawals be subject to, and only subject to, conditions and requirements prescribed by the Secretaries of Transportation and Commerce. Congress has thus unambiguously indicated that the basis for tax benefits -- deposits and withdrawals -- are subject to DOT/Commerce conditions at the time of contract entry, and that they remain so when the regulatory and contractual conditions so prescribed are interpreted and applied.

Section 607(a) therefore vests these two departments with comprehensive authority to interpret and apply all parts of 607, including those that are "tax related." The Secretary of Transportation, for example, has prescribed regulations, and entered contracts on behalf of the United States, that manifest his/her statutory authority to interpret and apply all parts of 607.[45] Under the regulations, only the Secretary of Transportation determines whether a party to a CCF contract with MARAD has failed to comply with any part of section 607 or the regulations (including the joint regulations) thereunder. Standard MARAD contracts, which provide that all such determinations will be made by the Secretary of Transportation, are binding on the United States, and thus on Treasury and the IRS.

The regulations also reinforce the mandate of the statute requiring the Secretaries of Transportation and Commerce to let and administer contracts in a manner that conforms to all the requirements of section 607. Thus, these Secretaries may and do approve contracts in light of

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[42] *Cf., Chevron U.S.A. v. Natural Resources Defense Council, Inc.*, 467 U.S. 834 (1984); *Shoals American Indus. v. United States*, 877 F.2d 883, 888-89 (11th Cir. 1989).

[43] § 607(a) .

[44] The sole specified exception is that "the Secretary may not require any person to deposit in the fund for any taxable year more than 50 percent of that portion of such person's taxable income for such year (computed in the manner provided in (b)(1)(A)) which is attributable to the operation of the agreement vessels." § 607(a). This exception obviously implicates the principle *expressio unius exclusio alterius.*

[45] The Secretary has the exclusive right to determine noncompliance with contracts whose implied contract terms include section 607 and all the regulations thereunder. The contract terms involved are prescribed by regulation. *See* 46 CFR § 390 App. 2.

section 607 requirements for permissible deposits and withdrawals that appear in sections addressing specific tax-related issues.[46] Indeed, Transportation and Commerce must consider such issues prior to contract approval, pursuant to their own regulations.[47]

The purpose of this broad grant of authority to Transportation and Commerce was to place them in control of CCF policy implementation. Since tax deferrals are the means Congress chose to induce private parties to participate in the Program, Congress took care to make Transportation and Commerce responsible for the administration of these tax deferrals.

B. Congress Gave the Maritime Agencies Control of CCF Deposits and Withdrawals Precisely in Order to Give Those Agencies Control of Tax Deferral Benefits

In 1970, Congress established the current CCF Program in order to promote domestic fleet renewal. The Program achieves its goals through contracts. The plan of deposits and withdrawals in the terms of each contract is the means by which the Program is implemented.

Contracting parties agree to a program of ship construction or reconstruction to be financed by withdrawals from Program deposits. Each private party participating in the Program agrees to deposit monies from approved sources to finance the proposed vessel construction program. Once MARAD or NOAA approves the vessel construction program and the financial plan, deposits in accord with the contract qualify for tax deferral. The plan of approved deposits and qualified withdrawals as established in the terms of each contract is at the core of the Program.

DOT/Commerce authority to confer access to CCF tax deferral benefits by entering contracts and approving deposits is matched by a parallel power to curtail or terminate tax deferral benefits.[48] DOT and Commerce do this by treating all or part of a fund as a nonqualified withdrawal. *Only* these agencies, moreover, are authorized to take the necessary prior step to such treatment: a determination that a substantial obligation under a Program agreement is not being fulfilled.[49]

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[46] MARAD, for example, routinely reviews applications for CCF contracts in light of whether proposed CCF deposits adequate to finance the proposed program of vessel renewal will derive from sources that qualify within the section 607(b)(1) deposit ceilings. Each contract application, accordingly, is required by law to include information as to proposed deposit sources. 46 CFR § 390 App. I (VII).

[47] *See, e.g.*, 46 CFR § 390 App. I. *See also* 46 CFR § 390 App. II, Item 5 ("Whereas" provisions) (wherein the Maritime Administrator attests that he "has determined that the [contracting] Party qualifies for an Agreement under the Act"). Note that the Maritime Administrator must attest to qualification under "the Act" as a whole, not merely certain sections of it.

[48] § 607(f)(2).

[49] *Id.*

DOT/Commerce thus set the terms for tax deferral availability after pre-contract negotiations, and they alone have the power to disallow such benefits when contract terms are violated. There are no provisions anywhere in the U.S. Code giving any other Department or agency any power to make judgments about contract compliance or non-compliance.[50]

Tax deferrals must be allowed so long as contract terms are met. Congressional intent on this point is further confirmed in the provision concerning nontaxability of deposits. Under section 607(d)(1), tax is required to be deferred on the amount of any deposit so long as the deposit comes from a permissible source.[51] Section 607(d)(2) adds that deferral will apply "only if such amount is deposited in the fund pursuant to the agreement, and not later than the time provided in joint regulations." No other condition is imposed on the statutory mandate to permit deferral on deposits within the subceilings.

The Secretaries of Transportation and Commerce are thus charged with the control of tax deferral on Program deposits: (1) because they control the initial approval of a deposit plan in the contract (where a formal agency determination is made as to whether an applicant's proposed deposits satisfy statutory requirements); and (2) because deferral may be challenged, other than for lateness, only where an actual deposit is not "pursuant to the agreement."[52]

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[50] The only other section 607 provision that grants discretion to treat an amount in a CCF as a nonqualified withdrawal also specifies DOT/Commerce as the judges of contract noncompliance. *See* § 607(h)(5)(D) (requiring the Secretary of Transportation or Commerce to treat an amount in a CCF as a nonqualified withdrawal *if he or she determines* that such amount is in excess of the amount "which is appropriate to meet the vessel construction program objectives of the person who established the fund," and the fundholder fails to develop "appropriate program objectives within 3 years to dissipate such excess.").

Actual nonqualified withdrawals, as well as those deemed nonqualified, are also within the discretion of Transportation and Commerce. Under MARAD regulations, "[t]he prior written permission of the Maritime Administrator is required before a nonqualified withdrawal may be made." 46 CFR § 390.10(b)(1). This requirement directly reflects the intent of Congress in the 1970 Amendments. 1970 Senate Report at 51, 1970 U.S.C.C.A.N. at 4225.

Two other provisions that permit an amount in a fund to be treated as a nonqualified withdrawal operate automatically. One such provision treats as a nonqualified withdrawal a mandated percentage of any amount remaining in a fund after 25 years. § 607(h)(5)(A). The other treats as a nonqualified withdrawal any amount of a qualified withdrawal used to pay the principal on indebtedness in excess of the basis of the fundholder's vessels. § 607(g)(4). An additional provision concerns discretion to waive a nonqualified withdrawal, rather than to treat funds as so withdrawn. § 607(i) (concerning transfers of CCF funds in corporate reorganizations or transactions in which a partnership is continued).

[51] Each deposit must fall within one of four subceiling categories. §§ 607(d)(1), (b)(1).

[52] For example, MARAD or NOAA might have approved for deposit only monies falling within one of the statutory subceilings. In such case, deposits under another subceiling, although of a type the Secretary could have approved, would not be "pursuant to the agreement."

There are no discretionary provisions for termination of CCF tax benefits other than the provisions discussed above. The only other ways that CCF tax benefits may be terminated are through qualified withdrawals, which generally follow upon disposition of a CCF-financed agreement vessel,[53] or through the automatic operation of other provisions for treating amounts in a fund as nonqualified withdrawals.[54] CCF contracts reflect this statutory scheme.[55]

Hence, it is clear that only DOT and Commerce may exercise any discretion with respect to termination of CCF tax benefits. CCF contracts specify permitted deposits and withdrawals. All determinations concerning deposits, withdrawals and the setting or interpretation of contract terms are within the exclusive control of DOT and Commerce, under section 607(a).

This fundamental statutory allocation of responsibility dictates that DOT or Commerce must decide that the taxpayer in question has acted in violation of a CCF agreement before IRS may determine a CCF related tax deficiency. Treasury itself has recognized this implication by promulgating joint regulations which provide that

> [a]ll amounts deposited in the fund shall be presumed to have been deposited pursuant to an agreement unless, after an examination of the facts upon the request of the Commissioner of Internal Revenue or his delegate, the Secretary of Transportation determines otherwise.[56]

Moreover, Transportation or Commerce must, in all cases, first determine whether any

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[53] Under section 607(g)(5), benefits may be retained, subject to conditions specified in joint regulations, if there is a redeposit of an amount determined under such regulations which will, insofar as practicable, restore the fund to the position it was in before the withdrawal.

[54] *See* §§ 607(h)(5)(A), (g)(4). *See also* § 607(i) (implying that transfers of funds through corporate or partnership transactions that do not maintain a continuity of interest between the persons controlling the transferor and the transferee will cause amounts in any such fund to be treated as withdrawn in a nonqualified withdrawal).

[55] Each MARAD contract, for example, includes a clause providing that "the Federal income tax benefits provided in the Act and the rules and regulations shall be available to the Party if the Party shall carry out its obligations under this Agreement." 46 CFR § 390, App. II., Article 15. Contract terms are subject only to the Act and the rules and regulations thereunder. *Id.*, Item 6 ("Whereas" provisions).

[56] 46 CFR § 391.3(h); 26 CFR § 3.3(h). The regulation is entitled *Presumption of validity of deposit*. The presumption is not easily overcome. The IRS may not even present such an issue for determination by Transportation or Commerce unless "there is a *substantial question* as to whether a deposit is made in accordance with an agreement." *Id.* (emphasis added).

violation of the agreement has been substantial.[57] The IRS must also await a DOT or Commerce determination that such noncompliance has caused a nonqualified withdrawal from the fund.[58] Thus, IRS may proceed with assessment and collection activity only after Commerce and Transportation report withdrawals that allow deferral benefits to be recouped or disallowed.[59]

The IRS may also seek to influence the underlying determinations by communicating with MARAD or NOAA concerning problems which it perceives in the course of IRS audits.[60] The IRS may not, however, disallow Program deferral benefits on its own authority, based on its own views about how the statutory and contractual conditions for benefits should be applied. Any independent attempt by the IRS to disallow Program deferral benefits in the course of an audit would necessarily abrogate the exclusive authority of DOT and Commerce to determine whether a factual situation exists which may justify such disallowances.

The language of section 607(a) attests to Congress' carefully expressed intent to place authority over CCF tax deferrals exclusively in the agencies charged with carrying out the legislature's maritime objectives. The congressional policy is the promotion of a domestic fleet and of domestic shipbuilding facilities through tax incentives, and the tax aspects of the program must be directed to that end.[61] Congress entrusted Commerce and Transportation, not Treasury

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[57] *E.g.*, 46 CFR App. II (Sample Capital Construction Fund Agreement), Articles 14, 15 (providing that the tax benefits under the contract shall be available to a private party contracting with MARAD so long as the party complies with the contract, and that the Maritime Administrator must determine that a substantial obligation under the Agreement has not been fulfilled before undertaking other steps toward benefit termination). *See also* § 607(f)(2); 46 CFR §§ 390.13, 391.5(d); 26 CFR § 3.5(d).

[58] 46 CFR § 391.3(h); 26 CFR § 303(h).

[59] Under section 607(m), Transportation and Commerce report withdrawals and deposits annually to Treasury. Withdrawal reports permit the IRS either to complete the process of recouping deferred tax on CCF deposits and fund earnings (in the case of a qualified withdrawal) or to disallow deferral benefits (in the case of a nonqualified withdrawal).

[60] The joint regulations make provision for such IRS input. *See* 46 CFR § 391.3(h); 26 CFR § 3.3(h). The IRS may use the annual Transportation and Commerce deposit and withdrawal reports to guide audits and develop information for such purposes.

[61] For example, in 1970, for example, Congress indicated that it was more interested in allowing fundholders to correct lapses in adherence to their program goals than in applying the available sanction: disallowance of the tax benefit. With respect to the authority of the Secretary of Commerce to determine that a substantial obligation under a CCF agreement had been violated and to treat all or part of a fund as a nonqualified withdrawal, the Senate committee stated:

> Under joint regulations, if the Secretary of Commerce determines that any substantial obligations of an agreement entered into under this section is not being fulfilled, he may after notice to the person maintaining the fund (and an opportunity for hearing), treat all or a part of the fund as a nonqualified withdrawal (that is, subject to tax in the year of withdrawal under the rules described

(continued...)

or IRS, to manage these priorities consistently with the congressional design.

C. Section 607 Limits the Authority of IRS and Treasury in Order to Protect DOT/Commerce Control of CCF Program Policy

Congress sought to ensure the integrity of the Program by entrusting its administration to the maritime agencies and limiting the role of the revenue collection agency. Congress intended that Treasury and IRS would play an extremely important, though subordinate, follow-on role: ensuring that Program participants claim only those tax deferrals consistent with DOT or Commerce determinations about particular Program contracts. Such determinations are governed by regulation as well as by statute, and Congress specifically limited the Treasury/IRS role in promulgating such regulations. The effect of this limitation was additional protection for the central authority of Transportation and Commerce in carrying out Congress' maritime tax policy.

The general limitations on Treasury/IRS regulatory authority are addressed in section 607(*l*), which authorizes regulations promulgated *jointly* by Treasury and the maritime agencies. Other references to joint regulations in section 607 reflect the limitations specified in subsection (*l*). The nature of these additional references attests further to Congress' care in crafting a framework that would protect the lead agencies' role in administering the Program, while making adequate provision for IRS input.

1. Section 607(*l*) Limits Treasury to Joint Rulemaking "Not Inconsistent" with The Authority of Dot and Commerce

Subsection (*l*) of section 607 provides, in relevant part:

> The Secretary of the Treasury and the Secretary shall jointly prescribe all rules and

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[61](...continued)

> below in *Tax treatment of nonqualified withdrawals*). The committee anticipates that the Secretary of Commerce will, insofar as possible, *exercise this remedy sparingly* and in determining whether the party maintaining the fund should have a reasonable opportunity to cure defaults which are remediable, will act in accord with normal commercial practice.

1970 Senate Report at 50, 1970 U.S.C.C.A.N. at 4224 (emphasis added). Similarly, in 1986, even in the process of tightening controls to correct abuses, Congress maintained the same priorities. Thus, new section 607(h)(5)(D) provided that

> If the Secretary determines that the balance in any capital construction fund exceeds the amount which is appropriate to meet the vessel construction program objectives of the person who established such fund, the amount of such excess shall be treated as a nonqualified withdrawal . . . *unless such person develops appropriate program objectives within 3 years to dissipate such excess.*

Pub. L. No. 99-514, § 261(e)(6), 100 Stat. 2214-15 (codified at 46 U.S.C. § 1177(e)(6) (emphasis added)).

> regulations, *not inconsistent* with the foregoing provisions of this section, as may be necessary or appropriate to the determination of tax liability under this section.[62]

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[62] 46 U.S.C. app. § 1177(*l*) (emphasis added). The Nixon Administration proposed changes in section 607 included the addition of a new subsection which would have provided for full Treasury participation in the promulgation of joint regulations to govern the new Program. Hearings on the President's Maritime Program, Part 2, Committee on Merchant Marine and Fisheries, 91st Cong., 2d Sess., Serial No. 91-23 (1970) (the "1970 House Hearings").

> Sec. 20. Section 607 . . . is amended by . . . the following new sentence:"The Secretary of Commerce and the Secretary of the Treasury are jointly authorized to prescribe all rules and regulations necessary or appropriate to the determination of the owner's tax liability under this section."

1970 House Hearings at 107.

As the Administration 's section by section analysis explained:

> This section would also add a new subsection which would authorize the Secretary of Commerce and the Secretary of the Treasury jointly to prescribe rules and regulations necessary under this section. Under the present tax deferred provisions of section 607, the tax liability of the subsidized operators is determined under closing agreements entered into between the operator and the Treasury. It is expected that the regulations prescribed under the authority of the new subsection (*l*) would generally follow the form of the present closing agreements with subsidized operators and thereby provide a uniform basis for determining the tax liability of operators that enjoy the benefits of extended by section 607 as it would be amended.

Transmittal to the Hon. John W. McCormack, Speaker of the House of Representatives, from Rocco C. Sicilliano, Acting Secretary of Commerce, December 22, 1969, as reprinted in 1970 House Hearings 123 at 151.

Treasury concurred, urging the confirmation of an expanded closing agreement program, with increased requirements for IRS participation.

> [T]he Treasury urges that Committee to retain the broad rule-making authority that would be granted to the Secretaries of Commerce and Treasury by section 20(*l*) of the bill. This authority would will permit the issuance of regulations of general application for taxpayers covered by the reserve fund system.

and

> As noted above, the proposed legislation would extend the reserve fund system to many more taxpayers, and this will impose a heavier administrative burden on the Internal Revenue Service.

Letter to Edward A. Garmatz, Chairman, Committee on Merchant Marine and Fisheries, from Roy T. Englert, Acting General Counsel, Department of the Treasury, dated April 15, 1970, as reprinted in 1970 House Hearings 160 at 162.

The Nixon Administration proposed language, and the Treasury Department request of April 15, 1970, were rejected by the House in a collaborative effort involving the Committee on Merchant Marine and Fisheries, the Committee on Ways and Means and the staff of the Joint Committee on Internal Revenue Taxation.

As Mr. Mailliard, the ranking minority member of the Committee, acting in his capacity as floor manager, reported to the House on May 21, 1970:

> *[Y]our Committee determined that section 607 of the Act should be completely rewritten to eliminate the need for Internal Revenue Service Closing Agreements.* In order to accomplish this, we turned to our colleagues,

(continued...)

This provision limits the authority of IRS/Treasury in two ways:

First, Treasury/IRS possess only *joint* rulemaking and regulatory authority. Unlike DOT

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[62](...continued)

the distinguished chairman of the Ways and Means Committee (Mr. Mills), and the distinguished ranking minority member of that committee (Mr. Burns). Through their cooperation, the staff of the Joint Committee on Internal Revenue Taxation assumed the principal role in this undertaking. ***The bill, as reported, sets forth the technical revisions to the tax deferral system as recommended by the staff of the joint committee.*** This revision will permit the administration of the tax deferral system . . . without the need for individual closing agreements.

116 Cong. Rec. 16,592 (May 21, 1970) (remarks of Mr. Mailliard) (emphasis added).

As reported on May 12, 1970, section 607 had been expanded to incorporate the technical recommendations of the joint committee staff -- designed to permit program administration by Commerce without Treasury interference -- and the language of subsection (*l*) had been completely rewritten so as to separate: (A) regulations for the keeping of records and the making of reports; from (B) regulations to be issued as "necessary or appropriate to the determination of tax liability", which were to be issued under the express limitation that they would be "not inconsistent with" the Program provisions which had been entrusted to Commerce.

(*l*) Records; Reports; Changes in Regulations.

Each person maintaining a fund under this section shall keep such records and shall make such reports as the Secretary of Commerce or the Secretary of the Treasury shall require.

and

The Secretary of the Treasury and the Secretary of Commerce shall jointly prescribe all rules and regulations, *not inconsistent with the foregoing provisions of this section,* as may be necessary or appropriate to the determination of tax liability under this section.

1970 House Report at 12 (emphasis added).

Or, as the Report went on to explain:

Records; reports; changes in regulations. -- The Secretary of Commerce and the Secretary of the Treasury are each authorized to require persons maintaining funds under this section to keep records and make reports. It is expected that each Department will require only needed records and reports to carry out their functions and that they would coordinate their requirements so as to prevent duplication of recordkeeping.

The two Secretaries are also authorized to jointly prescribe all rules and regulations *consistent with this section* which may be necessary or appropriate to determine tax liability under this section.

1970 House Report at 57 (emphasis added).

The Senate concurred in the House action, rejecting a similar Treasury request. And, subsection (*l*) was enacted into law with the technical revisions to the tax deferral system endorsed by the Committee on Merchant Marine and Fisheries and the Committee on Ways and Means, and as recommended by the staff of the joint committee -- in essence, a free standing set of detailed tax rules which were expected to allow Program administration by Commerce with a minimum of Treasury interference.

and Commerce, they have *no* authority to regulate independently with respect to CCF Program matters.

Second, Treasury and therefore the IRS may not act in any way that is inconsistent with subsections (a) through (k) of section 607. This crucially important "consistency requirement" forbids IRS and Treasury to act inconsistently with the exclusive regulatory and contracting authority granted to DOT/Commerce in subsection (a) concerning governance of deposits and withdrawals. Nor may IRS or Treasury act inconsistently with complementary DOT/Commerce authority to determine contract noncompliance, nonqualified withdrawals, or the application of statutory terms.

Note, too, that the consistency requirement concerning tax matters is *unconditional*. Thus, it prohibits not only rules and regulations permitting tax determinations that are formally and directly inconsistent with DOT/Commerce authority, but also regulations or practices permitting tax determinations that undercut DOT/Commerce authority in substance. Accordingly, joint rules and regulations may not allow any determination of CCF-related tax liability, the effect of which is to nullify, even indirectly, the terms of a MARAD or NOAA Program contract decisions.

2. The Statutory Provision for Limited Joint Rulemaking Enables DOT and Commerce to Control IRS/Treasury Participation in the CCF Program

Section 607(*l*) gives both DOT/Commerce and Treasury a veto over joint regulations. Because all residual authority over the CCF Program lies with DOT/Commerce, and because the maritime agencies can operate the Program in the absence of any joint regulations, this veto protects the contracting authority of DOT/Commerce against usurpation by Treasury.

The DOT/Commerce vetoes allow these agencies to keep Treasury out of Program administration. The veto is the tool Congress gave the contracting agencies for enforcing the consistency requirement. Treasury may *propose* a regulation that intrudes on DOT/Commerce Program authority, but the self-interest of those agencies will serve to guard against the adoption of such proposals.

The Treasury veto may also be used to block regulations, but that power has very little practical impact. If Treasury could block Program operation by blocking a regulation, it might be able to force DOT and Commerce to agree to regulations that those agencies would otherwise reject. But that is not the case. Congress did not make operation of the CCF Program dependent on the issuance of joint regulations. DOT and Commerce need agree only to regulations they consider "necessary or appropriate" and "not inconsistent" with section 607 generally.

In the absence of joint regulations, DOT/Commerce have the authority to specify by contract the necessary conditions and requirements. In fact, for the past twenty-five years, four of the eight specific joint regulatory provisions that Congress addressed outside section 607(*l*)

have remained reserved.[63] Treasury obviously does not consider the four specific regulatory provisions to be mandatory, since it has allowed the regulations to remain reserved since the Program began.[64]

Congress has made ample provision for IRS and Treasury to provide necessary or appropriate input to the administrative process. No upheaval in administrative structure is required for their voice to be heard. Indeed, as Congress fully understood, IRS priorities are more likely to be hostile than helpful to realization of its policy goals. This is why they were confined to an essentially advisory role in decisions having to do with the operation of the Program, and were deliberately deprived of the power to block or annul decisions made by the maritime agencies.

D. Section 607(*l*) Confirms the Judicially Established Principle that IRS/Treasury Must Accept Tax Deferral Decisions Made by DOT and Commerce

The instant interagency dispute is not unlike others that have arisen when Congress gives an agency authority to make decisions impacting the usual sphere of another agency.[65] The presence of tax issues in this case does not alter the applicable principles. While Congress' usual and understandable practice has been to assign tax authority to the IRS, it has deviated from this

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[63] Out of the eight areas Congress identified as appropriate for joint regulations, the four that remain reserved all concern enhancements of fundholder benefits: (i) redeposits that permit continuation of deferral benefits after vessel sale or disposition of a covered vessel (46 CFR § 391.6(e); 26 CFR § 3.6(e)); (ii) corporate reorganizations and partnership transfers that will not cause nonqualified withdrawals (46 CFR § 391.8; 26 CFR § 3.8); and (iii) and (iv) definition of net proceeds from vessel sales or dispositions that qualify for deposit and therefore for deferral under the relevant deposit subceiling (46 CFR §§ 391.2(c), 391.3(b)(2)(i)(*b*); 26 CFR §§ 3.2(c), 3.3(b)(2)(i)(*b*)).

[64] Treasury and the IRS have been willing to participate in the promulgation of joint regulations that tend to increase tax liabilities and predictably unwilling to participate in joint regulations that extend benefits to Program participants. Of the eight areas Congress considered suitable for joint regulation, IRS and the Treasury have cooperated in publishing regulations concerning only four: (i) the interest rate for nonqualified withdrawals (46 CFR § 391.7(e); 26 CFR § 3.7(e)); (ii) specification of factors likely to result in determinations that a fundholder has made a nonqualified withdrawal (46 CFR § 391.5(d); 26 CFR § 3.5(d)); (iii) setting a deadline after which deposits into funds will be ineligible for benefits (46 CFR § 391.3(b)(3); 26 CFR § 3.3(b)(3)); and (iv) setting an ordering rule for basis reductions after a qualified withdrawal to pay the principal of a debt (46 CFR § 391.6(c)(5); 26 CFR § 3.6(c)(3)). Treasury has been reluctant to see the other four (which would not tend to increase tax liabilities) promulgated. It is worth observing in this context that DOT and Commerce have not similarly dragged their bureaucratic feet with respect to the regulations that Treasury wanted for its own reasons to have in place.

[65] Last year, for example, OLC considered a matter concerning a different provision of the Merchant Marine Act of 1970, giving DOT authority to issue regulations governing administration of the Cargo Preference program. The program involves shipments of exports and shipments of foreign aid, including shipments of agricultural products. Hence, the program impacted the interests of the Departments of State and Agriculture, which challenged DOT's authority. OLC determined that DOT's express statutory rulemaking authority prevailed. *See* Memorandum to Stephen H. Kaplan, General Counsel, DOT, from Walter Dellinger, Assistant Attorney General, dated April 19, 1994.

practice when policy goals dictated other arrangements.[66] And when Congress chooses to deviate from its usual practice, that congressional choice must be respected.

The CCF program is a policy-driven exception to Congress' general practice of assigning tax-related matters to the IRS. Here, the IRS' customary and generally laudable institutional biases in favor of revenue maximization are at odds with Congress' purpose: maximizing participation in a Program that induces commitments to serve congressional goals by offering tax benefits in exchange for those commitments.

The Tax Court itself has twice rejected IRS attempts to interfere with the allocation of contracting authority for tax-benefitted reserve funds established under section 607 of the 1936 Act.[67] The court emphasized that the IRS lacks authority to take actions in contravention of section 607 provisions governing such funds, and refused even to discuss arguments that IRC definitions of taxable income can be applied to justify denial of 1936 Act tax benefits.[68] Instead, the court

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[66] The Oil Spill Liability Trust Fund is an example. As in the case of the CCF program, criteria for certain decisions are included in the IRC, even though statutory authority for such decisions—also granted to the Secretary of Transportation, in this case—is located outside the IRC. The reason for the IRC inclusions is the same as in the case of the CCF program: to promote coordination between program decisions and their tax consequences through consistent codification. Here, the provisions involved are IRC section 9509, which establishes the Oil Spill Liability Trust Fund and lists the criteria for expenditures, and 33 U.S.C. §§ 2701(11), 2701(33), 2712(5), 2715(6), which grant authority to the Secretary of Transportation to determine expenditures from the fund under the criteria stated in the IRC.

[67] *Seas Shipping Co. v. Comm'r*, 1 T.C. 30, 39 (1942) (rejecting IRS challenge to tax benefits connected with deposits which it found to have been required under the contract, and noting that the Maritime Commission had already considered the application of the Merchant Marine Act to the facts on which the IRS relied when it agreed to the contract). Facing a similar situation in a later case, the Tax Court noted that "[i]n *Seas Shipping Co.*, . . . this Court considered the issue in that case on the basis of both section 607 of the Merchant Marine Act and the *pertinent provisions of the contract between the taxpayer and the Maritime Commission.*" *Pacific Transport Co. v. Comm'r*, 29 T.C.M. (CCH) 133, 176 (1970) (emphasis added), *vacated and remanded on other issues*, 483 F.2d 209 (9th Cir. 1973), *cert. denied*, 415 U.S. 948 (1974). The later court pointedly aligned itself with the earlier precedent. *Id.* at 176-78.

[68] In the more recent of the two cases, the Tax Court stated that:

> [The IRS Commissioner] lacked authority at law, because of section 607(h) and other provisions of the Merchant Marine Act, to restrict and limit the statute-allowed, tax-deferral of all the deposits made. . .

Pacific Transport Co., 29 T.C.M. (CCH) at 176. Referring as well to *Seas Shipping Co.*, 1 T.C. 30, the Court added:

> In these cases, our conclusion is that the [IRS Commissioner] has exceeded his authority in making the adjustment and determination in issue here, and that his adjustment is not supported by any provision in the Merchant Marine Act, an act of Congress with which he is obliged to comply.
>
> [The Commissioner] has attempted to justify his adjustment by contending that the definition of

(continued...)

ridiculed both the challenges that have come before it as "novel [theories] for which no precedent is cited, and none can be found."[69] Fully recognizing that the IRS' attack on authority conferred by the 1936 Act was indirect, the court responded by looking through the rationalizations based on alleged IRC authority to the effects of these "novel theories" on application of 1936 Act provisions.[70]

The principle that the IRS must defer to the full scope of contracting agency authority over 1936 Act reserve funds and their tax benefits is all the more forceful today because it is now *directly mandated by statute*. Section 607(*l*) imposes just such a mandate on the IRS. It requires that "all" rules and regulations governing tax liability determinations under CCF provisions remain consistent with the authority assigned to Transportation and Commerce in section 607(a). Nor does the statute leave room for the IRS to make determinations about CCF-related tax liability outside *joint* rules and regulations reflecting the consistency requirement. CCF tax liability determinations themselves, accordingly, must remain consistent with DOT/Commerce authority, and with DOT/Commerce decisions made pursuant to their authority.

By enacting section 607(*l*) in 1970, Congress built into section 607 of the Act the essence of the Tax Court's decisions concerning tax-benefitted funds. Congress thus has pointedly and deliberately prevented the IRS from making tax liability determinations that nullify contractually granted tax deferral benefits.

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[68](...continued)

> taxable income in the 1954 Code provides a basis for the adjustment he has made, which is in conflict with section 607(h) of the Merchant Marine Act. His argument has been carefully considered, but it *is only an exercise in semantics, and is without merit.* No useful purpose would be served in discussing his contentions.

Id. at 178 (emphasis added).

[69] *Pacific Transport Co.*, 29 T.C.M. (CCH) at 177 (referring both to the matter then under consideration and the matter at issue in *Seas Shipping Co.*).

[70] The court emphasized that actual outcomes, rather than forms or terminology, were the controlling factor in the court's disposition of the case:

> The net effect of [the IRS Commissioner's] theory and determination is to hold [the plaintiff fundholder] liable to income tax . . . upon all or part of the earnings which were deposited in Marad reserve funds. That is the *real result* of [the Commissioner's] theory, even though his "adjustments" in this case served to produce a zero figure rather than a figure for "taxable income." [The Commissioner's] novel theory was applied here to bring [about a result described in tax terms], . . . but in order to [achieve that result] . . ., tax-deferral of deposit income has been denied, and that *denial is tantamount to holding that certain tax-deferred earnings shall become subject to tax.*

Pacific Transport Co., 29 T.C.M. (CCH) at 177 (emphasis added). The Court thus disapproved the Commissioner's "theory and adjustment" because it was "clearly contrary to the provisions of section 607(h) of the Merchant Marine Act." *Id.*

II. THE 1986 REVENUE ACT REAFFIRMED LONG-STANDING CCF POLICY

In 1986, Congress recodified the Internal Revenue Code as a whole. In the process, it made major changes to the tax laws. Section 261 of the 1986 Act, which dealt with the CCF Program, was of minor significance. And the republication of portions of section 607 in the IRC was the least significant aspect of section 261.

Section 261 did make important substantive changes in the CCF Program. However, as we show in detail below, it did not make the major administrative change claimed by Treasury. Rather, Congress confirmed the control of Commerce and Transportation over deposits and withdrawals through contracting and regulatory activities, and continued to confine the IRS to its follow-on role in determining tax liability.

New section 7518, added to the IRC by section 261 of the 1986 Act, simply mirrors certain provisions of section 607. It grants Treasury/IRS no new powers. The official legislative history, like the 1986 Act itself, provides no support for the IRS/Treasury claim that Congress intended suddenly to hand over control of the CCF Program to the revenue agency. Indeed, the section of the legislative history entitled "Reasons for Change" does not even allude to section 7518. The only reason mentioned anywhere for section 7518's addition to the IRC is "coordination" of the IRC with the CCF program.

Congress' single expressed purpose for republishing parts of section 607 in the IRC—coordination of CCF provisions with the IRC—reinforces the mandate of section 607(*l*). As we saw above, section 607(*l*) constitutes specific legislative enactment of a principle that had already been established by the Tax Court: tax liability determinations must proceed in a manner consistent with 1936 Act provisions, including the contracting authority of the maritime agencies. Neither common sense nor familiar principles of statutory construction will tolerate the IRS effort to read general IRC provisions like sections 7801(a) and 7805(a) as licenses to administer section 7518 as though parts of section 607 had been repealed.

Congress simply does not make sweeping changes in program structure without giving any signals of such an intent in *either* the legislative language *or* the legislative history. The IRS/Treasury position, however, requires one to believe that Congress—without a single word expressing any such intent—meant to reverse a seventy-five year history of entrusting maritime authorities with control of merchant marine programs that employ tax incentives. The signals are all in the opposite direction.[71]

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[71] The congressional intent on this issue was so clear that Treasury did not dare begin its campaign to "interpret" the 1986 statute in a different manner until almost a decade after the statute's enactment.

A. CCF Provisions Constituted an Extremely Minor Element of the 1986 Revenue Act

The 1986 tax reform statute accomplished the first major recodification of the Internal Revenue Code since 1954.[72] The 1986 Act made substantial changes in a number of far-reaching provisions: flattening the income tax rate structure; eliminating the reduced tax rate for capital gains; eliminating or reducing widely used deductions; repealing the investment tax credit; repealing a rule that allowed certain corporate distributions of appreciated property to escape tax on gains; ending a host of tax shelters, and the like. The CCF program was a minor aspect of the portion of the bill devoted to capital cost recovery provisions. Indeed, it was the final item on a list of 26 discrete topics covered in that segment of the bill alone.[73] The CCF provisions were of very little interest to the Congress as a whole or to the public at large during consideration of the massive 1986 revision of the tax laws.

The CCF provisions did make changes that were of interest to the shipbuilding and ship operating community. Probably the most important was the 25-year "sundown" provision, which phased out tax deferral benefits on CCF deposits and their earnings after they had remained in a particular fund for 25 years.[74] Another significant provision eliminated shipowners' ability to make nonqualified withdrawals in loss years, so as to replenish working capital.[75]

These and other substantive changes were the focus of the very limited congressional attention the CCF provisions received.[76] Approximately two pages of the Joint Committee and

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[72] The House Report stated:

> This bill, H.R. 3838, was introduced and ordered favorably reported on December 3, 1985, after almost a year-long comprehensive review in the 99th Congress by the committee and subcommittees in public hearings and markup consideration. This has been the most extensive review of internal revenue laws since enactment of the 1954 Code. In light of this fact, this tax reform bill redesignates the Internal Revenue Code of 1954 as the Internal Revenue Code of 1985.

H.R. Rep. No. 426, 99th Cong., 2d Sess. 2 (1986) ("1986 House Report").The bill was redesignated the Internal Revenue Code of 1986 when it was passed the following year.

[73] Committee of Conference, Conference Report, H.R. Rep. No. 841, 99th Cong., 2d Sess. I-vii-viii, *reprinted in* 1986 U.S.C.C.A.N. 4075, 4080 ("1986 Conf. Report").

[74] § 607(h)(5)(A).

[75] § 607(h)(6)(C). *Cf.* 46 CFR § 390.10(b)(3)(i) (authority for such nonqualified withdrawals prior to enactment of § 607(h)(6)(C)).

[76] As specified in the conference agreement, the principal changes were: (1) imposition of the maximum rate of tax on nonqualified withdrawals (section 607(h)(6)), added by 1986 Act section 261(e)(6)); (2) requirement that the Secretaries of Transportation and Commerce make reports to the Secretary of the Treasury regarding monies in funds (section 607(m), added by 1986 Act section 261(d)); (3) requirement that a taxpayer whose fund balance exceeds the

(continued...)

House Ways and Means Committee Reports were devoted to the rationale for the CCF provisions, and those discussions included only five lines dealing with the addition of section 7518 to the IRC.[77] These five lines, in turn, included only one sentence of explanation:

> The tax provisions relating to capital construction funds are recodified as part of the Internal Revenue Code of 1986.[78]

The Conference Report made *no* reference to republication of CCF provisions in section 7518. Its discussion was devoted entirely to the substantive changes in the program.[79]

Treasury takes the position that the republication of section 7518 in the IRC was intended to shift control of the CCF program from Transportation and Commerce to Treasury. If so, that would have been a change at least as significant as those that the congressional committees actually saw fit to discuss. The legislative history contains not one word to support the Treasury theory. And neither, of course, does the actual language of the statute.

B. The 1986 Revenue Act Reinforced DOT/Commerce Responsibility for CCF Program Administration

Any increase in IRS/Treasury authority over the CCF program at the expense of DOT/Commerce would amount to at least a partial repeal of the structure laid out in section 607. There are no signs of any such repeal in the 1986 Act. Indeed, the effect of the changes made in 1986 was actually to reinforce the authority the 1936 Act granted to Transportation and Commerce.

Congress' 1986 changes to the CCF program, which included several changes to section 607, did not include repeal of any part of section 607. This clearly implies that no such repeals

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[76](...continued)
amount appropriate for the vessel construction program in the original CCF contract develop appropriate program objectives within three years or treat the excess as a nonqualified withdrawal (section 607(h)(5)(D), added by 1986 Act section 261(e)(6)); and (4) imposition of a 25-year limit on the amount of time monies can remain in a fund without being treated as nonqualified withdrawals (section 607(h)(5)(A), added by 1986 Act section 261(e)(6)). 1986 Conf. Report at II-104, 1986 U.S.C.C.A.N. at 4192.

[77] Staff of the Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* 175-77 (Joint Committee Print 1987) ("1986 Bluebook"). *See also* 1986 House Report at 191-193. The 1986 House Report language is almost identical to that of the 1986 Bluebook.

[78] The only other sentence on the subject stated: "For purposes of the Internal Revenue Code of 1986, defined terms shall have the meaning given such terms in the Merchant Marine Act of 1936, as amended, as in effect, on the date of enactment of the Act." 1986 Bluebook at 176; 1986 House Report at 192.

[79] 1986 Conf. Report at II-104, 1986 U.S.C.C.A.N. at 4192. The CCF provisions were an issue in the conference because the Senate bill had not addressed the CCF Program at all.

were intended. It is, after all, a firm and well-settled principle of statutory construction that implied repeals are strongly disfavored, and that they may in any event be found only where necessary to remove an inconsistency that would otherwise arise. Apart from the complete absence of any such inconsistency here, an implied repeal is especially implausible in cases, like this one, where the statute in question has been expressly amended in *other* respects.[80]

Accordingly, the authority of the Secretaries of Transportation and Commerce under section 607(a) remains intact. Through their contracting and regulatory authority, DOT/Commerce retain exclusive control of all conditions and requirements for deposits and withdrawals. The elaboration of this authority throughout section 607 likewise remains intact. Section 607(*l*), moreover, continues to confine IRS/Treasury to a role in determination of the tax liability of CCF fundholders that is "not inconsistent" with DOT/Commerce prerogatives.

IRS, therefore, may not disallow CCF deferral benefits without prior DOT or Commerce approval. This remains true today, just as it was before the 1986 Act. The joint regulations, which Treasury itself has promulgated and which remain in effect, require the IRS to await DOT or Commerce action before issuing any deficiency notices.[81] The joint regulations, moreover, are implied terms of every CCF fundholder's contract with the United States.[82] Each party to a CCF contract therefore has a vested right to retain the deferral benefits agreed to in the contract unless and until DOT or Commerce terminates the benefits in accord with the terms of the contract.

The *only* new "right" IRS and Treasury obtained in the 1986 Act was the right, under new subsection 607(m), to receive annual reports about fundholders and fundholder activities from DOT and Commerce. The language of the new subsection is unambiguous.[83] It was designed to

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[80] *See, e.g., Hagen v. Utah,* 114 S. Ct. 958, 968 (1994). *Accord, Interpretation of District of Columbia Good Time Credits Act of 1986,* 12 Op. Off. Legal Counsel 119, 121, 125 (1988) (preliminary print).

[81] 46 CFR § 391.5(d); 26 CFR § 3.5(d). *See also* MARAD regulations: 46 CFR § 390.13 & App. II, Article 14 (A).

[82] *See* 46 CFR § 390, App. II, Item 6 ("Whereas" provisions).

[83] The language of section 607(m), which is styled "Departmental Reports and Certification," unambiguously shows that its purpose is to provide for the coordination of CCF Program decisions by DOT/Commerce with the IRS/Treasury follow-on responsibilities for the audit monitoring of fundholder tax returns (and the allowance of claimed deductions for deposits, or the assessment and collection of tax in those instances where the contracting agency has determined a "nonqualified" withdrawal). The text of subsection (m), *in its entirety* reads as follows:

> (1) In General.—For each calendar year, the Secretaries [of Transportation and Commerce] shall each provide the Secretary of the Treasury, within 120 days after the close of such calendar year, a written report with respect to those capital construction funds that are under their jurisdiction.
>
> (2) Contents of Reports.—Each report shall set forth the name and taxpayer identification number of each person—(A) establishing a capital construction fund during such calendar year; (B)

(continued...)

assure that Treasury/IRS would receive timely notice of Program agency decisions potentially affecting fundholder tax liability, which would be useful to the IRS in the course of its customary audit activities.[84] Section 607(m) does not state *or even suggest* that IRS might proceed to assess tax liability based upon IRS views about the proper "usage" of terms in the Internal Revenue Code. The purpose of section 607(m) is coordination. It therefore serves to confirm, rather than in any way to alter, the established relationships among the various agencies involved. In seeking to assure that information concerning Program participants and activities would be provided to the IRS by the Program agencies on a timely basis (so that the IRS might better perform its follow-on audit role), Congress gave no hint of any intent to go beyond that modest and sensible step. Certainly, Congress did not imply or suggest the administrative revolution now claimed by Treasury/IRS.

Congress, moreover, added only one CCF provision granting discretionary authority in 1986.[85] That provision augmented DOT/Commerce's authority, not that of the IRS. It granted the Secretaries of Transportation and Commerce "authority to treat excess funds as withdrawn."[86] This provision, too, confirms the continuing control of DOT/Commerce over the critical prerequisite to benefit disallowance, namely treatment of all or part of a fund as a nonqualified withdrawal.[87]

Like section 607, section 7518 specifies no new IRS/Treasury powers with respect to CCF matters. Section 261(b) of the 1986 Act, which added section 7518 to the IRC, republished the pre-1986 portions of section 607 in the IRC. Section 7518 also included a number of new provisions, all of which were also added to section 607.[88] Section 7518 therefore contains no

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[83](...continued)

maintaining a capital construction fund as of the last day of such calendar year; (C) terminating a capital construction fund during such calendar year; (D) making any withdrawal from or deposit into (and the amounts thereof) a capital construction fund during such calendar year; or (E) with respect to which a determination has been made during such calendar year that such person has failed to fulfill a substantial obligation under any capital construction fund agreement to which such person is a party.

[84] Annual reports would indicate such action by showing first, that DOT or Commerce had found contract noncompliance, and then in the same or later report, by showing the fact and the amount of any subsequent nonqualified withdrawal DOT or Commerce decided to declare. § 607(m)(2)(D), (E); § 607(f)(2); 46 CFR §§ 390.13, 391.5(d), § 390 App. II, Article 14(A).

[85] § 607(h)(5)(D); § 7518(g)(5)(D).

[86] *Id.*

[87] § 607(f)(2); 46 CFR § 390 App. II (Sample Capital Construction Fund Agreement), Article 14(A).

[88] The only new provision not appearing in both sections is the section 607(m) reporting provision.

provisions that do not also appear in or reference section 607.[89] Since IRS/Treasury gained no new section 607 powers in 1986, it is clear that IRS/Treasury did not, and could not, gain any new powers under section 7518.

C. The Legislative History of the 1986 Revenue Act Shows that Congress Intended No Alteration of DOT/Commerce's Responsibility for CCF Program Administration

The portion of the 1986 Act legislative history that explains the reasons for the CCF Program changes does not even mention section 7518, or the republication of certain CCF provisions in the Internal Revenue Code. Thus, the Congress gave no indication that it thought this republication effected any change at all, much less the sweeping jurisdictional revolution that Treasury purports to have uncovered.[90]

The only changes referred to in the portion of the legislative history entitled "Reasons for Change" are "additional requirements . . . imposed to insure that capital construction funds are used for the intended purpose."[91] The only other specific matter addressed in this portion of the history is a clarification that Congress did *not* intend to alter the expectations of then-existing fundholders.[92]

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[89] Section 7518(i) references section 607(k), providing that any term defined in section 607(k) that is also used in section 7518 (including the term "Secretary") shall have the same meaning as in section 607.

[90] Indeed, nowhere in any of the committee reports is there any allusion to any shift in jurisdiction to Treasury. *See* 1986 House Report at 190-92; 1986 Conf. Report at II-104, *reprinted in* 1986 U.S.C.C.A.N. at 4192. *See also* 1986 Bluebook at 174-77. The Senate Finance Committee made no proposal with respect to CCF legislation. *See* S. Rep. No. 313, 99th Cong., 2d Sess. (1986).

[91] 1986 House Report at 191; 1986 Bluebook at 175. There is a separate reference to concerns "about the ability of taxpayers to avoid taxation on nonqualified withdrawals by making such withdrawals in years for which there are net operating losses (or other tax attributes that reduce the tax attributable to the withdrawal)." The provision addressing this concern, however, is included in new section 607(h)(6), along with other aspects of the first "additional requirement." These "new requirements," as enumerated in the "Explanation of Provision," are "(1) the tax treatment of nonqualified withdrawals, (2) certain reports to be made by the Secretaries of Transportation and Commerce to the Secretary of the Treasury, and (3) a time limit on the amount of time monies can remain in a fund without being withdrawn for a qualified purpose." *Id.*

[92] The Bluebook states:

> The Congress became aware during its tax reform hearings that Treasury's proposal to terminate the Capital Construction Fund (CCF) could have a serious adverse impact on the financial reporting requirements of CCF holders. The Congress did not intend that the modifications to the CCF program be viewed as requiring any change in the financial statement presentation of income taxes by CCF holders. These taxpayers should be allowed to provide future financial statements necessary for ship financing on a basis consistent with that anticipated at the time these taxpayers entered into CCF agreements with the Federal government.

(continued...)

Where the legislative history associates the republication with any purpose, that purpose is "coordination." The lead sentence of the Joint Committee's explanation articulates that same intent:

> The Act coordinates the application of the Internal Revenue Code of 1986 with the capital construction fund program of the Merchant Marine Act of 1936, as amended.[93]

This explanation tracks the language of the legislation itself. Section 261(a) of the 1986 Act states:

> The purpose of this section is to coordinate the application of the Internal Revenue Code of 1986 with the capital construction program under the Merchant Marine Act, 1936.

Thus, Congress' purpose in section 261(a) was not to effect any transfer of CCF Program authority. Rather, the expressed reason for adding section 7518 to the IRC was the same reason given for modifying other CCF-related parts of the IRC,[94] and for adding certain new provisions to section 607: to coordinate tax determinations with the program decisions they implement. The new section 607(m) reporting provisions illustrate this intent, and the legislative history provides other examples.[95]

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[92](...continued)
1986 Bluebook at 175; 1986 House Report at 191 (referring to the intent of the "committee" instead of that of "Congress"). The changes attributed to the 1986 Act by Treasury/IRS would wreak far greater havoc on the contract entry understanding of CCF contract holders than the potential changes that Congress actually discussed and rejected.

[93] 1986 Bluebook at 175.

[94] Section 261(c) amended IRC section 26(b)(2) to coordinate it with the CCF provision for taxing nonqualified withdrawals at the highest marginal rate.

[95] The House Committee Report provides such an example in its discussion of section 7518(e), which mirrors section 607(f). By way of clarification of both sections, the Committee noted that its interpretation of the phrase "acquisition, construction, or reconstruction of a qualified vessel," in the Committee's words, "parallels the structure" of two concepts in section 607. 1986 House Report at 191-92; 1986 Bluebook at 175-76 (tracking the House Committee Report language).

One of these concepts is "the scope of eligibility to establish a capital construction fund," which, the Committee observed, includes an ownership or lease requirement and is governed by section 607(a) of the 1936 Marine Act. Thus, the legislative history underlines the continuing application of section 607 concepts in section 7518, specifically including concepts concerning the role of ownership in determining eligibility for a contract under section 607(a). The legislative history also underlines the fact that concepts such as vessel ownership that apply in section 607(a) apply uniformly throughout section 607 and therefore throughout section 7518.

(continued...)

Treasury apparently now takes the position that the 1986 Act somehow authorizes the IRS to redefine any term appearing in section 7518, thus exercising a retroactive veto over Transportation or Commerce applications of key CCF terms. The IRS, that is, supposedly gained the authority in 1986 to nullify DOT/Commerce contract provisions and the determinations on which such provisions are based, when they do not accord with IRS views about correct usage of terms that appear in Title 26. The legislative history contains no support for this extraordinary suggestion. Indeed, the evidence contradicts the IRS theory. The only illustrations in the House Committee Report of the relationship between section 607 and section 7518 indicate precisely the opposite: *i.e.*, that terms in section 7518 are to be read in light of their usage in section 607.[96]

The Treasury claims about congressional purpose in the 1986 Act imply that Congress intended to repeal the CCF Program administrative structure expressly laid out in section 607. There is simply no way to stretch the term "coordinate" far enough to produce this result. Furthermore, the language of section 261(a), like the legislative history, indicates that section 7518 must be read in conjunction with, not in isolation from, section 607. Moreover, Congress' stated purpose for enacting section 7518—to coordinate section 607 more closely with the IRC—suggests that the consistency requirement of subsection (*l*) must be given more prominence, not less.[97]

The official legislative history makes no reference to any change in CCF Program administration, whether explicitly tax-related or not. Neither section 261 nor its legislative history reveals any evidence to support the Treasury theory that section 7518 was intended to transfer authority over CCF Program administration away from Transportation and Commerce. The Treasury theory, in fact, has been erected entirely on thin air.

D. The Addition of IRC Section 7518 Was a Byproduct of Congress' Decision to Reject the Reagan Treasury Department's Call for Abolition of the CCF Program

The purpose of the 1986 Act CCF provisions is best understood as a congressional response to the Treasury Department's proposal to abolish the CCF Program.[98] The dynamics of

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[95](...continued)

Section 607(a) determinations are, of course, expressly the province of the Secretaries of Transportation and Commerce. Accordingly, the legislative history implies that any attempt by the IRS to redetermine vessel ownership necessarily interferes with DOT/Commerce authority to determine eligibility for a CCF contract. The same principle applies to any other concept DOT/Commerce interpret in the course of contract entry.

[96] *See* 1986 House Committee Report at 191-92.

[97] Note that section 607(*l*) continues to authorize and control the joint regulations under which the IRS claims part of its authority to proceed.

[98] *See* 2 Treasury Department Report to the President, *Tax Reform for Fairness, Simplicity, Economic Growth*, ch. (continued...)

the response emerge from the legislative history of the contacts between the Merchant Marine and Fisheries Committee and the Ways and Means Committee.

Two parts of that history are particularly revealing. The first is a July 1985 exchange between Congressman Mario Biaggi, who was chairman of Merchant Marine and Fisheries' merchant marine subcommittee, and Congressman Brian Donnelly. Mr. Donnelly, who was himself a former member of Merchant Marine and Fisheries, appeared as a representative of Ways and Means before Mr. Biaggi's hearing on CCF tax reform proposals.[99] Their exchange clearly indicates that the proposed changes in the CCF Program, which were eventually enacted as section 261 of the 1986 Act, were viewed as alternatives to the Treasury Department's proposal to abolish the CCF Program.[100]

Mr. Donnelly then encouraged cooperation between the two committees in developing reform alternatives like the "sundown" provision. In the process, Mr. Donnelly mentioned a key fact: since the CCF issue had arisen in the context of tax reform, the decisive legislation would come from Ways and Means. Mr. Donnelly was clearly at pains to express his solicitude for the

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[98](...continued)
15.04 ("Repeal Merchant Marine Capital Construction Fund Exclusion"), at 324-26 (November 1984); *The President's Tax Proposals to Congress for Fairness, Growth and Simplicity,* at 304-06 (May 1985).

[99] Committee on Merchant Marine and Fisheries, *Ship Financing and Taxation—Part 2: Hearings Before the Subcommittee on Merchant Marine of the Committee on Merchant Marine and Fisheries, House of Representatives*, H. Rep. No. 52, 99th Cong., 1st Sess. 5-8 (Comm. Print 1985) ("1985 Merchant Marine Hearings").

[100] Congressman Donnelly began his testimony by noting its purpose:

> I am honored and pleased to appear before you today to share my concerns and sentiments in regard to [President Reagan's] tax reform proposal as it would affect the maritime industry, in particular the domestic commercial shipbuilding component of the American merchant marine. . . . I will focus my remarks today specifically on the proposal to repeal section 607 of the Merchant Marine Act, the Capital Construction Fund Program.

1985 Merchant Marine Hearings at 6. After indicating his support for the CCF program and its policies, Mr. Donnelly continued:

> Instead of repealing the program and eliminating this valuable mechanism for fleet revitalization, I would suggest that what is really called for is an improvement in the current program. One option that should be considered would be placing a limit on the time that tax-deferred CCF moneys can retain their special tax status. By doing so, there would be a heightened impetus for turning those funds back into fleet modernization projects. And by requiring a quicker reinvestment of those funds, domestic shipyards could gain some life-saving work.

Id. at 7.

members of his old committee, since this was likely to be a sore point.[101] Mr. Biaggi's response indicated he was indeed upset about the loss of full Merchant Marine and Fisheries Committee jurisdiction over the CCF Program. At the same time, he accepted the inevitable.[102]

When Ways and Means reported its bill, the attached correspondence between the committee chairmen again revealed two themes: (1) that Ways and Means had rescued the CCF Program from the Reagan Administration's attack, a result for which Merchant Marine and Fisheries should be grateful; and (2) the fact that the rescue had come in the context of tax legislation had altered the heretofore exclusive jurisdiction of Merchant Marine and Fisheries, a fact that continued to provoke that committee's concern.

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[101] Mr. Donnelly stated:

> I want to take this time to commend the chairman and all the members of this subcommittee for their leadership over the past few years in keeping this vital issue alive in public opinion. I will commit to the members of this committee to work very closely with them as a member of the House Ways and Means Committee to see, as we go through the process in scrubbing the numbers in the President's tax reform proposal, that any reform that would come from our committee would be the result of a constant and very intensive relationship, and leaning on the advice and experiences of the members of this committee.
>
> As you know, *under the Rules of the House the Ways and Means Committee has jurisdiction over all tax legislation.* But the fact of the matter is that tax legislation also determines, in many instances, public policy . . .
>
> I think it is critical that our committee work closely with the Merchant Marine Committee in this instance in regards to public policy, in regards to the U.S. merchant marine. . . . And I know that the chairman of our full committee and the chairmen of our subcommittees have and will continue to continue [sic] that dialog in process so that *when we make the decisions that need to be made* in terms of simplifying and reforming our tax system, that we donate decisions with the full input and knowledge and experience of those Members of the House of Representatives that have a unique view and unique understanding of how tax legislation affects industries over which their committees have direct jurisdiction.

Id. at 7-8 (emphasis added).

[102] Referring to Merchant Marine and Fisheries testimony on the CCF program proposals before Ways and Means, Mr. Biaggi commented:

> I am convinced we made a case—although I think anybody could have made a case because the case is so evident. But we don't want to get lost in the cracks. This is a purely jurisdictional comments [sic]. We understand what is properly that of the Ways and Means Committee. I think CCF is one area that is exclusively ours.
>
> Nonetheless, at this point we will not be contentious. We know the awesome power of the Ways and Means Committee in dealing with this matter.

Id. at 8.

Specifically, Chairman Rostenkowski's letter on behalf of Ways and Means noted that the amendments to the CCF program, although similar to changes that had come before Merchant Marine and Fisheries, were "proposed by the Committee on Ways and Means."[103] Apparently, Chairman Rostenkowski referred to proposals in the form of IRC provisions, since he noted that they required conforming amendments to section 607 of the 1936 Act. Chairman Rostenkowski then referred to the addition of new section 7518 to the IRC as being "[i]n addition" to the these changes.[104] The point of the addition emerges in the last paragraph of Chairman Rostenkowski's letter:

> As in this instance, I have every expectation that our committees will continue to cooperate fully when considering amendments to the Capital Construction Fund program whether the amendments are to section 7518 of the Internal Revenue Code or to section 607 of the Merchant Marine Act, 1936. In this way both tax policy and maritime policy will be well served by the committees of Congress charged with their development and oversight.[105]

Although it might have been possible for Chairman Rostenkowski simply to obtain the concurrence of Merchant Marine and Fisheries for amendments to section 607 and include such amendments as part of the 1986 Act (as he did), he chose to go one step further. He used the opportunity to propose the amendments in the form of tax legislation and to include them in the Internal Revenue Code alongside the other explicitly tax-related portions of section 607. The result was that Ways and Means achieved the right to participate in future legislation concerning the CCF program. Although this result concerned Chairman Jones, there was little he could do except to strike a gracious tone and seek reassurances that his committee's role would continue to be respected.[106]

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[103] Letter from House Ways and Means Committee Chairman D. Rostenkowski to Merchant Marine and Fisheries Committee Chairman W.B. Jones (December 4, 1985), *reprinted in* 1986 House Report at 194 ("Rostenkowski letter").

[104] *Id.*

[105] *Id.*

[106] Chairman Jones wrote:

> It is . . . most gratifying that you have agreed not only to retain the Capital Construction Fund, but also that you have agreed that the Capital Construction Fund should not be treated apart from the other promotional elements in the Merchant Marine Act, 1936. At the same time, we certainly understand and agree with the positioning, in parallel, of certain portions of the program in the Internal Revenue Code.
>
> I appreciate our understanding that my Committee's cooperation in expediting key tax reform legislation in no way prejudices any of its jurisdictional rights regarding the Capital Construction Fund under section 1(n) of House Rule X.

(continued...)

This history reveals the actual reasons for the addition of section 7518 to the IRC. It explains the absence of references in the official legislative history to any substantive reasons for republication of parts of section 607 in the Internal Revenue Code: the reasons were not substantive. Substantive considerations informed only the substantive changes in section 607—the ones intended as an alternative to the Reagan Treasury Department's proposal to eliminate the CCF program altogether.

The real story here was not a shift in administrative jurisdiction between executive agencies, but a partial shift in oversight jurisdiction between congressional committees. That partial shift of jurisdiction within Congress *may* someday lead to significant changes in the law. But it has not done so yet. The fact that Ways and Means now shares CCF legislative oversight with the House committee that oversees merchant marine affairs does not imply or even suggest that Congress has altered the roles or relative authorities of the executive agencies that administer the CCF Program. It would, furthermore, be particularly ironic if the steps Congress took in 1986 when it *rejected* Treasury's proposal to abolish the CCF Program were now used to give Treasury the effective power to carry out just such an abolition.

E. IRC Sections 7801 and 7805 are Not Licenses for IRS to Ignore the Authority of DOT/Commerce under Section 607

Neither the substance of Congress' changes to the CCF program in 1986, nor Congress' purpose in making those changes, supports the IRS/Treasury claims of a revolution in the administration of the CCF Program. IRS/Treasury staff have therefore relied principally on the mere fact of republication to justify their assertions.

The statute and the legislative history are devoid of signs that republication of subsections (b) through (i) of section 607 in Title 26 was intended to reassign control of the CCF Program. That fact alone is enough to defeat the IRS/Treasury theory. Section 607 remains in the U.S. Code, and Congress has never even hinted at an intent to alter or repeal its provisions. Intent to change the meaning of any statutory provision during recodification must be clear; otherwise new

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[106](...continued)

> I am certain that consideration by our committees of legislation dealing with either section 607 . . . or section 7518 . . . will be conducted in the spirit of cooperation that existed during the pendency of consideration of the Tax Reform Bill, and further that neither committee will utilize any device to frustrate the consideration by the House of Representatives of any measure that may be referred jointly to the Committee on Merchant Marine and Fisheries and the Committee on Ways and Means.

Jones letter, 1986 House Report at 193-94.

provisions are presumed to be consistent with prior law.[107] It follows *a fortiori* that section 7518, which simply republishes certain provisions of section 607, did not change the meaning of those provisions.

Since the language and history of the 1986 Act give them no support whatsoever, IRS/Treasury seek to rely on sections 7801(a) and 7805(a) of the IRC. These provisions, it is argued, grant the Secretary of the Treasury authority to proceed independently under all IRC provisions, including the CCF provisions republished in section 7518.

IRS/Treasury reliance on sections 7801(a) and 7805(a) is utterly misplaced. These are merely the standard general provisions for administration and rulemaking that accompany Title 26.[108] The application of both provisions is governed by the familiar rule of statutory construction that the specific overrides the general.[109] As we show below, the expansive IRS/Treasury interpretation of these general provisions creates an untenable conflict with much more specific, contrary provisions in Title 46 and in section 7518 of the IRC itself. The IRS/Treasury position would also require one to accept a novel theory about the effect of republication, which cannot be erected on the basis of precedent or standard legal reasoning.

1. Section 7801(a) Does Not Operate to Transfer CCF Administration or Enforcement Authority to Treasury

Section 7801(a) of the IRC reads as follows:

> *Except as otherwise expressly provided by law*, the administration and enforcement of this title shall be performed by or under the supervision of the Secretary of the

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[107] *See, e.g., Fulman v. United States*, 434 U.S. 528, 539 (1978) (declining to "read legislation to abandon previously prevailing law when . . . a recodification . . . departs substantially and without explanation from prior law . . . ."); *Fourco Glass Co. v. Transmirra Prod. Corp.*, 353 U.S. 222, 227 (1957) ("[I]t will not be inferred that Congress, in revising and consolidating the laws, intended to change their effect unless such intention is clearly expressed."); *CNA Financial Corp. v. Donovan*, 830 F.2d 1132, 1148-49 (D.C. Cir. 1987) (presumption against changes in existing law applies especially when the new codified statute would conflict with existing precedent or policy, or impede the operation of existing law), *cert. denied*, 485 U.S. 977 (1988).

[108] Such general provisions, of course, also accompany other titles of the U.S. Code, including Title 46. *E.g.*, 46 U.S.C. § 1114.

[109] *See, e.g., Morales v. Trans World Airlines,* 504 U.S. 374, 384-85 (1992) (holding that a general "remedies saving" clause cannot be allowed to supersede a specific substantive preemption provision: "It is a commonplace of statutory interpretation that the specific governs the general."); *Crawford Fitting Co. v. J.T. Gibbons Inc.*, 482 U.S. 437, 444-45 (1987) ("[W]here there is no clear intention otherwise, a specific statute will not be controlled or nullified by a general one, regardless of the priority of enactment.") (citations omitted).

Treasury.[110]

The phrase "by law" encompasses statutory provisions other than those in the IRC: statutory provisions in Title 46, for example. Where provisions in Title 26 are identical to those in another title, as they are here, the Title 26 provisions must be read in conjunction with all the relevant provisions of that other title. Congress' expressed intent to coordinate the application of the IRC with the 1936 Act underlines this imperative.

When sections 7518 and 7801 are read in light of section 607, as they must be, the express provisions of section 607(a) prove fatal to Treasury's claims. Because section 607(a) expressly specifies that deposits and withdrawals "shall be subject to . . . conditions and requirements" set by the Secretary of Transportation or Commerce, the IRS is necessarily forbidden from overruling determinations by those Secretaries as to whether such conditions and requirements have been fulfilled.[111]

The phrase "by law" in section 7801(a) also includes regulations.[112] The joint regulations issued by Treasury itself in conjunction with DOT and Commerce—which must and do conform with the consistency requirement in section 607(*l*)—expressly provide for administration by DOT and Commerce, not by Treasury or IRS.[113] These regulations pose yet another insuperable obstacle to Treasury's interpretation of the effect of section 7801(a).

The IRS/Treasury reading of section 7801, moreover, would produce absurd results. Their claim of authority over the CCF Program necessarily involves, in substance if not in form, an indefensible claim of authority to administer and enforce CCF contracts. The tax benefits authorized by the 1936 Act are actually conferred through the terms of CCF contracts. Benefits flow or cease depending on the interpretation of those terms and of the fundholder's compliance with those terms. If the IRS, while purporting to exercise the general authority granted in section 7801(a), may directly or indirectly interpret contract terms, it in effect administers and enforces

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[110] 26 U.S.C. § 7801(a) (emphasis added).

[111] The omission of subsection (a) from the set of 607 subsections republished in Title 26, moreover, confirms that administrative control over the CCF program did not shift to IRS/Treasury. IRS/Treasury assert that the mere appearance of certain provisions in the IRC bestows on the IRS the authority to proceed independently with respect to such provisions. Section 607(a), however, is *not* mirrored in the IRC. Thus, to be consistent with its own logic, the IRS must refrain from determinations that intrude in substance (or form) on section 607(a) deposit, withdrawal or contract matters.

[112] *See, e.g., Chrysler Corp. v. United States*, 441 U.S. 281, 301-03 (1979).

[113] *See, e.g.*, 46 CFR § 391.5(d); 26 CFR § 3.5(d) (confirming that only the Secretaries of Transportation and Commerce may determine that a substantial obligation under an agreement has not been fulfilled, and may then treat all or part of the fund as withdrawn in a nonqualified withdrawal); 46 CFR § 391.3(h); 26 CFR 3.3(h) (indicating that the presumption of deposit validity may be overcome only if Transportation or Commerce so determine, and that IRS may not even present the issue for their consideration unless it is based upon a "substantial question").

CCF contracts. This plain fact was recognized by Congress in the 1970 Amendments, when it restored administration of the Program to the maritime agencies by designating Commerce as the sole contracting agency.[114]

Permitting a non-contracting agency to administer and enforce CCF agreements, however indirectly, would violate the express provisions of section 607(a). It would also violate the terms of the CCF contracts themselves, thereby breaching the Government's contract with the fundholder. Section 7801(a), which is merely a general housekeeping provision in the IRC, cannot be read to effect violations of other U.S. laws and to cause breaches of U.S. contractual obligations. That is exactly why section 7801(a) begins with the phrase, "Except as otherwise provided by law . . ."

2. Section 7805(a) Does Not Operate to Transfer CCF Administration or Enforcement Authority to Treasury

Section 7805(a) of the IRC reads as follows:

> AUTHORIZATION. Except where such authority is expressly given by this title to any person other than an officer or employee of the Treasury Department, the Secretary [of the Treasury] shall prescribe all needful rules and regulations for the enforcement of this title, including all rules and regulations as may be necessary

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[114] The Senate report accompanying the 1970 Act states that while "the Treasury Department was able to *administer* the [tax deferred reserve funds] through closing agreements signed with each shipping company. . . . the bill provides a more specific statutory framework for determining the tax status of deposits into and withdrawals from the fund." 1970 Senate Report at 43-44, 1970 U.S.C.C.A.N. at 4217 (emphasis added).

In the House, the minority floor manger, Mr. Mailliard, characterized responsibility for the section 607 Program administration in the following terms:

> The principal element in the new tax deferral system will be the vessel acquisition or modernization agreement which each carrier will enter into with the Secretary of Commerce. This agreement will simply set forth the building program which the carrier hopes to achieve and will provide for the orderly deposit of earnings into the fund. We have deliberately left the terms of this agreement flexible, so that it may be fitted to the needs of each carrier.

116 Cong. Rec. 16,592 (May 21, 1970) (remarks of Mr. Mailliard). Similarly:

> The bill, as reported, sets forth the technical revisions to the tax deferral system as recommended by the staff of the joint committee. This revision will permit the administration of the tax deferral system by the Secretary of Commerce in conjunction with the Secretary of the Treasury without the need for individual closing agreements.

Id.

by reason of any alteration of law in relation to internal revenue.[115]

As with section 7801(a), IRS/Treasury claim that section 7805(a) gives them authority to regulate the CCF Program. In effect, they read sections 7805(a) and 7518 as broad stand-alone grants of authority, and they read those provisions as though section 607(a) did not exist.[116] The result is no more tenable here than it was in the case of section 7801(a).

If IRS/Treasury's reading were accepted, absurd results would follow. First, section 7805(a) would govern section 7518, while the Title 46 analog of section 7805(a) would govern section 607.[117] Thus, the Secretary of the Treasury and the Secretary of Transportation would each be given mutually exclusive authority to enforce *identical* provisions of law, namely those portions of section 607 that were republished in section 7518. This is absurd in the strictest sense of the term.

Another absurd result of the IRS/Treasury theory would be the possibility of two competing and inconsistent sets of regulations, one based on section 607 and the other based on the provisions of section 607 that are mirrored in section 7518. Congress could not have intended, and did not intend, to generate such inconsistencies when it republished parts of section 607 in the IRC in 1986.[118]

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[115] 26 U.S.C. § 7805(a).

[116] IRS/Treasury also read the term "expressly" in section 7805(a) as narrowly as possible. IRS/Treasury staff have claimed, for example, that the Secretary of Transportation or Commerce has authority only where the word "Secretary" is mentioned in section 7518, and that the Secretary of the Treasury has jurisdiction over every provision where no secretary is mentioned.

[117] Section 1114(b) of Title 46 provides that "[t]he [Federal Maritime] Commission and the Secretary of Transportation are authorized to adopt all necessary rules and regulations to carry out the powers, duties, and functions vested in them by this chapter." Since 1983, the relevant authority for purposes of the merchant marine portion of the CCF program has been the Secretary of Transportation.

[118] Under the IRS/Treasury staff theory, IRS would administer all provisions that do not mention the word "Secretary." These would include, for example, section 7518(c)(2), which mirrors section 607(d)(2) and which indicates that deposits within subceilings are entitled to tax deferral provided they are deposited pursuant to an agreement and not later than the time provided in joint regulations. Those very joint regulations, moreover, indicate that the IRS Commissioner may not determine whether a deposit is pursuant to an agreement; he or she is limited to requesting a determination from the Secretaries of Transportation or Commerce on any such issue. 26 CFR § 3.3(h); 46 CFR § 391.3(h). The IRS/Treasury position that a delegate of the Treasury Secretary may decide the matter therefore contradicts the very joint regulations that IRS/Treasury rely on and expressly claim to accept in other contexts.

The IRS/Treasury theory would also bring it into conflict with other joint regulations that Treasury itself has published. Most notably, the theory would cause numerous conflicts with 46 CFR § 391.1(b) and with 26 CFR § 3.1(b), which defer to MARAD and NOAA regulations for all rules relating to deposits and withdrawals, contract

(continued...)

The IRS/Treasury interpretation is untenable for other reasons as well. Even assuming, *arguendo*, that section 7518 itself does not clearly authorize DOT/Commerce rulemaking authority in all relevant instances, section 7805(a) cannot be read as a license for the IRS to ignore other agencies' statutory and regulatory authority. In particular, section 7805(a) cannot be read as a device for expanding the reach of section 7518 so as to interfere with DOT/Commerce authority under section 607(a). To do so would be to make section 607(*l*) a dead letter. Section 607(*l*) carefully *denies* IRS and Treasury any independent authority to issue rules or regulations with respect to the provisions mirrored in section 7518: their only ruling or regulatory authority with respect to such provisions must be exercised *jointly* with DOT or Commerce. Even Treasury's joint authority, moreover, does not permit determinations of tax liability that violate the consistency requirement of section 607(*l*).

IRS/Treasury's reading of section 7805(a), like its reading of section 7801(a), necessarily reads into section 261 of the 1986 Revenue Act an intent that Congress did not so much as hint at, either in the statute itself or in its legislative history. This reading, moreover, ignores Congress' express intent to coordinate section 607 with the IRC, and substitutes a completely unarticulated intent to transfer authority over the CCF Program from DOT/Commerce to IRS/Treasury. Thus, the IRS/Treasury reading of 7805(a) also reads into section 261 of the 1986 Act an implied repeal of the authority structure in section 607(a), as well as an implied repeal of section 607(*l*).

There is simply no support for any of this in what Congress did, or in what Congress said about what it was doing. All of the evidence about Congress' purpose in 1986 shows that it meant, as usual, to give full effect to prior statutes not expressly repealed. The contrary theory now proposed by IRS/Treasury is entirely a product of their desire to exert bureaucratic hegemony over all matters relating to taxation. Understandable as that desire may be, it is not binding on Congress. And it is Congress' decisions, not the wishes of the IRS or the Treasury, that must be respected.

F. In 1986, Congress Reaffirmed its Historic Policy of Promoting Maritime Interests through Tax-Deferred Funds Administered by Maritime Program Agencies

In November 1984, Treasury proposed that the CCF Program be terminated.[119] This

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[118](...continued)
eligibility and other matters. The IRS/Treasury theory would imply a claim, for example, to determine when a withdrawal is made in accordance with the terms of an agreement and is therefore a qualified withdrawal. § 607(f)(1); § 7518(e)(1). But MARAD and NOAA control express approval of qualified withdrawals and all requirements for such withdrawals under their respective regulations. *E.g.*, § 607(a); 46 CFR § 390.9 (MARAD regulation).

[119] 2 Treasury Department Report to the President, *Tax Reform for Fairness, Simplicity, Economic Growth*, ch. 15.04 ("Repeal Merchant Marine Capital Construction Fund Exclusion"), at 324-26 (November 1984).

proposal was carried forward as a part of the Reagan Administration's submission to Congress.[120] Congress rejected the proposal. As the House Committee emphatically commented:

> The committee believes that the provision of tax benefits for U.S. shipping through the Capital Construction Fund mechanism is appropriate. Aid to U.S. shipping industries is necessary to assure an adequate supply of ships in the event of war. Congress has adhered to a policy of providing tax incentives to the domestic shipping industry for many years, and the committee was concerned that the elimination of such incentives, coupled with reduced appropriations for maritime construction, could injure the industry.[121]

In rejecting the Treasury proposal, Congress was merely reaffirming its long-standing policy of using tax incentives to foster the maintenance of what Congress considers an adequate merchant marine. Tax deferral benefits, now as in the past, depend on maritime agency approvals of proposed shipbuilding or ship acquisition programs, and the role of Treasury remains very limited.

Apart from the substantive adjustments it made in the CCF Program, the 1986 Act simply provided for more careful coordination of IRS tax-collection responsibilities with the CCF Program responsibilities of DOT and Commerce.[122] The goal of better coordination does not imply, or even suggest, the sweeping jurisdictional shift that IRS/Treasury would like to find lurking in the 1986 Act. On the contrary, the IRS/Treasury jurisdictional claims are *antithetical* to the congressional purpose because they guarantee conflicts between interpretations of the law reflected in CCF contracts and later interpretations imposed in IRS enforcement actions.[123]

Congress' actions in 1986 also reflected the continuing congressional recognition that tax deferral under the CCF Program is unique, since it is a tax benefit that can be acquired only by contract, and can be lost only through breach of contract.[124] There are no other programs in which

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[120] *The President's Tax Proposals to Congress for Fairness, Growth and Simplicity,* at 304-06 (May 1985).

[121] 1986 Bluebook at 175; 1986 House Report at 191.

[122] Section 607(m) illustrates the coordination Congress intended. Section 607(m) requires that Transportation and Commerce inform Treasury annually as to withdrawals (which would include DOT/Commerce determinations as to nonqualified withdrawals), deposits and other CCF data. The withdrawal information, in particular, is necessary before the IRS may proceed with its tax assessment and collection activity.

[123] See the discussion in Section II.E *supra*.

[124] In 1986, Congress reaffirmed the role of the contracting agency in the critical matter of contract compliance and non-compliance determinations. *See* § 607(h)(5)(D) (providing that even when the Secretary of Transportation or Commerce determines that a contracting party has deposited funds in excess of the amount needed to achieve the fleet renewal program such Party has undertaken, the Secretary may permit the Party to develop "appropriate program

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tax deferrals (or any other tax benefit) constitute contract consideration. Initiation and termination of such tax benefits are therefore also, uniquely, assigned to the contracting agency rather than to the IRS. Under section 607 and its implementing regulations, CCF tax benefits may be disallowed *only* for contract noncompliance, and the contracting agency makes *all* determinations concerning such contract noncompliance.[125]

Congress has recognized that IRS/Treasury expertise may assist DOT/Commerce in carrying out their responsibilities. That is why section 607 establishes a mechanism for promulgating joint regulations.[126] It is also why Congress sought to improve the coordination of the CCF program through specific mechanisms put in place in 1986. IRS/Treasury may resent the limited role that Congress has chosen to assign them in the administration of this Program, but no revolution in Program control is needed to accommodate their legitimate contributions.

III. IRS INTERFERENCE IN CCF CONTRACTS EXPOSES THE UNITED STATES TO COSTLY LIABILITY FOR BREACH OF CONTRACT

CCF contracts are contracts with the United States, and the terms of such contracts are binding obligations of the United States. They are the result of negotiated agreements entered by MARAD and NOAA under properly delegated statutory authority. The CCF tax deferrals are consideration for activities that CCF applicants agree to undertake. The commitments made by the United States must be honored by all of its agencies, including the IRS.

As we show in detail below, each CCF contract guarantees the private contractor the right to the tax deferrals that are consideration for its performance, so long as the private party complies with the contract. The contract also guarantees that determinations necessary for denying the tax deferrals will be made only by the contracting agency. Before the IRS may proceed to disallow any tax benefits under the DOT program, for example, MARAD must make three separate determinations: noncompliance, breach, and nonqualified withdrawal. In addition, the contracting party must be afforded the opportunity to cure any breach that has occurred. Accordingly, any effort by IRS to disallow CCF tax benefits outside such contractually established

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[124](...continued)
objectives" over a period of three years "to dissipate such excess."); § 607(m)(2)(E) (indicating that the Secretary of Transportation or Commerce advises Treasury of whether a party has failed to fulfill substantial obligations under CCF agreement). Noncompliance determinations, of course, are the indispensable prerequisite to any disallowance of benefits.

[125] The contract itself provides that its terms may be modified or amended only by written consent of the parties. All schedules are incorporated into and made a part of the contract, and modification of the contract's agreement vessel or qualified vessel schedules, or of the financial plan, require mutual consent. Contract terms may be set or reset only by the contracting agencies, and IRS/Treasury have no role in either process.

[126] IRS/Treasury could expand their input by participating more fully in the existing regulatory process and would undoubtedly do so if their real goal were to offer the benefits of their expertise.

procedures breaches the private party's contract with the United States.

The IRS takes the position that it is entitled to pursue its own customary auditing and assessment procedures without regard to the terms of contracts that require it to await the determinations of authorized contracting agencies. If the IRS is allowed to do this, it will force the United States into breach of its contractual commitments. It is virtually inevitable that the U.S. Government will be held liable for these breaches, since the contracting agencies are clearly authorized to let CCF contracts in exactly the form that they have been letting them for many years.

The potential costs to the United States of the proposed IRS course of action are high. They can be entirely avoided, however, if OLC appropriately resolves this jurisdictional dispute between IRS/Treasury and DOT/Commerce.

A. Treasury and IRS are Bound by CCF Program Contracts which DOT and Commerce Enter on Behalf of the United States

Under section 207 of the 1936 Act, the contracting agency enters into CCF contracts "upon behalf of the United States."[127] Accordingly, CCF contracts expressly state at the outset that the contracting party is the United States, and that MARAD or NOAA is its representative.[128] The government incurs obligations under a contract it enters when a private party assumes obligations in exchange. In such a context the benefits conferred by the government are legal consideration, bargained for to secure the commitments of the private contracting party.[129]

After an agency authorized to undertake such obligations on behalf of the United States enters into contracts with private parties, the United States is bound just as surely as the private parties are bound. As the Supreme Court has observed:

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[127] 46 U.S.C. app. § 1117; *Seatrain Shipbuilding Corp. v. Shell Oil Co.*, 444 U.S. 572, 585 (1980).

[128] The first paragraph of the model MARAD contract set out in the agency's regulations reads:

> This Capital Construction Fund Agreement ("Agreement"), made on the date hereinafter set forth, by and between the United States of America, represented by the Maritime Administrator, Department of Transportation ("Maritime Administrator") and _____, a corporation organized and existing under the laws of the State of _____ ("Party"), a citizen of the United States of America.

46 CFR § 390, App. II (Sample Capital Construction Fund Agreement).

[129] *See, e.g., Winstar v. United States*, 64 F.3d 1531, 1546 (Fed. Cir. 1995) (en banc) ("In contracts involving the government, as with all contractual relationships, rights vest and contract terms become binding when, after arms length negotiation, all parties to the contract agree to exchange real obligations for real benefits." (quoting the decision below)).

> When the United States, with constitutional authority, makes contracts, it has rights and incurs responsibilities similar to those of individuals who are parties to such instruments.[130]

The Attorney General has specifically held that contracts entered into by maritime agencies under the 1936 Act are binding on the United States.[131] The courts, too, have been consistent in their enforcement of 1936 Act contractual commitments.[132]

It is obvious—but also important to note—that the IRS and Treasury are bound by contracts that other agencies enter into on behalf of the United States. The United States, for contract purposes, includes all the agencies thereof.[133] The IRS has no more authority to ignore MARAD and NOAA contracts with CCF fundholders than it would have to ignore a properly authorized plea bargain agreed to by the Department of Justice.[134]

B. IRS Interference with CCF Contracts Will Force the United States into Breach of its Contractual Commitments

If the IRS is allowed to interfere with CCF contracts, it will force the United States into breach of its obligations. The United States breaches a binding contract if it withholds contract

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[130] *Perry v. United States*, 294 U.S. 330, 352 (1935). The Court also stated: "To say that the Congress may withdraw or ignore [its] pledge is to assume that the Constitution contemplates a vain promise, a pledge having no other sanction than the pleasure and convenience of the pledgor. This Court has given no sanction to such a conception of the obligations of our Government." *Id.* at 351. *See also Lynch v. United States*, 292 U.S. 571, 579 (1934) (footnote omitted) (the government's "rights and duties . . . are governed generally by the law applicable to contracts between private individuals.").

[131] *See Merchant Marine Act, 1936 - Ship Mortgage and Loan Insurance - Faith and Credit of the United States*, 41 Op. Atty. Gen. 363, 369-70 (1958) (Secretary of Commerce had power under the Merchant Marine Act of 1936 to obligate the United States by contract in connection with Title XI loan guarantees, and United States was bound by such obligations).

[132] *See, e.g., Moore-McCormack Lines, Inc. v. United States*, 413 F.2d 568, 582 (Ct. Cl. 1969) (emphasizing non-gratuitous nature of agreement in which private party gave consideration for obligations assumed by government); *Pacific Far East Line, Inc. v. United States*, 394 F.2d 990, 998 (Ct. Cl. 1968) (agreement "treated like any other commercial contract between the United States and a private party"); *American Export Isbrandtsen Lines, Inc. v. United States*, 499 F.2d 552, 576 (Ct. Cl. 1974) (private party's eligibility for benefit "governed by the principles of contract law and not by the auguries of agency discretion"); *Delta S.S. Lines, Inc. v. United States*, 3 Cl. Ct. 559 (1983) (grant of benefit held binding on the United States).

[133] *See, e.g., Margalli-Olvera v. Immigration and Naturalization Service*, 43 F.3d 345, 352 (8th Cir. 1994) ("[I]f unambiguous, the term 'United States' [in an agreement] is a reference to the entire United States government and all the agencies thereof." (citations omitted)).

[134] *See, e.g., Margalli-Olvera,* 43 F.3d at 353-54 (plea agreement reached by United States attorney was binding on INS).

benefits or otherwise violates contract obligations to a private party that has fulfilled its own commitments under the contract.[135] The contract is breached in such situations whether the contracting agency or another agency violates the Government's obligation. Accordingly, any IRS act that contravenes a CCF contract will place the United States in breach of its contract obligations to the CCF fundholder.

The jurisdictional dispute that is now before OLC has arisen because the IRS claims the right to disallow CCF contract benefits without awaiting the MARAD or NOAA determinations that by law must precede any such IRS action. IRS, that is, asserts the right to contradict and nullify the terms of a contract even though the fundholder is fully in compliance with the contract and with all relevant MARAD or NOAA determinations. If the IRS is allowed to proceed in this manner, it will force the United States into breach.

Nor can there be any doubt that CCF fundholders have contractual rights to specified tax benefits. Under the typical MARAD contract, for example, the fundholder is assured of CCF tax deferrals so long as such party complies with the contract:

> The Maritime Administrator agrees that the Federal income tax benefits provided in the Act and the rules and regulations shall be available to the Party if the Party shall carry out its obligations under this Agreement.[136]

The CCF contractor thus has a vested right to retain tax deferrals unless there is a finding of

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[135] Such a violation will constitute breach unless the private party has not fulfilled its own commitments. *See Sun Oil Co. v. United States*, 572 F.2d 786 (Ct. Cl. 1978) (failure by Department of Interior to provide contract benefit constituted breach where plaintiffs had performed all contract obligations up to time of denial). *Cf. Chevron Chem. Corp. v. United States*, 5 Cl. Ct. 807, 811 (1984) (granting summary judgment to plaintiff on breach of contract claim where EPA breached a settlement agreement, and noting that "if an agency enters into contracts to facilitate administration of a program sovereign in nature, the agreements are enforceable under general contract principles").

[136] 46 CFR § 390, App. II (Sample Capital Construction Fund Agreement), Article 15. *See also* 46 CFR §§ 390.13, 391.5(d). Note that since MARAD and NOAA enter CCF contracts with private fundholders under the authority delegated to Transportation and Commerce in section 607 of the 1936 Act, each CCF contract expressly indicates that its terms (including amendments) are subject to the provisions of section 607, and the rules and regulations thereunder. *E.g.*, 46 CFR § 390 App. II, Item 6 ("Whereas" provisions). The Act, and the rules and regulations implementing it, are therefore implied terms of each CCF contract. *See, e.g., Coflexip & Services, Inc. v. United States*, 961 F.2d 951, 953-54 (Fed. Cir. 1992) (where implied-in-fact contract was expressly subject to certain regulations, the contract incorporated the pertinent provisions of such regulations).

Section 607 and the rules and regulations implementing it augment the express terms of a CCF contract. Under section 607 and its implementing regulations, contract noncompliance is the only circumstance that permits discretionary disallowance of CCF tax benefits. The implied terms of the contract therefore confirm that the sole condition for enjoyment of tax benefits is the one specified in the express terms—namely compliance with the contract.

contract noncompliance by the contracting agency.[137] Should the IRS disallow tax benefits provided by contract, it will nullify specific substantive contract terms by nullifying determinations made in the course of contract entry or of contract administration.[138] Such unilateral and fundamental modification of the contract, without the consent of the parties, would necessarily expose the United States to claims for breach of its binding contractual commitments. The IRS is not authorized to take this step, and the agency cannot be allowed to seize such a role.

In addition to the substantive contractual rights that CCF fundholders enjoy, there are equally important procedural protections surrounding the termination of contractual benefits. The contracts specifically provide that *only MARAD may determine whether the requisite contract violations have occurred.*[139] The statute and the joint regulations (which have been promulgated by Treasury itself as well as by DOT) require this provision.[140] Both are implied terms of the contract, reinforcing the express contractual guarantee that the private fundholder is entitled to its tax deferral until and unless the contracting agency, not IRS, decides that it is appropriate to terminate such contract benefits.

By asserting the right to disallow benefits on its own initiative, IRS proposes to deprive CCF parties of their guaranteed procedural protections under the Program contract. If permitted to act without awaiting findings by the contracting agency, IRS will violate a series of such protections. After any determination that a fundholder has violated a substantial obligation under a CCF agreement, the Maritime Administrator must make two additional determinations before tax deferral may be disallowed: first, that a breach has occurred; and second, that some or all of

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[137] The prerequisite for discretionary termination of tax benefits under the contract is a determination by the Maritime Administrator that a substantial obligation under a contract is not being fulfilled by the private party. 46 CFR § 390, App. II (Sample Capital Construction Fund Agreement), Article 14.

[138] Such actions would therefore constitute breach even if IRS rather than MARAD or NOAA were deemed to be the agency principally responsible for administering the CCF contracts. *See Resolution Trust Corp. v. FSLIC*, 25 F.3d 1493, 1501 (10th Cir. 1994) (an agency "may properly be held in breach of any agreements which could have been honored by the exercise of discretion afforded them by Congress").

[139] 46 CFR § 390, App. II (Sample Capital Construction Fund Agreement), Article 14. The prerequisite for discretionary termination of tax benefits under the contract is a determination by the Maritime Administrator that a substantial obligation under a contract is not being fulfilled by the Party. *Id.*

[140] In accord with the statute, § 607(f)(2), the contract provides that MARAD, the contracting agency, must determine all such substantial violations. 46 CFR § 390, App. II (Sample Capital Construction Fund Agreement), Article 14. This statutory provision, which also appears in IRC section 7518(e)(2), applies, of course, to the particulars of the current IRS challenge. The joint regulations are in accord. § 46 CFR § 391.5(d): 26 CFR § 3.5(d). With respect to deposits, see also 46 CFR § 391.3(h), 26 CFR § 3.3(h)(2) (IRS must request a determination by the Secretary of Transportation where there is a substantial question as to whether a deposit is made in accordance with the Agreement); 46 CFR § 390.13.

the fund is to be treated as a nonqualified withdrawal.[141] Both such determinations must be made after notice and an opportunity to be heard, pursuant to procedures specified in the rules and regulations under section 607. Moreover, in obedience to the legislative history and the regulations reflecting it, the Maritime Administrator is required to provide an opportunity for the fundholder to cure any breach so declared.[142]

By violating these contractually guaranteed procedures, the IRS' proposed course of action also violates another contract term: the provision that the contract may be modified or amended only by written consent of the parties.[143] This provision indicates that contract terms may be reset only by the contracting agencies, just as they may be set initially only by those agencies. The IRS is given no role in either process, and it cannot assume such a role in the guise of exercising its audit functions.

C. IRS Interference with CCF Contracts Will Unnecessarily Expose the United States to Costly Liability for Breach of Contract

If IRS disallows CCF tax deferrals outside the procedures specified in MARAD and NOAA contracts, or in contravention of the substantive terms of those agreements, its action will clearly constitute breach of contract. Any such breach will unnecessarily expose the United States to liability.

The potential costs to the Government of such actions exceed any tax revenues that the IRS might eventually collect, for breach of contract subjects the Government to claims for both actual and consequential damages.[144] Such damages would include, at a minimum, the amount of any lost or withheld CCF tax benefits, along with any interest, penalties, or other additions to tax that had

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[141] 46 CFR § 390, App. II (Sample Capital Construction Fund Agreement), Article 14(A); 46 CFR §§ 390.13, 391.5(d).

[142] 46 CFR App. II (Sample Capital Construction Fund Agreement), Article 14(B); 46 CFR § 390.13(b)(1)(iii) & (2), (d). This requirement implements the clearly expressed intent of Congress to avoid benefit disallowance, if possible, by applying sanctions for contract violations "sparingly." *See* 1970 Senate Report at 50, 1970 U.S.C.C.A.N. at 4224.

[143] 46 CFR App. II (Sample Capital Construction Fund Agreement), Article 10. *Cf.* 46 CFR § 390.6(d)(1) (requiring mutual consent for contract modification). Note that since all schedules are incorporated into and made a part of the contract, modification of the list of agreement vessels of the financial plan also requires mutual consent. 46 CFR App. II, at Article 11. *Cf.* 46 CFR § 390.6(d)(1) & (2) (indicating that MARAD consent to modifications of the schedules is subject to certain policy restrictions and that the Maritime Administrator will withhold his consent when, for example, such modification, "in his opinion," adversely affects imposition of tax "in a manner not contemplated or authorized by the Act . . . .").

[144] *Smokey Bear Inc. v. United States*, 31 Fed. Cl. 805, 808-09 (1994) (holding that government's breach of a licensing agreement entitled plaintiffs to seek both actual and consequential damages).

resulted from disallowance or withholding of the CCF benefits.[145] Consequential damages, of course, could exceed such amounts. In addition, the Government would incur substantial litigation expense, and might have to pay the plaintiff's litigation and administrative proceeding costs.[146]

The risk of government liability for damages would be extremely high. The Government can escape liability for damages only if its breach of contract is excusable,[147] and the Government is very unlikely to be excused if the contracting agency acted within its authority.[148] There can be no doubt that MARAD and NOAA are authorized to act for Transportation and Commerce in letting CCF contracts, and that such authority has been properly granted by Congress in section 607(a).

Thus, the Government could prevail only if the manner in which a properly authorized act is implemented may affect whether the act is "within the authority" of a contracting agency for purposes of determining liability for breach. To put it differently, the Government would not be able to escape liability unless the generally authorized act—in this case, setting and administering the terms of a CCF contract—was erroneous and "outside the authority" of MARAD or NOAA.

Even in the unlikely event that a court were to conclude (as IRS suggests) that MARAD or NOAA has misconstrued some tax-related concept in the statute, such legal error would almost certainly be irrelevant to the definition of "authority" for purposes of determining the Government's liability for breach of contract.[149] To the extent that any such error may be relevant at all, it can be so only in the exceptional case, where the resulting illegality is "plain and palpable."[150]

Even assuming that egregious legal error in the process of entering or administering a contract might as a general proposition allow the Government to escape liability for breach, it is

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[145] The plaintiff will be entitled, as well, to interest on any overpayment of tax due to the IRS action. 26 U.S.C. § 6611.

[146] 26 U.S.C. § 7430(a).

[147] For a general discussion, see *Winstar v. United States*, 64 F.3d 1531, 1547-48 (Fed. Cir. 1995) (en banc).

[148] *See, e.g., Broad Ave. Laundry & Tailoring v. United States*, 681 F.2d 746, 747-48 (Ct. Cl. 1982).

[149] *See, e.g., Broad Ave. Laundering*, 681 F.2d 746 (government forbidden to repudiate written modification of contract even though the modification was based on a mistake of law).

[150] *See, e.g., Broad Ave. Laundering*, 681 F.2d at 749-50 (discussing government-cited cases involving so-called "palpable illegality," but expressing doubt "whether a contractor must scrutinize an order for palpable illegality, refuse to perform if it sees palpable illegality, and perform subject to resolution of the dispute on appeal only if the illegality, in its eyes, is not palpable"); *id.* at 750 ("We think it is with small dignity indeed that [the United States] argues that an illegality should be perceivable to [the private contractor] that was not perceivable to its own contracting officer . . . .").

altogether improbable that the Government could demonstrate such error with respect to CCF contracts. The Government would have to show that the terms of such contracts were "palpably illegal" under the statute and the regulations, which would be virtually impossible because the terms of the contracts closely track the language of the statute and regulations.[151] MARAD regulations containing both the standard form contract terms and the statutory interpretations on which these terms are based, moreover, were first published in 1972 and have stood unchanged for nearly twenty years.[152]

The standard contract terms that appear in MARAD regulations include the procedural terms that provide due process for fund contract holders prior to any disallowance of tax deferral benefits under MARAD regulations. The same criterion that applies to contract terms derived verbatim from the form contract set out in the regulations (such as procedural terms) would also apply to specific, substantive clauses derived in part from the standard form contract. In defending against a breach of contract claim, the Government would have to show that the interpretations of an agency that has been administering this statute for two and a half decades have suddenly become "palpably illegal" now that the IRS believes section 7518 of the IRC allows it to annul MARAD/NOAA judgments. This task would be made insuperably difficult by the scope of section 607(a), which grants sweeping contract authority to Transportation and Commerce.[153]

If the IRS is convinced that MARAD or NOAA has misinterpreted a statute in setting or administering the terms of a CCF contract, it is not helpless. Its first recourse is to bring the matter to the attention of the contracting agency.[154] If IRS is dissatisfied with the result of its efforts, it can appeal the legal issue to OLC. The IRS can also go back to the legislature and try once again to have the CCF program altered or eliminated. What the IRS may *not* do is attack

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[151] *See* 46 CFR Part 390 and App. II (Sample Capital Construction Fund Agreement).

[152] MARAD regulations setting out the sample capital construction fund agreement contract were published in proposed form in the Federal Register of October 7, 1972, 37 Fed. Reg. 21336. After MARAD receipt and consideration of comments, the sample contract was published in final form on January 29, 1976, at 41 Fed. Reg. 4265. Subsequent modifications in MARAD regulations are not material to our discussion.

[153] The contract principle that an agency is liable for its commitments unless, perhaps, they were "plainly or palpably illegal," accords with the familiar *Chevron* doctrine, under which the interpretations by an agency of a statute it administers are controlling provided only that they are reasonable—including being free of obvious error. *See Chevron U.S.A. v. Natural Resources Defense Council, Inc.*, 467 U.S. 834 (1984). Absent such obvious error, such agency interpretations must be accepted by the courts. Thus, under *Chevron* alone, IRS may not proceed independently—that is, without prior MARAD or NOAA determinations, or in contravention of such determinations—unless MARAD or NOAA contract terms or decisions applying such terms are unreasonable. It would not be enough, under *Chevron*, to demonstrate that an IRS interpretation of a statute or regulation was the "preferred" or "better" reading. The MARAD reading would have to be proved unreasonable. Note that even in the unlikely event that IRS efforts to disallow CCF tax benefits outside the contract did not cause the government to be liable for breach of its CCF contract commitments, the IRS actions would still have to confront the formidable hurdles presented by *Chevron*.

[154] *See, e.g.*, 46 CFR § 391.3(h); 26 CFR § 3.3(h).

fundholders' contractual rights, by disallowing tax benefits without awaiting the requisite determinations from MARAD or NOAA.

CCF contracts are binding contracts with the United States. The United States may not breach the commitments made in such a contract without exposing itself to liability. This principle is so fundamental that the courts have held that *Congress itself* may not accomplish what the IRS proposes to do here.[155] It follows, *a fortiori*, that the IRS/Treasury position is untenable.

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[155] *Winstar v. United States*, 64 F.3d 1531 (Fed. Cir. 1995) (en banc).

CONCLUSION

Revitalization of America's shipyards remains an important goal. Indeed, in August 1994, President Clinton participated personally in the announcement of the MARAD award of $22.7 million in Title XI federal loan guarantees for the modernization of NASSCO's San Diego shipyard under the Administration's 1993 program to help United States shipyards become competitive in world markets. The President's stance toward revitalization, not the stance of IRS/Treasury, correctly reflects the priorities embodied in the law.

The extent that IRS/Treasury hostility to the CCF program is motivated by revenue concerns, Congress has already decided that other concerns must take precedence. In the instant case, moreover, IRS nullification of the NASSCO CCF contract can be expected to lead to contract damage awards against the United States far in excess of any tax that could possibly be collected. The same would surely prove true for other CCF contracts as well.

Beyond the NASSCO/MK case, however, attacks upon the competitiveness of United States shipyards and fisheries will surely prove short-sighted. Congress continues to support the CCF Program for a variety of reasons. Some reasons have to do with the importance of a vigorous domestic shipbuilding capability to our national defense industrial base. Others concern the role of an independent U.S. merchant marine and of U.S. citizen mariners in assuring carriage for United States trade and defense needs.

But whatever Congress's reasons for continuing to support the CCF Program, this congressional determination must not be overridden by a tax agency that is manifestly motivated largely by bureaucratic jealousy over Congress's decision to confer tax-related authority on DOT and Commerce. Apart from the unseemliness of allowing IRS and Treasury to decide which tax-related functions Congress shall be permitted to lodge in other agencies, it is the United States (not IRS or Treasury) that will find itself liable if these agencies cause a breach of the Government's contractual obligations.

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Respectfully submitted,

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