

transactions involving agreement vessels or realized by the fund, see paragraph (d) of this section. For rules relating to the treatment of capital losses on assets held in the fund, see paragraph (e) of this section.

(d) *Ordinary income account.* The ordinary income account shall consist of:

(1) Amounts referred to in section 607(b)(1)(A) of the Act and § 3.2(a)(1)(i) (relating to taxable income attributable to the operation of an agreement vessel),

(2) Amounts representing (i) deposits of gains from the sale or exchange of capital assets held for 6 months or less (for purposes of this section referred to as “short-term capital gains”) referred to in section 607(b)(1) (C) or (D) of the Act and § 3.2(a)(1) (iii) and (iv) (relating respectively to certain agreement vessels and fund assets), reduced by (ii) amounts representing losses from the sale or exchange of capital assets held in the fund for 6 months or less (for purposes of this section referred to as “short-term capital losses”). For rules relating to the treatment of certain agreement vessels as capital assets, see paragraph (c) of this section,

(3) Amounts representing interest (not including any tax-exempt interest referred to in section 607(e)(2)(D) of the Act and paragraph (b)(4) of this section) and other ordinary income received on assets held in the fund (not including any dividend referred to in section 607(e)(2)(C) of the Act and subparagraph (5) of this paragraph),

(4) Amounts representing ordinary income from a transaction (involving certain net proceeds with respect to an agreement vessel) described in section 607(b)(1)(C) of the Act and § 3.2(a)(1)(iii), including gain which is ordinary income under section 607(g)(5) of the Act and § 3.6(e) (relating to treatment of gain on the disposition of a vessel with a reduced basis) or under section 1245 of the Code (relating to gain from disposition of certain depreciable property), and

(5) Fifteen percent of any dividend referred to in section 607(e)(2)(C) of the Act and paragraph (b)(3) of this section received on any assets held in the fund.

(e) *Limitation on deduction for capital losses on assets held in a fund.* Except on termination of a fund, long-term (and

short-term) capital losses on assets held in the fund shall be allowed only as an offset to long-term (and short-term) capital gains on assets held in the fund, but only if such gains are deposited into the fund, and shall not be allowed as an offset to any capital gains on assets not held in the fund. The net long-term capital loss of the fund for the taxable year shall reduce the earliest long-term capital gains in the capital gain account at the beginning of the taxable year and the net short-term capital loss for the taxable year shall reduce the earliest short-term capital gains remaining in the ordinary income account at the beginning of the taxable year. Any such losses that are in excess of the capital gains in the respective accounts shall reduce capital gains deposited into the respective accounts in subsequent years (without regard to section 1212, relating to capital loss carrybacks and carryovers). On termination of a fund, any net long-term capital loss in the capital gain account and any net short-term capital loss remaining in the ordinary income account is to be taken into account for purposes of computing the party’s taxable income for the year of termination as a long-term or short-term (as the case may be) capital loss recognized in the year the fund is terminated. With respect to the determination of the basis to a fund of assets held in such fund, see § 3.2(g).

[T.D. 7398, 41 FR 5812, Feb. 10, 1976, as amended by T.D. 7831, 47 FR 39675, Sept. 9, 1982]

§ 3.5 Qualified withdrawals.

(a) *In general.* (1) A qualified withdrawal is one made from the fund during the taxable year which is in accordance with section 607(f)(1) of the Act, the agreement, and with regulations prescribed by the Secretary of Commerce and which is for the acquisition, construction, or reconstruction of a qualified vessel (as defined in § 3.11(a)(2)) or barges and containers which are part of the complement of a qualified vessel (or shares in such vessels, barges, and containers), or for the payment of the principal of indebtedness incurred in connection with the acquisition, construction, or reconstruction of such qualified vessel (or a

barge or container which is part of the complement of a qualified vessel).

(2) For purposes of this section the term *share* is used to reflect an interest in a vessel and means a proprietary interest in a vessel such as, for example, that which results from joint ownership. Accordingly, a share within the meaning of § 3.2(f) (relating to the definition of "agreement vessel" for the purpose of making deposits) will not necessarily be sufficient to be treated as a share within the meaning of this section.

(3) For purposes of this section, the term *acquisition* means any of the following:

(i) Any acquisition, but only to the extent the basis of the property acquired in the hands of the transferee is its cost. Thus, for example, if a party transfers a vessel and \$1 million in an exchange for another vessel which qualifies for nonrecognition of gain or loss under section 1031 (a) of the Code (relating to like-kind exchange), there is an acquisition to the extent of \$1 million.

(ii) With respect to a lessee's interest in a vessel, expenditures which result in increasing the amounts with respect to which a deduction for depreciation (or amortization in lieu thereof) is allowable.

(b) *Payments on indebtedness.* Payments on indebtedness may constitute qualified withdrawals only if the party shows to the satisfaction of the Secretary of Commerce a direct connection between incurring the indebtedness and the acquisition, construction, or reconstruction of a qualified vessel or its complement of barges and containers whether or not the indebtedness is secured by the vessel or its complement of barges and containers. The fact that an indebtedness is secured by an interest in a qualified vessel, barge, or container is insufficient by itself to demonstrate the necessary connection.

(c) *Payments to related persons.* Notwithstanding paragraph (a) of this section, payments from a fund to a person owned or controlled directly or indirectly by the same interests as the party within the meaning of section 482 of the Code and the regulations thereunder are not to be treated as qualified withdrawals unless the party dem-

onstrates to the satisfaction of the Secretary of Commerce that no part of such payment constitutes a dividend, a return of capital, or a contribution to capital under the Code.

(d) *Treatment of fund upon failure to fulfill obligations.* Section 607(f)(2) of the Act provides that if the Secretary of Commerce determines that any substantial obligation under the agreement is not being fulfilled, he may, after notice and opportunity for hearing to the party, treat the entire fund, or any portion thereof, as having been withdrawn as a nonqualified withdrawal. In determining whether a party has breached a substantial obligation under the agreement, the Secretary will consider among other things, (1) the effect of the party's action or omission upon his ability to carry out the purposes of the fund and for which qualified withdrawals are permitted under section 607(f)(1) of the Act, and (2) whether the party has made material misrepresentations in connection with the agreement or has failed to disclose material information. For the income tax treatment of nonqualified withdrawals, see § 3.7.

§ 3.6 Tax treatment of qualified withdrawals.

(a) *In general.* Section 607(g) of the Act and this section provide rules for the income tax treatment of qualified withdrawals including the income tax treatment on the disposition of assets acquired with fund amounts.

(b) *Order of application of qualified withdrawals against accounts.* A qualified withdrawal from a fund shall be treated as being made: First, out of the capital account; second, out of the capital gain account; and third, out of the ordinary income account. Such withdrawals will reduce the balance within a particular account on a first-in-first-out basis, the earliest qualified withdrawals reducing the items within an account in the order in which they were actually deposited or deemed deposited in accordance with this part. The date funds are actually withdrawn from the fund determines the time at which withdrawals are considered to be made.

(c) *Reduction of basis.* (1) If any portion of a qualified withdrawal for the