

the taxpayer's liability under the contract. Deposits will be deemed to be so obligated in the order of deposit, each new contract obligating the earliest deposit not previously expended, obligated, or withdrawn. If the liability under the contract exceeds the amount in the construction reserve fund, the contract will be deemed to obligate, to the extent of that part of such excess not otherwise satisfied, the earliest deposit or deposits thereafter made.

(c) *Illustration.* The foregoing rules are illustrated in the following example:

Example. (1) A taxpayer who makes his returns on the calendar year basis sells a vessel in 1963 for \$1,000,000, realizing a gain of \$400,000. Payment of \$100,000 is received in March 1963 when the contract is signed, and the balance of \$900,000 is received in June 1963 on delivery of the vessel. The \$1,000,000 is deposited in a construction reserve fund in July 1963. In December 1963, the taxpayer also deposits \$150,000, representing earnings of that year. In 1964, he sells another vessel for \$1,000,000, realizing a gain of \$250,000. The sale price of \$1,000,000 is received on delivery of the vessel in February 1964, and deposited in the construction reserve fund in March 1964. In September 1964, the taxpayer purchases for cash out of the construction reserve fund a new vessel for \$1,750,000. To the cost of this vessel must be allocated the 1963 deposits of \$1,150,000 and \$600,000 of the March 1964 deposit. This leaves in the fund \$400,000 of the March 1964 deposit. The amount of the unrecognized gain to be applied against the basis of the new vessel is \$550,000, computed as follows: Gain of \$400,000 represented in the 1963 deposits, plus the same proportion of the \$250,000 gain represented in the March 1964 deposit (\$1,000,000) which the amount (\$600,000) allocated to the vessel is of the amount of the deposit, i.e., \$400,000 plus $600,000/1,000,000$ of \$250,000 or \$150,000, a total of \$550,000. This reduces the basis of the new vessel to \$1,200,000 (\$1,750,000 less \$550,000).

(2) In 1965, the taxpayer sells a third vessel for \$3,000,000, realizing a gain of \$900,000. The \$3,000,000 is received and deposited in the construction reserve fund in June 1965, making a total in the fund of \$3,400,000. In December 1965, the taxpayer contracts for the construction of a second new vessel to cost a maximum of \$3,200,000, thereby obligating that amount of the fund, and in June 1966, receives permission to withdraw the unobligated balance amounting to \$200,000. To the cost of the second new vessel must be allocated the \$400,000 balance of the March 1964 deposit and \$2,800,000 of the June 1965 deposit. The unrecognized gain to be applied

against the basis of such new vessel is that proportion of the gain represented in each deposit which the portion of the deposit allocated to the vessel bears to the amount of such deposit, i.e., $400,000/1,000,000$ of \$250,000, or \$100,000 plus $2,800,000/3,000,000$ of \$900,000, or \$840,000 making a total of \$940,000. The \$200,000 withdrawal is applied against the June 1965 deposit and the portion thereof which represents gain will be recognized as income for 1965, the year in which realized. The computation of the recognized gain is as follows: $200,000/3,000,000$ of \$900,000, or \$60,000.

§ 287.19 Requirements as to new vessels.

(a) *Requirements.* For the purposes of section 511 of the Act and the regulations in this part, the new vessel must be—

(1) Documented under the laws of the United States when it is acquired by the taxpayer, or the taxpayer must agree that when acquired it will be documented under the laws of the United States;

(2)(i) Constructed in the United States after December 31, 1939, or (ii) its construction has been financed under Title V or Title VII of the Act, or (iii) its construction has been aided by a mortgage insured under Title XI of the Act; and

(3) Either (i) of such type, size, and speed as the Administration determines to be suitable for use on the high seas or Great Lakes in carrying out the purposes of the Act, but of not less than 2,000 gross tons or of less speed than 12 knots, except that a particular vessel may be of lesser tonnage or speed if the Administration determines and certifies that the particular vessel is desirable for use by the United States in case of war or national emergency, or (ii) constructed to replace a vessel or vessels requisitioned or purchased by the United States, in which event it must be of such type, size, and speed as to constitute a suitable replacement for the vessel requisitioned or purchased, but if a vessel already built is acquired to replace a vessel or vessels requisitioned or purchased by the United States, such vessel must meet the requirements set forth in paragraph (a)(3)(i) of this section. Ordinarily, under paragraph (a)(3)(i) of this section, a vessel constructed more than

five years before the date on which deposits in a construction reserve fund are to be expended or obligated for acquisition of such vessel will not be considered suitable for use in carrying out the purpose of the Act, except that the five-year age limitation provided above in this sentence shall not apply to a vessel to be reconstructed before being placed in operation by the taxpayer.

(b) *Time of construction.* A vessel will be deemed to be constructed after December 31, 1939, only if construction was commenced after that date. Subject to the provisions of this section, a new vessel may be newly built for the taxpayer, or may be acquired after it is built.

(c) *Replacement of vessels.* It is not necessary that vessels shall be replaced vessels for vessel. The new vessels may be more or less in number than the replaced vessels, provided the other requirements of this section are met.

§ 287.20 Obligation of deposits.

(a) *Time for obligation.* Within three years from the date of any deposit in a construction reserve fund, unless extension is granted as provided in § 287.22, such deposit must be obligated under a contract for the construction or acquisition of a new vessel or vessels (or in the discretion of the Administration for a share therein), with not less than 12½ percent of the construction or contract price of the entire vessel or vessels actually paid or irrevocably committed on account thereof or must be expended or obligated for the liquidation of existing or subsequently incurred purchase-money indebtedness to persons other than a parent company of, or a company affiliated or associated with, the mortgagor on a new vessel or vessels. Amounts on deposit in a construction reserve fund will be deemed to be obligated for expenditure when a binding contract of construction or acquisition has been entered into or when purchase-money indebtedness has been incurred and, if obligated under a contract of construction or acquisition, will be deemed to be irrevocably committed when due and payable in accordance with the terms of the contract of construction or acquisition.

(b) *Requirements for obligation.* Unless otherwise authorized by the Administration, contracts for the construction of new vessels must be for a fixed price, or provide for a base price that may be adjusted for changes in labor and material costs not exceeding 15 percent of the base price. The fixed or base price, as the case may be, shall be fair and reasonable as determined by the Maritime Administration. Any financial or other interests between the taxpayer and the contractor shall be disclosed to the Administration by the taxpayer. Plans and specifications for the new vessel or vessels must be approved by the Administration to the extent it deems necessary. A deposit in a construction reserve fund may be expended or obligated for expenditure for procurement under an acquisition or construction contract of a part interest in a new vessel or vessels only after obtaining the written consent of the Administration. The granting of such consent shall be entirely in the discretion of the Administration and it may impose such conditions with respect thereto as it may deem necessary or advisable for the purpose of carrying out the provisions of section 511 of the Act. Applications for such consent shall be executed in triplicate, and, together with eight conformed copies thereof, filed with the Administration.

§ 287.21 Period for construction of certain vessels.

A new vessel constructed otherwise than under the provisions of Title V of the Act, and not purchased from the Administration must, within six months from the date of the construction contract, or within the period of any extension, be completed to the extent of not less than 5 percent as estimated by the Administration and certified by it to the Secretary of the Treasury. In case of a contract covering more than one vessel it will be sufficient if one of the vessels is 5 percent completed within the six months' period from the date of the contract or within the period of any extension, and so certified. All construction must be completed with reasonable dispatch as determined by the Administration. If, for causes within the control of the taxpayer, the entire construction is