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Trading Up, Saving Taxes

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Section 1031 of the federal tax code offers fishermen a way to put tax-deferred dollars into boats and permits

Introduction

Poor fish prices may be taking some of the profit out of fishing but they haven't diminished most fishermen's dreams of buying a bigger boat or investing in another fishery. After years of planning and saving toward that end, many are shocked to learn that much of the proceeds from the sale of the old boat and permit will be soaked up in taxes. In fact, as much as a third of the value of the item sold typically ends up in the coffers of federal and state treasuries.

While there is no way for fishermen to avoid the tax man, under certain circumstances there is a perfectly legal way to keep him from the door for quite some time. It can be done by deferring the tax liability resulting from the disposal of business property through what is known as a "like-kind exchange." This is a specific transaction where items of business property are traded for similar items rather than being sold for cash.

Taking Advantage of Taxes

Any time fishermen sell their vessels, gear, permits, or other business property for more than the current adjusted value (purchase price plus improvements minus claimed depreciation), they incur a tax liability. For example, if Cap'n Fisher buys the F/V Enterprise for \$100,000 in 1983 and sells it in 1993 for \$150,000, he must pay taxes on the \$50,000 "capital gain." That is true even if inflation has rendered the purchasing power of \$150,000 in 1993 less than that of his original \$100,000 at the time of the purchase. To complicate matters, if Cap'n Fisher bought the Enterprise for \$100,000 in 1983 and claimed depreciation on it for income tax purposes at the rate of 10% per year for 10 years, and then sold it for \$150,000 in 1993, he would have an ordinary gain of \$100,000 plus a capital gain of \$50,000 on the sale (since he had been deducting a hypothetical decrease in the vessel's value from his annual taxes all along).

The seemingly punitive effect of the tax law is that after fishermen have worked to build equity in their business property, they stand to lose nearly a third of its value when they sell it, depending on their tax bracket. This is true not only when they sell out of the business for good, but even if they are staying in and are simply trying to improve their equipment. In writing the tax law, however, Congress did allow a special provision for individuals to reinvest in property associated with their business without incurring a tax bill at that time.

Section 1031 to the Rescue

The salvation of the fisherman's investment equity resides in Section 1031 of the federal tax code, which dates back to 1924. What it says, essentially, is that owners may defer the gain on the disposal of business property if, rather than selling for cash, they trade it for another item of business property of a similar type. The tax liability isn't eliminated; it is deferred until the sale of the newly acquired item. This means, for example, if Cap'n Fisher's original \$100,000 boat has a current value of \$150,000 and he trades it for another one, he can defer the payment of tax on the \$50,000 capital gain (or the tax on \$150,000 if the boat is fully depreciated) until he sells the new boat.

This can be a tremendous financial advantage. Assuming Cap'n Fisher is in the 31% tax bracket and has fully depreciated the original boat, his tax on the sale of that boat would be \$46,500, payable during that tax year. By deferring the tax liability he retains that cash for the purchase of the new boat. In essence, the tax-deferred exchange acts like an interest-free loan from the government.

The idea sounds great but in order for Cap'n Fisher to take advantage of the Section 1031 provision, he has to find someone who has what he wants, and also someone who wants what he has. The obvious solution is a "three-corner" exchange where Fisher transfers ownership of the F/V *Enterprise* to one person and receives title to the boat of his dreams, the F/V *Biggerisbetter*, from another. If he is lucky, he will locate the *Biggerisbetter* just when he wants to unload the *Enterprise*, and simultaneously will find a buyer for the *Enterprise* who is willing to make out his purchase check to the owner of the *Biggerisbetter*. Then Cap'n Fisher can simply pay the owner of the *Biggerisbetter* the difference (in this case \$50,000), and take possession of that boat without paying taxes on the sale of his old boat.

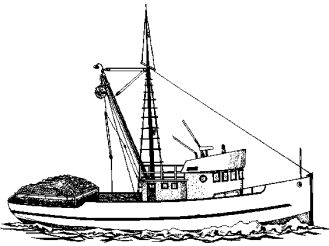
Rarely in real life, however, are business deals this clean. Chances are he'll find a buyer for the *Enterprise* before he can locate or make a deal on the *Biggerisbetter*, or vice versa. Fortunately, the tax code allows for this under the rules of a delayed exchange. When Cap'n Fisher sells his boat he can employ the services of an "exchange facilitator" to write up legal documents and to hold payment from the buyer of the *Enterprise* in escrow. Fisher then has 45 days to identify in writing a new boat he wishes to acquire and 180 days to complete the purchase. He may not receive or have "constructive use" of the money paid for the *Enterprise*, however. Similar deals can be made trading like property (a small boat) and non-like property (a house) in order to acquire a larger boat, though taxes must be paid on the capital gain of the non-like property. Further, a like-kind exchange may not be desirable if the individual wants to recognize a tax loss on the property being trading away.

Exchange facilitators have participated in real estate transactions for many years, and delayed exchange in that business is a standard practice. The concept is fairly new to the fishing industry, however, and although a number of transactions have taken place since about 1990, few if any have been tested in tax court. Whether any specific exchanges are ultimately ruled not legitimate by a tax court will depend on the care with which the participants structure the transactions, and the courts' interpretations of what constitutes like-kind property.

Know the Rules

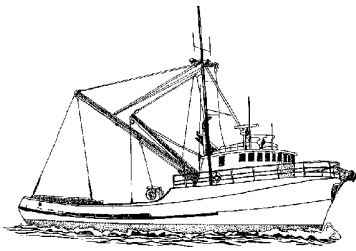
The tax code sets down six requirements for non-taxable exchanges:

1. The property must be business or investment property.
2. The property must not be property held for sale (property acquired specifically for resale).
3. There must be an exchange of like property.
4. The property must be tangible property.



purse seiner

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crabber

5. The property must meet the identification requirement (45 days).
6. The exchange must meet the completed transaction requirement (180 days).

For fishermen, requirements three and four cause the greatest concern because there is currently not a clear definition of either “like property” or “tangible property” as pertaining to the specifics of commercial fisheries. It is likely that a trade of a gillnetter for a gillnetter is “like property” and probably a gillnetter for a seiner. A tougher call might be a seiner for a crabber-tender, or a gillnetter for a setnet operation. (As an indication of just how sticky such definitions can be, the courts have ruled that an exchange of cattle of one sex for cattle of the opposite sex is not like-kind.)

A central consideration for salmon and herring fishermen is whether the IRS will recognize an exchange of limited entry permits as like-kind. According to one IRS interpretation, although a permit does not meet the strict definition of “tangible property” it can still be eligible for a like-kind exchange, provided that the appropriate tests are met. The first test stipulates that the rights (fishing licenses) being traded must be similar in nature. The second specifies that the underlying properties to which the rights relate must be similar. For example, exchange of a limited entry permit for another limited entry permit passes the first test. A salmon permit for a salmon permit passes the second, but a salmon permit for a herring permit probably does not.

Although some individual IRS agents have informally voiced the opinion that they should not qualify, limited entry permits have been the subject of like-kind exchanges for several years now. Brokers and facilitators feel the practice is legitimate, provided that fishermen who want to use Section 1031 to defer their tax liabilities when changing permit areas meet the list of legal requirements.

Currently, there are many ambiguities and potential complications surrounding Section 1031 as it applies to the fishing industry. As specific questions pertaining to a particular transaction arise, they will be left to the facilitators, lawyers, and the courts to be worked out. Some special cases which have already been clarified are worth mentioning. If a person takes a piece of property that has any financial liabilities associated with it, the person who transferred the property will be treated by the IRS as if cash was received in the amount of the liability. For example, suppose Cap’n Fisher had borrowed \$40,000 from his cannery to put a new engine in the *Enterprise* just before he traded the boat away for the *Biggerisbetter*. If the new owner of the *Enterprise* assumes the liability for payment of the engine, Cap’n Fisher will have to pay taxes on the \$40,000 because he has effectively been made \$40,000 richer.

Another special case that is somewhat common is a like-kind exchange between related parties, including family members, business partners, or corporations in which the individual has majority interest. In this instance the exchanged property must be held for at least two years or the non-taxable status is invalidated. A special form has to be filed with income tax returns for the year the exchange occurs and for the two following years. In the case of exchanges between spouses, usually no gain or loss is recognized by the IRS.

Be Certain When You Sign on

Like-kind exchanges can be complicated and expensive, with a facilitator, attorney, escrow officer, and one or more brokers all potentially extracting a fee or commission from the transaction. The facilitator’s fee alone may run \$800 to \$1,200. (The facilitator can’t be a relative, employee, agent, or business partner of the person making the transaction.)

When fishermen want to trade into a new boat or permit through a like-kind exchange, they typically begin working through a broker to find what they are looking for. They then engage a facilitator to help with the actual transaction. After first declaring in writing their intent to acquire specific property through a like-kind exchange, the

fishermen then transfer ownership of their own property to the facilitator. In return, they get a promise to receive the like-kind property of their choosing at a later date. Once the facilitator has a fisherman's property, he then sells it to a buyer. Proceeds from the sale are held in trust for eventual use in purchasing the replacement property. The fisherman then has 45 days to identify the new property to be acquired and 180 days to complete the transaction.

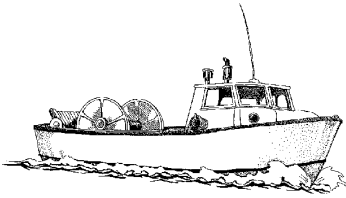
When a fisherman succeeds in completing a like-kind exchange, it then has to be reported on the individual's income tax return. Form 8824 is specifically intended for that purpose, and a publication is available from the IRS called "Instructions for Form 8824." The results of the calculations on Form 8824 then must be reported on Schedule D: Capital Gains and Losses, which is an addendum to the income tax return Form 1040. There is an accompanying publication called "Instructions for 1040 Schedule D."

In the case of a questionable transaction, the participant may be advised by an attorney or accountant to apply for a Private Letter Ruling, which is essentially an official legal opinion from the IRS. This is a formal procedure which requires proper completion of a set of documents, and it may take up to a year to receive a response from the government. The filing fee for a PLR is \$1,000; the attorney's bill is additional.

While the investment benefit to a fisherman looking to upgrade can be substantial, it is imperative that all procedures associated with a Section 1031 transaction be closely followed. If the taxpayer is found during an audit to have claimed a non-taxable exchange when the exchange doesn't qualify, additional costs can be incurred. First, the taxpayer has to pay the tax the government claims is due. On top of that there is 12% interest, a 5% negligence penalty, and, if the tax was underpaid by more than 20% or \$500, there is a 20% underestimation penalty.

Like-kind exchanges may be new to a lot of fishermen but they are a common practice in real estate and other industries which have had the benefit of many years of legal interpretation by the courts to determine what is permissible and what isn't. In recent years, increasing numbers of brokers have begun to organize such trades for boats and permits. This has already fostered some disagreement among brokers, facilitators, accountants, and IRS agents about the applicability of Section 1031 to some kinds of fishing-related exchanges. Despite all the possible complications, however, the tremendous savings offered by a Section 1031 like-kind exchange will likely encourage increasing numbers of fishermen to test these relatively uncharted legal waters when looking for new boats and permits.

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