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A galley, head... and tax deduction? Tax savings and boat ownership

Tax benefits, tax reform, and fractional boat memberships

INSIGHT ARTICLE | October 02, 2018

These days there are many companies that target would-be boat owners with programs offering boat ownership at a 'reduced cost' of ownership. While some offer full charter service structures, within which a boat owner could enter their boat, other companies offer fractional ownership programs (similar to timeshares) to help defray some of the costs associated with owning a boat.

A relatively new breed of companies, however, offers fractional memberships as the primary way to off-set some of the costs associated with boat ownership. With a fractional membership program, the boat owner remains the exclusive owner of the boat and allows specific people (usually the same set of people) to use the boat for a fee. Instead of selling shares of ownership, the boat owner works with a company to sell these annual usage memberships to fellow boating enthusiasts who may not be ready for full boat ownership. For example, a boat's usage might be broken up into 60 time slots per month (2 per day), some weekdays and some weekends. While the boat owner would retain the actual titled ownership of the boat (and all of the legal obligations and benefits along with it), the boat owner would work with a company to lease a portion of those time slots to 'members' on an annual basis, while usually retaining a certain number of time slots for personal use by the boat owner. These members would then pay a monthly fee that would generally be split between the boat owner and the company which helped to find the members on behalf of the boat owner. Finally, as part of the agreement with the company, the boat owner would reimburse the company for its expenses associated with providing the slips, insurance, maintenance and other costs of ownership which are negotiated and maintained by the company.

So at the end of the day, the boat owner retains certain personal use of the boat, earns income from the members, and generally doesn't have to worry about the day-to-day maintenance, insurance and other costs associated with the boat itself which are all provided by the company. In addition to the above, the boat owner could also end up with moderate to significant tax benefits depending on how they structure their ownership and the membership program. Surprisingly, the tax benefits associated with owning a boat are similar to those of owning a house, with a few key differences.

People often encounter the following questions when faced with purchasing a house: Is it going to be my primary home? Is it going to be my vacation home/second home? Will I rent it out? If rented, how often will I rent it? Will I use it as my office? Many people, however, don't realize that these same scenarios may apply to the purchase of a boat, assuming it has both a kitchen (galley) and a toilet (head). Each scenario carries with it certain pros and cons from both a practical and tax perspective. From a tax perspective, each scenario requires a special classification that is largely dependent on how the property is used, by whom it's used, and how often it is used

in that way. The intended use of the boat causes the boat to fall into one of the following primary tax categories, each carrying with it certain federal and state tax ramifications: primary home, vacation home, vacation rental, rental, trade or business.

Which tax benefits relate to which scenarios?

Primary home

Generally, if a person buys a boat with the intention of living on it and using it as their primary home, they are entitled to the same types of tax benefits associated with owning a house. The tax benefits include: (1) a deduction for mortgage interest or, in the case of a boat, boat financing interest and (2) a deduction for real estate taxes or, in the case of a boat, property taxes associate with the boat. These deductions are itemized on Schedule A of an individual's tax return. With the changes resulting from tax reform at the end of 2017, for 2018 and after, there is a maximum allowance for interest on new loans up to $750,000 (aggregate of all mortgages), compared to the $1 million amount that used to be permitted. This applies to single or married individuals. Also, there is a $10,000 aggregate cap on the combined amount of both state income taxes and real estate/property taxes. This also applies to single or married individuals, meaning the allowable amount for this deduction is not doubled for married filers. While many people are familiar with these rules, this will not likely be the relevant scenario for someone purchasing a boat (in particular if they want to take advantage of placing the boat into a charter or fractional ownership program).

Vacation home

Generally, this scenario results when a person buys a house or boat for exclusively personal use when they already have a primary home. Thus this purchase becomes their second home, a.k.a. a vacation home. The tax benefits are the same as those described above under primary home. Note that the person will simply add the interest and property taxes associated with this 'vacation home' to that of their 'primary home,' hopefully without exceeding the limitations discussed above.

Vacation rental

If a person buys a boat with the intention to both use it personally (greater than 14 days per calendar year) and rent it (greater than 14 days per calendar year), they may be said to have purchased a 'vacation rental' and the tax treatment and benefits will change. The high-level benefit of a vacation rental is that the owner may be able get certain of the benefits available under the primary home and vacation home categories, while at the same time being able to earn income to help off-set certain related costs. This benefit may be further enlarged due to recent tax reform, which permits certain taxpayers to deduct 20 percent of qualified business income (which may, depending on the specific taxpayers situation, include the income from the fractional membership program). As a general rule, however, in the event of a net loss (which boat ownership may produce, particularly if the boat is financed and depreciated quickly), a taxpayer is prohibited from off-setting the net loss against other forms of income, and the loss will carryforward to off-set future rental revenue.

When computing the net income or loss of the rental activity, a taxpayer is permitted to off-set the rental revenue with related expenses, which include depreciation, interest, and taxes. The Internal Revenue Code and

Treasury Regulations provide rules on (1) how to allocate expenses and (2) the order in which those allocated expenses may off-set the rental revenue. First, 100 percent of expenses directly related to the rental activity itself are off-set against the revenue (advertising, background checks, initiation fees, cleaning fees, etc.). Then expenses that do not exclusively apply toward the rental activity itself are bifurcated between business and personal use of the boat; for example, repairs and maintenance, financing interest, property taxes, depreciation, etc.

The additional benefit in this vacation rental scenario relates to the personal portion of the financing interest and property taxes. Although disallowed as an off-set against rental revenue (in which they aren't likely needed anyway [given the other costs related to the rental portion, which can be off-set]), the personal portion of the financing and property taxes are permitted as itemized deductions on the individual's income tax return, similar to the primary home or vacation home scenarios above. Further, there is a certain mismatch in the expense allocation rules that could provide for a result where one is able to off-set the entire amount of rental revenue and still have a large amount of unused personal portions of mortgage/financing interest and real estate/property taxes, both of which may be further deducted as itemizations on Schedule A of an individual's income tax return. This is a common planning strategy where the intended result can differ depending on the facts and circumstances of the individual taxpayer and the chosen methodology. Depending on the taxpayer's facts and circumstances, their accountant may be able to run various calculations to find the optimal split to more effectively minimize the taxpayer's tax obligations.

For example, assume the following facts: $500,000 new boat purchase price, $100,000 annual rental revenue, $50,000 annual rental commission expenses, $20,000 annual expenses associate with repairs and maintenance directly related to the renting of the boat, $12,000 annual financing interest, and $5,000 annual property taxes (ignoring depreciation expense). Now assume that the boat is used personally each year for 60 days and rented to others each year for 90. Under the general allocation principles we would allocate the expenses based on the total personal to total rental days such that 60 percent (90 rental days/150 total days) of all expenses are used to off-set the rental revenue. This would mean that 40 percent of those expenses not directly related to the rental activity itself would be deemed 'personal expenses.' Accordingly, 40 percent of the financing interest and property taxes would be available as an itemized deduction on Schedule A of the individual's tax return as personal expenses. Under another accepted methodology with regard to interest and taxes alone, the personal portion of the financing interest and property taxes could instead be computed by looking at actual rental day use over 365 days; *i.e.*, the rental/business portion of interest and taxes would be 25 percent (90/365), leaving 75 percent of those same expenses to be considered personal and thus achieving a higher itemized deduction. Note that while maintenance and other similar expenses can be apportioned based on days of actual use due their direct correlation to use, courts have repeatedly ruled that interest and taxes are allocated over the course of the entire year (e.g. 365 days). Depending on the taxpayer's specific facts and circumstances, the difference between these two allocation methodologies could mean significant tax savings.

Tax reform

While the outcomes really depend on the facts and circumstances of the individual taxpayer, it is worth considering how recent tax reform has affected this scenario. First, it may be possible to deduct 20 percent of qualified business income, effectively paying only 29.6 percent on the net income of the rental activity, assuming that it qualifies. Second, it may be possible to take advantage of increased section 179 deductions and 100

percent bonus depreciation deductions to depreciate the boat quickly and off-set all rental revenue for years into the future, noting that net losses are not permitted to off-set other types of income from other activities and therefore would carryforward to off-set future rental revenues. Further, 1031 exchanges no longer apply to boats, only actual real property like buildings, houses, and land. Absent the possibility of a 1031 exchange to defer gain, with a $0 or reduced basis in the boat due to depreciation, the taxpayer will face depreciation recapture upon a later sale, meaning the taxpayer will be forced to increase his income (subject to the taxpayer's ordinary income tax rates) by the gain. Thus if the boat was fully depreciated and had an adjusted basis of $0, then even a later sale of $1, could trigger a $1 gain subject to the taxpayer's ordinary income tax rates. Note that there are differences in computing the recapture amount depending on whether the taxpayer depreciated under section 179 or Bonus Depreciation, the former likely causing a larger recapture amount.

Further, the tax outcome depends on how the boat is owned (personally, through a corporation, through an S-Corporation/Partnership, a limited liability company or other 'pass through' entity, etc.). And while there is no need to get caught up in the rules and definitions related to 'passive/active activities' or legitimate 'trade or businesses,' outlined below in the Trade or Business scenario, the benefits of a Vacation Rental scenario may be limited due to (1) the prohibition of off-setting the taxpayer's other types of income (such as 'active' W-2 income) with the net losses and (2) the possibility that the taxpayer may have already exceeded his/her limits with regard to taking itemized deductions of financing interest and property tax. On the up side, even within these limitations, the taxpayer is still earning money that may serve to off-set the costs associated with owning a boat. And why not earn money on a boat that might otherwise be sitting unused in a slip. A taxpayer considering purchasing a boat to place into a fractional membership program should consult their tax and legal advisors well in advance of any purchase to confirm the most advantageous structure and course of action.

Rental

If a person buys a boat with the intention to rent it, only using it personally for fewer than 15 days per calendar year, then the boat will simply be considered a rental property. As this is not likely to be the case, and since it's better from a tax perspective to use it more than 14 days and fall under the vacation rental scenario, this article will not go into depth with respect to a pure rental property. However, under the passive income rules for real estate investors, the taxpayer may be able to use up to $25,000 of annual losses to off-set other income. While boats are generally considered tangible personal property, the IRS has previously determined that boat slips constitute real estate assets that generate rents from real property, so rental income or losses attributable to the boat slips may be deductible under the passive income rules. Again, the specific facts and circumstances of each case will be important in making any determination as to whether the rental income generated can be apportioned to the boat slip.

Trade or business

Generally, if a person buys a boat with the intention of using it in an existing, or to establish their own, boat charter business, they are entitled to the same types of tax benefits associated with traditional trade or businesses. The types of tax rules that apply to a trade or business also depend on how the boat and business are setup. For example, if the business is a C Corporation that owns the boat, then any net loss from the business simply carries forward to future tax years of the corporation. If the business is setup such that the boat is owned by the taxpayer directly, or through some form of pass-through entity (S Corporation, Partnership, LLC,

Trust, etc.), then it may be possible for the net loss from the business to flow directly through to the taxpayer and off-set other types of income on the taxpayer's personal return. It is this scenario that entices many would-be charter boat owners, though it is complex (largely turning on the specific facts and circumstances for each taxpayer) and not without peril.

What most taxpayers don't realize is that there are complex rules that must be satisfied if they are to fully benefit from this scenario (a fact that many fractional ownership and fractional membership companies may not adequately address). Generally, these complex rules require the taxpayer to demonstrate that the taxpayer is (1) engaged in a trade or business and (2) actively involved in that business. Failure to satisfy the former could trigger the hobby loss rules and result in either not being able to deduct expenses or not being able to off-set other types of income with the losses from the charter business. Failure to satisfy the latter could classify any losses as 'passive' in nature, thereby limiting their off-setting potential to only other forms of passive income which would reduce or eliminate much of the tax benefit originally sought by the taxpayer (and potentially subjecting them to penalties and interest for tax amounts which would have been payable but for the treatment as a trade or business).

Engaged in a trade or business

Section 162 of the Internal Revenue Code generally allows a taxpayer to deduct expenses associated with the carrying on of a trade or business. While there is no actual definition of 'trade or business' in the Internal Revenue Code or the Treasury Regulations, the U.S. Supreme Court has indicated that "to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and that the taxpayer's primary purpose for engaging in the activity must be for income or profit. A sporadic activity, a hobby, or an amusement diversion does not qualify." *Whipple v. Comm'r*, 373 U.S. 198, 197 (1968). For pass-through structures (not a C Corporation), section 183 of the Internal Revenue Code serves to both define an "activity not engaged in for profit" and disallow those deductions associated with such an activity. The Treasury Regulations associated with section 183 of the Internal Revenue Code present nine factors which might be present to determine whether an activity is engaged in for profit. While a single factor alone is not dispositive, the IRS will take all nine factors into account. These nine factors include the following:

1. Manner in which the taxpayer carries on the activity

2. The expertise of the taxpayer or his advisors

3. The time and effort expended by the taxpayer in carrying on the activity

4. Expectation that assets used in the activity may appreciate in value

5. The success of the taxpayer in carrying on other similar activities

6. The taxpayer's history of income or losses with respect to the activity

7. The amount of occasional profits, if any, which are earned

8. The financial status of the taxpayer

9. Elements of personal pleasure or recreation

Treas. Reg. section 1.183-2(b).

It is important to note that there have been several tax court cases specifically challenging charter businesses and the courts have continued to interpret and provide examples, beyond those provided in the Treasury Regulations themselves, associated with each factor. And while the regulations indicate that a reasonable expectation of profit is not required, the courts and the IRS have primarily focused on the fact that the *primary* purpose of engaging in the activity must be for income or profit (which may include certain financial models which the taxpayer's advisors should help to prepare in advance of any boat purchase). Accordingly, while the taxpayer may be able to satisfy several of the above factors, if the taxpayer cannot show that the activity ever even had the potential of being profitable, meaning that at some point it would recoup its associated costs, then the taxpayer will fail to satisfy what the courts have determined the primary purpose component, and the rules of section 183 will disallow the deductions. So a business plan, separate books and records, and management agreements alone will not necessarily satisfy the above tests. Further, the taxpayer could be subjected to additional tax assessment, as well as penalties and interest on those assessments going back to earlier years.

Generally, the IRS can only go back three years to assess additional tax due (so long as a return has been filed; there is no such limitation for years in which no return has been filed). This is known as the statute of limitations. In instances, however, where the taxpayer may have underreported his gross income by 25 percent or more due to taking additional trade or business expenses now deemed to be disallowed under section 183, it is possible that the statute of limitations would extend to six years. Further, the initial burden of proof is on the taxpayer under section 7491 to minimally establish the basic elements of the pertinent nine factors listed above, thereafter the burden shifts to the IRS.

Actively involved in that trade or business

So let's assume that the taxpayer is able to structure his business in such a way as to satisfy the rules of being engaged in a trade or business. The taxpayer gets to off-set all his expenses of operating and financing the boat against his revenue from the business. But to the extent that the business has net losses, those losses may still be limited to only off-setting other sources of *passive* income, unless the taxpayer satisfies the rules of section 469, showing that the taxpayer materially participated in the activity thus making it 'active.' And without going into detail in this article, to determine whether or not a taxpayer is deemed to materially participate in an activity involves another comprehensive analysis that is outlined in the tax code and regulations, and further interpreted by the courts.

It is important to note, however, that before one can even conduct the material participation analysis, the taxpayer must determine whether they can structure their charter agreements to avoid being deemed rental activities (per se passive activities) under section 469. Where the taxpayer's activities fall within one of the

exceptions detailed in the code and regulations, the taxpayer can then move on to perform the material participation analysis.

The first and most common exception to the rule involves limiting the average charter (referred to as the average period of customer use in the regulations) to 7 days or less. Notably, the regulations include any days that the customer has a right to use the boat, which likely means that all days covered by the contract, and not just days of actual use, would be included in the day count calculation. Where the average charter length is more than 30 days, the taxpayer can still fall outside the definition of a rental activity if they provide significant personal services along with the boat rental. There are detailed definitions of what the IRS considers "personal services," along with other exceptions that involve greater degrees of owner involvement or additional services related to the charter activity. whichgenerally fall outside the scope of activity boat owners would like to provide but may be enough to avoid being classified as a rental activity.

A taxpayer should consult with their legal and accounting advisors well in advance of any boat purchase to ensure that these tests are satisfied if the taxpayer is seeking to maximize the tax benefits under the trade or business classification.

Tax Reform

As discussed above under the Vacation Rental section, the impacts of tax reform with regard to a Trade or Business (again presuming a structure apart from a C Corporation) are the same; *i.e.*, 20 percent deduction on qualified business income, increased section 179 deduction, 100 percent bonus depreciation, and lack of 1031 exchange applicability. In a Trade or Business scenario, the impact of an increased section 179 deduction or 100 percent bonus depreciation could serve to trigger extremely large business losses in the first year of the business, which could be used to directly off-set the taxpayers other income (assuming the taxpayer is both engaged in a trade or business and materially involved for at least the calendar year in which full depreciation occurs). It is important to note, however, that while this may look like a great tax break (being able to off-set other income such as 'active' W-2 income), section 1031 no longer applies to boats. Section 1031 used to defer the gain from the sale of a boat if the funds received in the sale were used to buy another boat; however, now the taxpayer must realize any gains at the time of a sale.

Accordingly, if a taxpayer depreciates the entire boat in year one, taking a large loss in the business to off-set other income, the adjusted basis of the boat will be $0 for tax purposes (the full value will be depreciated to maximize the tax off-set). This means that any future amount of money received from the sale of the boat will be deemed a 'recapture of depreciation' and will trigger a tax liability (noting, as described above, that the amount of the recapture depends on the depreciation method used, etc.). For example, assume a $500,000 boat is fully depreciated in the first year. A future sale of the boat for $100,000 could mean a taxable gain of $100,000 because there is a $0 adjusted basis. And since $500,000 was depreciated, all $100,000 of that gain could be deemed to be depreciation recapture, meaning it will be subject to the taxpayer's individual income tax rates in the year of sale, rather than the more beneficial capital gain rates.

So assuming that the taxpayer successfully satisfies the rules outlined above, the taxpayer may be able to take the losses from the charter business, which could be large, and off-set them against other income earned by the taxpayer for a large tax savings. This will be minimized, however, by depreciation recaptures upon a later sale. So

in a sense, a taxpayer may be able to depreciate a $500,000 boat in the first year (ignoring other revenue or expenses) to off-set $500,000 of other non-boat related income at the personal level for a tax savings of $185,000 (assuming maximum 37 percent individual income tax rate times $500,000). However, assuming a sale price of $200,000 five years later, the taxpayer could have a gain of $200,000, all subject to depreciation recapture, increasing ordinary income by $200,000 and his federal tax liability by $74,000. While this may still be advantageous for the taxpayer (in particular given the potential additional cash flow to off-set the financing costs while the taxpayer owned the boat), it will ultimately depend on the facts and circumstances of the taxpayer.

Finally, while a taxpayer may properly satisfy this Trade or Business scenario, the taxpayer should also be aware of the new net operating loss limitations resulting from tax reform. A taxpayer's loss from an active trade or business is now limited to $500,000 for married individuals filing jointly ($250,000 for other taxpayers). Excess business losses will be treated as a net operating loss and carried forward (taxpayers are no longer permitted to carry back these losses to the previous two years). Further, net operating losses may now only be used to off-set 80 percent of a taxpayer's taxable income in a carryforward year. The remainder of any losses which are not allowed to be used to off-set their income may be carried forward to be used in future years.

In conclusion, similar to buying a home or rental property, buying a boat can also generate tax savings and revenue to help off-set the costs. And while there are varying ways to structure the boat ownership, each structure can carry significant tax benefits. Although the most advantageous structure may be the Trade or Business scenario, the Trade or Business scenario also comes with the most hurdles, traps, and risks. The Vacation Rental scenario, however, offers the next best set of tax advantages, may be tailored to the individual's tax circumstances, and doesn't need to apply the hurdles imposed by section 183 or section 469 of the Internal Revenue Code.

It is critical for a taxpayer to work with their tax and legal advisors prior to attempting to navigate these complex rules. Every taxpayer's facts and circumstances are different, and may benefit from different structures and classifications for boat ownership. If you have any questions, or would like to discuss your individual situation prior to purchasing a new boat, please give me a call or send me an email. I would be happy to help you navigate these complex rules to minimize your tax obligations, and help you to enjoy your boat as painlessly as possible (at least from a tax perspective!).

Key summary chart for fractional membership program[1]

Structure	Key benefits	Key considerations and risks	Key questions to ask your CPA and lawyer
Vacation rental	· Use and rent the boat more than 14 calendar days per year. · Potential to be able to take advantage of both personal and rental deductions for tax obligations (different calculations could provide a significant difference in your specific situation). · May be able to obtain a 20% deduction on qualified business income. · Use the income to offset ownership costs. · Tax Reform now allows for bonus depreciation of the entire purchase price of the boat. · Why not earn money on a boat that might otherwise be sitting in a slip costing you money?	· Losses will likely only be able to offset future passive (rental/charter) income. · Property taxes and mortgage/financing interest may limited or disallowed depending on your existing state income taxes and property taxes, or outstanding and new mortgages/financing loans. · Depending on your facts and circumstances, the depreciation may trigger recapture tax obligations upon a future sale of the boat. · 1031 exchanges no longer apply to boats.	· Discuss how the rental versus personal deductions should be split (or if this is a benefit for your tax situation). · Discuss if you have already maxed out on your state and local property tax deductions, or your mortgage/financing interest. · What structure would be best to hold the new boat? In your personal name? In an LLC?
Trade or business	· The tax benefits for high-income earners could be substantial. · May be able to obtain a 20% deduction on qualified business income.	· Very complex rules and requiring detailed analysis: Is is a trade or business? Are you actively participating? · Advice of tax planners and lawyers is needed well in advance of any	· What can I do to qualify for the active trade or business classification? · How can I prevent reclassification in the

	· 100% bonus depreciation and section 179 deduction of the boat purchase price could trigger extremely large business losses in the first year. · Active/material participation may only be needed in the first year of the depreciation to get substantially all of the material tax benefits (all future passive income can be offset by the future passive losses). · All additional costs (financing, maintenance, fees, etc.) are deductible, in addition to the bonus depreciation of the full purchase price of the new boat. · Potential to offset losses against other active income.	purchase. · Losses may be trapped in certain entities (such as C-Corp), so proper planning is needed in advance. · 1031 exchanges no longer apply to boats. · Significant recapture tax obligations are possible upon future sale of the boat. · Many tax court cases challenging charter businesses. The actions and set-up at the beginning of the new business are critical. · If the tax losses are reclassified, the IRS could potentially go back up to 6 years to recoup the tax due (including penalties and interest). · Losses from an active trade or business are capped at $250k/$500K per year, depending on your specific tax situation, with the excess carried to future years as a net operating loss. · Net operating loss may only offset 80% of your taxable income in a carryforward year.	future? · How much will I owe in back taxes, interest, and penalties if I'm deemed to not be engaged in a trade or business? · What type of entity should own the boat? · How much of the active depreciation should I take each tax year? How much will be carried forward?

[1] Nothing in this article or summary is meant to be advice for any specific person or situation. It is critical for a taxpayer to work with their tax and legal advisors prior to attempting to navigate these complex rules. Every taxpayer's facts and circumstances are different and may benefit from different structures and classifications for boat ownership. If you have any questions, or would like to discuss your individual situation prior to purchasing a new boat, we would be happy to help you navigate these complex rules to minimize your tax obligations, and help you to enjoy your boat as painlessly as possible (at least from a tax perspective!).

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