

Fishing Information Newsletter

News You Can Use from the Internal Revenue Service

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Message from the Editor

Thanks to those of you that have provided input via questions and/or article suggestions. If there is a topic that you would like addressed in an upcoming newsletter, or if you have a fishing-related question you would like answered, please send us your topic ideas and questions and we will make certain they are addressed in future issues.

This edition of the newsletter contains the second installment in a series of articles on Health Insurance, an update on tax incentives, and an article on sales and buy-back of fishing permits.

We have updated our index of newsletters to include this issue of the newsletter. The revised index is included in this mailing. If there is a past newsletter you would like a copy of please e-mail or write me at the below addresses.

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Please send us your topic ideas and questions....

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Tax Incentives:

The April newsletter discussed some of the law changes in regards to Depreciation and Net Operating Losses made by the Job Creation and Worker Assistance Act of 2002 signed into law March 9 by President Bush.

This edition covers some of the individual tax incentives extended or changed by the Job Creation and Worker Assistance Act of 2002.

Alternative Minimum Tax:

Of most relevance to individuals is a provision that protects most personal tax credits, including the dependent-care credit and the Hope and Lifetime college tuition credits, from being reduced by the alternative minimum tax. The provision had expired at the end of 2001. The new law extends the protection through the end of 2003.

Archer Medical Savings Accounts:

The new law extends the pilot program for Medical Savings Accounts through the end of 2003. The program was scheduled to expire the end of 2002.

Congress created Medical Savings Accounts (MSAs) in 1996 to help workers covered by high-deductible health-care plans. MSAs can be used to pay out-of-pocket medical bills that fall below the policy deductible. Contributions to MSAs are deductible and withdrawals are tax-free when used to pay eligible medical expenses. Any unused funds can be carried over from year to year.

Currently, only a narrow segment of the population is eligible to take advantage of MSAs: self-employed workers and employees of small businesses (employing no more than 50 workers) who are covered by high-deductible health insurance plans. Medicare recipients are also eligible under certain circumstances.

The new law also makes more than 20 technical corrections. Some of which are child tax credit, Adoption credit, Hope credit, and retirement plans.

Retirement plan changes:

A) The annual contribution limit to Simplified Employee Pension (SEP) plans increases from 15% to

25% of compensation for 2002, up to a maximum deposit of \$40,000.

B) The new law provides eligible small businesses a credit for new retirement plan expenses. To take advantage of the credit, the plan must be first effective after December 31, 2001.

C) One of the most significant reforms was the allowance of catch-up contributions for qualifying taxpayers over age 49. The law clarifies that a person who reaches age 50 by the end of the tax year is eligible to make catch up contributions as of the beginning of the year.

D) When a spouse consents to a cash-out of the plan benefits the law clarifies when rollover amounts may be disregarded.

E) Plan participants are required to receive notice of significant future reductions in benefits. The law clarifies that the notice requirement applies only to qualified defined benefit plans and, depending on the type of the reduction, only if the benefit is significant.

Additional Information Sources

For more information on the new laws and extension of other laws see Publication 3991, *Highlights of the Job Creation and Worker Assistance Act of 2002*.

This Publication will highlight provisions of the Act that take effect in 2001, 2002, and later years.

Health Insurance – Schedule C

*By Jacki Morin, Revenue Agent
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Special considerations for the fisherman filing a Schedule C – sole proprietorship business return.

Fishermen who are sole proprietors and file a Schedule C to report their fishing activity, should not deduct their health insurance premiums on their Schedule C. The premium, subject to the percentage limitation, is deductible as an adjustment to income on page 1 of the Form 1040. The deduction is also limited by the positive net income from the Schedule C. (If the taxpayer is eligible to participate in any employer subsidized health plan (including their spouse's), at any time during any month, they do not

qualify for the health insurance deduction during that month.)

An exception to this is if the owner's spouse is a bona fide employee of the business operation and that spouse qualifies as an employee participant in a health insurance plan offered to all employees of the Schedule C. The spouse must not be considered an owner of the Schedule C business operation in order to qualify as an employee. If assets, bank accounts, loans, supplier accounts, and other business activity are in the name of the owner and the spouse, then the spouse would be considered an owner of the Schedule C business operation. If the spouse's only involvement in the business operation is as an employee being paid for doing a specific job such as bookkeeper, then the spouse would qualify as an employee. As a qualified participant, the health insurance policy may be in the spouse's name and the premium would qualify for a full deduction as a business expense as would any other qualified employee's policy cost. If the fisherman/owner is not covered under the spouse's policy but is listed under separate policy, then the fisherman/owner's premium would not be deductible on the Schedule C but would qualify for deduction under the adjustments to income part of the tax return based on the appropriate percentage and positive net income from the Schedule C. (**NOTE:** Community property states may deem the spouse to be a 50% owner even if the business assets and accounts are solely in the owner's name. This would classify the spouse as an owner which would disqualify the spouse for treatment as a qualified employee for the health insurance purposes.)

Sales of Fishing Permits

If you dispose of a fishing permit/license, you may have a gain or loss that should be reported on your tax return. However, in some cases you may have a gain that is not taxable or a loss that is not deductible. This article discusses sales and buy-backs of fishing permits/licenses, how to figure the gain or loss, and where to report the gain or loss.

A disposition of property includes the following transactions.

- You sell property for cash or other property.
- You exchange property for other property.
- You transfer property to satisfy a debt.

- Your bank or other financial institution forecloses on your mortgage or repossesses your property.
- Your property is condemned, or disposed of under the threat of condemnation, and you receive property or money in payment.
- You abandon property.
- You give property away.

Nontaxable exchanges

Certain exchanges of property are not taxable. This means any gain from the exchange is not recognized and you cannot deduct any loss for example, transfer of property incident to divorce. An exchange meeting the requirements of a like-kind exchange, gain or loss will not be recognized until you sell or otherwise dispose of the property you receive. A sale meeting the requirement of an installment sale, gain will be postponed until you receive payments.

Like-kind exchanges. A like-kind exchange is the exchange of business property for similar business property rather than being sold for cash. It is the most common type of nontaxable exchange.

The exchange of a fishing permit/license for another fishing permit/license qualifies for nontaxable exchange treatment under Internal Revenue Code (IRC) Section 1031.

Any time fishermen sell their permits/licenses for more than the current adjusted basis (purchase price minus claimed amortization); they incur a tax liability. For example, if Captain Fisher buys a fishing permit for \$100,000 in April 1994 and sells it in May 2002 for \$150,000, he must pay taxes on the \$50,000 capital gain. In addition, because he has amortized the permit/license (taken a deduction on his returns), he would also be liable for taxes on the amortized amount of \$53,336. This amount would be reported as an ordinary gain.

If the fisherman does a like-kind exchange under IRC Section 1031 he can defer the capital and ordinary gains. This code section allows owners to 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, i.e. a fishing permit for a fishing permit. The tax liability is not eliminated; it is deferred until the sale of the newly acquired fishing permit/license. This means, for example, if Captain Fisher's original \$100,000 fishing

permit 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 and \$53,336 ordinary gain until he sells the new fishing permit. Basis in the new permit is adjusted by the gain deferred.

If the fisherman receives money or unlike property in the trade, or his permit had a note that the other party assumed, he might have to report a gain on his tax return.

Report the exchange of like-kind property on Form 8824, *Like-Kind Exchanges*. For more information about like-kind exchanges, see Publication 544, and May 2000 and July 2000 issues of the Fishing Information Newsletter.

Installment sales. An installment sale is a sale of property where you receive at least one payment after the tax year of the sale. If you finance the buyer's purchase of your property, instead of having the buyer get a loan or mortgage from a third party, you probably have an installment sale. In an installment sale you report part of your gain when you receive each payment. You cannot use the installment method to report a loss. For more information about installment sales, see Publication 537.

Taxable exchanges

When you dispose of business property, your taxable gain or loss is usually an IRC section 1231 gain or loss. Its treatment as ordinary or capital is determined under rules for section 1231 transactions.

Gain or loss on the sale or exchange of amortizable intangible property held longer than 1 year (other than an amount recaptured as ordinary income) is a section 1231 gain or loss. Gain or loss on dispositions of other intangible property is ordinary or capital depending on whether the property is a capital asset or a noncapital asset. A fishing permit acquired before the amortization rules changed (see note) is a capital asset and any gain or loss remains capital.

(**Note:** IRC section 197(d)(1)(D) allows amortization of permits/licenses. Fishing permits/licenses acquired after 8/10/93 or if an election was made property acquired after 7/21/91 are eligible for amortization.)

Gains. If you sell your fishing permit/license that results in a profit/gain, the **gain** is taxed. For example, assume the following facts:

Permit purchased for \$50,000

Amortization claimed on returns \$26,665

Remaining basis \$23,335 (\$50,000 cost minus \$26,665 amortization = \$23,335 remaining basis)

Example 1: If you sell the permit for \$40,000, you will have a gain of \$16,665 (\$40,000 selling price minus \$23,335 basis = \$16,665). Since amortization recapture is treated as ordinary income, the gain is not eligible for the more beneficial capital gain treatment. The rate of tax that you must pay on this \$16,665 will depend upon your other income and the tax bracket at which this income is taxed. The tax rate will not be the 20% long-term capital gains rate.

Example 2: If you sell the permit for \$60,000, you will have a gain of \$36,665 (\$60,000 selling price minus \$23,335 basis = \$36,665). In this situation, the amount of the gain representing the prior amortization claimed, or \$26,665, will be taxed at the ordinary income rates as explained in Example 1. The remaining \$10,000 gain, representing the amount received in excess of the original cost of the permit, is taxed at the 20% capital gain rates. The maximum capital gain rate of 20% does not apply if it is higher than your regular tax rate.

Losses. If you sell your fishing permit/license that results in a loss, the **loss** is deductible. For example, assume the following facts:

Permit purchased for \$50,000

Amortization claimed on returns \$26,665

Remaining basis \$23,335 (\$50,000 cost minus \$26,665 amortization = \$23,335 remaining basis)

Example 1: If you sell the permit for \$20,000, you will have a loss of \$3,335 (\$20,000 selling price minus \$23,335 basis = \$3,335). The loss is deductible as an ordinary loss.

Example 2: Assume the permit was purchased in 1991 and no election was made to amortize the permit. If you sell the permit for \$20,000, you will have a loss of \$30,000 (\$20,000 selling price minus \$50,000 basis = \$30,000). A fishing permit is a capital asset. IRC section 1221 defines a capital asset to mean property held by the taxpayer whether or not connected with his trade or business, but it does not include - section 1221(a)(2) property used in his trade

or business which is subject to the allowance for depreciation (section 167 or 197). In this situation, the sale remains a section 1221 property and must be reported on Schedule D as a long-term capital loss.

The sale of business assets is reported on Form 4797.

Buy-Back of Fishing Permits/Licenses. Money received for the buy back of a fishing license is a sale. The disposition must be reported on your tax return and may be taxable income or a loss as explained in the prior examples. There is no tax law that allows these funds to be excluded from income.

The amount that would be reported is the following: **Sales Price** (buy back amount) – **Cost** (the amount you purchased your permit) – **Previously Claimed Amortization** = **Gain/Loss** to report.

Normally if you did not purchase your permit, then the total buy back amount would be taxable income in the year received.

Condemnations. If a fishing permit/license is condemned then follow the rules under Involuntary Conversions, IRC Section 1033. In Publication 544 go to the Chapter on Gain or Loss from Condemnations for more information.

If your property was condemned or disposed of under the threat of condemnation, figure your gain or loss by comparing the adjusted basis of your condemned property with your net condemnation award. See prior examples to figure gain or loss.

If your net condemnation award is more than the adjusted basis of the condemned property, you have a gain. You can postpone reporting gain from a condemnation if you buy replacement property. The replacement period starts with the date of disposition and ending not earlier than 2 years after the close of the first taxable year in which any part of the gain from the condemnation is realized.

If your net condemnation award is less than your adjusted basis, you have a loss. You must report any deductible loss in the tax year it happened.

If money is received in a condemnation meeting the requirements of IRC section 1033 you could exchange your permit for a like permit. Depending on the cost of the "new" permit purchased you may or may not have to pay taxes on the gain.

Additional Information Sources

Publication 544, *Sales and Other Dispositions of Assets*, provides further explanations on how to treat sales of business assets.

Publication 535, *Business Expenses*, and Publication 946, *How To Depreciate Property*, provide more information on amortizable intangible property. Publication 537, *Installment Sales*, provides more information about installment sales.

The May 2000 and July 2000 issues of the *Fishing Information Newsletter* (FIN) have more information on like-kind exchanges

The January and February 2001 issues of the FIN have more information on transfers of fishing permits.

The July 2000, Nov/Dec 2000 and February 2001 issues of the FIN have more information on amortization of fishing permits.

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