

## Improve Your Fleet Using a Tax Free Exchange



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For vessel owners that are in need of expanding or modernizing their fleet, The United States Department of Transportation Maritime Administration provides a great opportunity to defer any gains that you may have on a vessel that you are selling. The program, commonly referred to as the Construction Reserve Fund (CRF), allows a vessel owner to defer the gain related to the sale or loss of a vessel when the proceeds from the sale are used to upgrade or purchase another vessel or vessels. The scope of this program includes all American flagged vessels that operate on the high seas regardless of its trading pattern. In a nutshell, the program allows a vessel owner to postpone the payment of taxes on the gain associated with the sale of a vessel providing the vessel owner with additional capital that can be used to purchase new vessels.

American flagged vessels that operate in the Nation's foreign or noncontiguous domestic trade are eligible for the Capital Construction Fund (CCF). The CCF is a tax deferral program similar to the CRF but provides the additional benefit of allowing the deposit of operating profits into the fund and a longer time frame to acquire a new vessel. Although the CCF has several additional financial incentives, it includes far fewer eligible vessels due to its trading restrictions.

Although the use of the CRF program requires some planning, the concept is very simple. When you sell your vessel, or receive proceeds related to a loss, you set up a CRF account and deposit the proceeds of the sale into the account. These proceeds can be used for the construction, reconstruction or acquisition of a new vessel or vessels. The gain from the sale of the vessel is not recognized as income in the year that the sale occurred. Although you will ultimately have to pay the tax when you sell the last vessel and do not purchase a new one, this program can be

effectively used to increase the amount of leverage that you can use to buy new vessels.

To take advantage of the tax benefits associated with utilizing the fund, the vessel owner must deposit the gain into the CRF within sixty days after the owner receives the proceeds from the sale of the vessel. According to the rules, the owner must deposit an amount equal to the sum of the adjusted basis of the vessel and the amount of gain that would be recognized by the owner absent participation in the CRF.

Once the monies are deposited into the CRF, the vessel owner is entitled to invest his fund while waiting to acquire the next vessel. The interest gained on the investment can also be put back into the fund and used, along with operating profits, to acquire the next vessel. Although the tax due on this interest and operational income is not tax deferred, according to IRS rules the funds can be accumulated for the reasonable needs of the business.

The vessel owner has three years from the date of deposit into the CRF to obligate the funds under a contract for the construction or acquisition of a new vessel. The target vessel must be constructed and documented in the United States and, in the case of used vessels, constructed within five years of the acquisition. In order to take advantage of the tax deferral, the Maritime Administration must approve the purchase of the vessel after determining that the vessel is suitable for use on the high seas or Great Lakes and that the sales price for the new vessel is reasonable.

Once the fund is established, the account owner must file a detailed annual statement showing the fund's activity over the previous twelve month reporting period.

According to the Maritime Administration, as of November 2007, there are approximately 40 construction reserve fund contracts with deposits totaling approximately \$100,000,000 for the construction, reconstruction and acquisition of the proposed programs.

A typical use for the program would look something like this. The owner of a vessel makes a decision to sell a boat for \$2,000,000 and, based upon the original sales price and depreciation, recognizes a gain of \$400,000. Within

sixty days of receiving the proceeds, the money is placed into a CRF approved by the Maritime Administration. The owner then has three years to obligate a portion of the fund to purchase a new vessel or fleet of vessels. By using the fund, the owner will have the money that he or she saved by not paying tax on the \$400,000 to help pay for the new equipment. By using this cash as leverage, the owner will be able to purchase a much more expensive vessel or vessels that he or she could have without using the fund.

The CRF program has been used by many vessel owners to build or purchase better equipment, a larger fleet and reduce outstanding vessel mortgage debt. If you are in the process of modernizing or expanding your fleet, you may be able to use this program to defer your current tax liability and modify your existing fleet to be more competitive in the years ahead.

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