THE RIGHTING MOMENT

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YACHT OWNERSHIP, CHARTER OPERATIONS AND FEDERAL TAX, THE HOBBY LOSS TRAP

By David M. Bohonnon

For some, the allure of tropical breezes, calm waters and retirement aboard a beautiful new yacht travelling the world seems satisfying. For others, the slow boat to nowhere may not be enough, and to offset the restless pursuit of tranquility (and, frankly, expenses), a charter strategy is introduced to yacht ownership and operations.

Over the years, we have seen many seasonal and full time charter programs operated by clients around the world meet with success; in some cases, they experience frustration. Recently we have noted an increase in IRS scrutiny and audits of yacht charter operations in which the IRS challenges business expenses and depreciation claimed by taxpayers. There are many regulatory challenges to a charter program for a yacht which include complex domestic and international law, regulations, safety and insurance considerations. If all of this is not enough to consider, the federal and state tax treatment of such operations are additionally tricky for anyone not up on the law in this area.

For any new business, and specifically yacht charter, it is not unusual to generate a loss in the first several years of operation. Before you start to apply your charter losses against your income, it is essential that you understand how the IRS might evaluate your "business." In addition to the IRS code and any applicable state law, there are numerous

Tax Court cases on this issue of yacht chartering and so-called “hobby loss”. The facts of these cases widely vary and the abundance of content is intoxicating.

Fundamentally, if you are legitimately trying to make a profit in an endeavor, it may be considered a "business" by the IRS. In this case, generally, you can deduct the full amount of expenses relating to the business operation. Again, typically, you might show losses in the early years of ownership. These losses can conceivably be used to offset other income such as investment earnings or wages from a full-time job (yours, your spouse's, or both).

On the other hand, if the IRS treats the activity as a "hobby," the tax benefits are more limited. Expenses can be deducted only up to the amount of the income received from the charter activity. Thus, you can't apply your charter losses against non-charter income and claim an overall tax loss for the year.

More punishing, hobby loss expenses must be deducted as miscellaneous expenses. Miscellaneous expenses are deductible only to the extent the annual total exceeds 2 percent of your adjusted gross income. So you may derive little or no tax benefit from your losses.

How can one distinguish a "business" from a "hobby"? A number of factors must be considered, but in general, an activity is treated as a business only if you are operating it with the actual intention of turning a profit.

Though IRS regulations itemize nine factors, in practice, determining whether a particular activity is a business or a hobby is an art, not a science. Courts (and the IRS) will consider:

- The manner in which the taxpayer carries on the activity.
- The expertise possessed by the taxpayer and any advisers.
- The time and effort spent on the activity.
- Any expectations the taxpayer has that assets used in the activity will appreciate in value.
- Prior success in carrying on other activities.
- The history of income or losses with respect to the activity.
- The amount of profits, if any, that are earned.
- The financial status of the taxpayer.
- Any elements of personal pleasure or recreation.

No single factor by itself is conclusive, but a preponderance of factors can tip the scales in your favor or against you. If you operate your yacht chartering profitably, a tax presumption may be on your side. If you show a profit in any three out of the last five consecutive years, the IRS may agree that you are carrying on a business. The IRS can

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rebut the tax law presumption by providing evidence that the activity is actually a hobby. For example, personal use and enjoyment of your yacht exceeding charter use compounded with consist losses may present an issue. In addition, depreciation conventions and bonus depreciation programs all shift with the political winds and the economy and are at a matrix of very complicated regulations and trappings for the uninformed.

Simply stated, you may likely fight a bit of an uphill battle when an activity involves entertainment or recreation (ownership of a yacht and yacht charter activity are prime targets). The IRS tends to give less leeway to these types of endeavors. There is good news; the Tax Court makes this point in many cases: A business will not be deemed a hobby merely because the owner enjoys the activity.

The above is merely an outline of some important planning issues which must be considered before commencing a charter program. Securing the advice of a seasoned tax advisor familiar with this specific area is equally as important as hiring competent charter management and marketing the vessel for charter. We have handled many so-called "Hobby Loss" audits and appeals over the years in this area, and are happy to further discuss specific questions or relevant facts to your operations.

AN UNHAPPY MARRIAGE WITH CHRISTENSEN SHIPYARDS

By Dean W. Baker

The recent demise of a well known and respected builder of custom yachts in the United States market underscores the significance of state law issues to the "financing buyer's"[1] interest in the vessel under construction and the options the buyer retains in the wake of the builder's insolvency. On February 9, 2015 Christensen Shipyards, Ltd., ("Christensen") stopped construction of all vessels located at its Vancouver, Washington shipyard. See The Columbian, *Christensen Shipyards Close Gates*, February 9, 2015. Prior to November of 2014, potential buyers, as well as existing buyers whose boats were under construction would not have predicted the collapse of Christensen. The yard was teeming with workers constructing more than seven new builds. Despite the appearance of a healthy boatyard, Christensen stopped paying some of its vendors in the last quarter of 2014. Whatever the cause of that failure, buyers found

[1] A "financing buyer" provides financing to the shipyard to build the vessel by making payments in installments, typically at agreed-upon milestones of completion. The Christensen contracts provided for monthly installment payments, presumably to better manage cash flow. That arrangement is not standard in the large custom yacht industry and may have been a red flag, reflecting a thinly capitalized builder.

themselves in the uncomfortable position of having to deal with a shipyard that was unable to pay its debts as they became due. The effect on buyers was immediate, resulting in the realization that the boats under construction were now subject to vendor's liens for unpaid bills and that Christensen could no longer perform existing construction contracts for previously agreed-upon fixed prices.

With respect to the vendor liens, Washington state law (similar to federal law) sanctions "secret liens". The liens are "secret" because they do not need to be recorded at either the county or state level. Although, claims for materials, labor, and services rendered prior to completion of new construction of a vessel are characterized as nonmaritime "dry land" liens, the Washington statute explicitly provides that they have "preference over all other demands". See RCWA 60.36.010. Accordingly the statutory language suggests that these liens have priority over all other liens, including any lien that buyers were afforded under their original construction contracts to secure the payment and performance obligations of Christensen. In that regard, Christensen construction contracts were typical of most American-build contracts, providing title to the vessels under construction resided in the builder until delivery and granting the "financing buyer" a security interest in the vessel under construction to secure builder's obligations to the buyer under the contract. Notwithstanding the fact that vendor liens prime the buyer security interest, it is critical that the buyers do have liens (perfected under American law by filing in accordance with the Uniform Commercial Code) in order to preserve their interests in the face of any ensuing bankruptcy or receivership proceedings.[2] Without a lien, the buyer's contractual interest (as well as all advances made by the buyer to the builder) in delivery of a completed vessel is at risk of being lost. A trustee or receiver has the power to reject the contract, retain the vessel under construction and relegate the buyer to the status of an unsecured creditor in the bankruptcy or receivership proceeding -- a disastrous outcome for the buyer who might receive pennies or no dollars on account of his unsecured claim. The security interest that was afforded buyers under the Christensen contracts, however, does not insulate the buyers from the reach of the vendor liens. The burden of satisfying those liens has now shifted to the only deep pocket available, namely the buyers.

The other immediate consequence of Christensen's bleak financial condition is the certainty that each buyer's bargained for fixed-price contract is no longer possible. Buyers are faced with the choice of moving their vessels to

[2] If the construction project is in fact deemed to be construction of a new vessel, buyers perfect their security interests (typically granted under the construction contract) by the filing of a financing statement with the Secretary of State in the state where the builder is incorporated. We have seen form new build contracts that do not provide for the grant of a security interest in favor of the buyer. A buyer that is lulled into signing such a contract is playing russian roulette and any lawyer who blesses such an arrangement is risking a malpractice claim.

another yard or renegotiating their contracts with Christensen, in some cases for millions of dollars more than what they originally budgeted for a completed vessel. In either case, buyers understand that the original fixed price may be exceeded substantially.

In March of 2015 certain vendors initiated lawsuits to foreclose their liens and on March 20, 2015 a receiver was appointed to take control of and manage Christensen's operations.[3] A receivership proceeding under Washington law is analogous to a bankruptcy proceeding and the receivership statute borrows heavily from the federal bankruptcy code. There is now an automatic stay in effect and buyers that would like to remove their vessels will need to seek court permission to do so, most likely on the ground that there is no residual value in the vessel for the receiver because of the security interest initially granted by Christensen in favor of the buyer.[4] Simply, there is little doubt that the value of each of the vessels under construction is substantially less than the debt owed by the builder to the buyer.[5] In short there is no equity available for the receiver. Additionally, the buyers as secured creditors enjoy a constitutionally protected property interest in the vessels that will diminish over time[6], unless the buyers agree to renegotiate their contracts with the receiver or any purchaser of Christensen's operations that succeeds the receiver through a court approved sale consummated by the receiver.

For now the receiver is educating himself on Christensen's operations and ideally would like to turn a dead shipyard into a going concern that he can either operate or sell to a ready and willing purchaser. Either objective will require at least some level of participation by buyers willing to renegotiate their contracts. Certain buyers have already indicated a willingness to work with the receiver, believing that the option to remove their vessels to another shipyard will be more costly in the long run. At the time of this article it is too early to tell whether the receivership proceeding will benefit the buyers or delay any particular buyer's decision to divorce himself from the proceedings.

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[3] Any decision to remove a vessel from the yard would have required a transfer from Christensen to the buyer of title to the vessel. Such a title transfer could be effected either voluntarily (i.e. with the agreement of Christensen) or involuntarily by a foreclosure of the buyer security interest.

[4] Any buyer that gained title to the vessel through foreclosure (of its security interest) prior to appointment of a receiver will have an easier time convincing the court that it should be afforded relief from the automatic stay in order to remove the vessel, since the receiver has at most a possessory interest in that vessel.

[5] The debt owed by the builder to a buyer under a defaulted construction contract includes, inter alia, return of all advances made by the buyer to the builder on account of the contract.

[6] The value of Buyer's secured interest will potentially erode from the accrual of interest (if that is allowed under Washington law) on any paramount liens that vendors have under the secret lien statute and from any dimunition in the value of the vessels as they sit in the builder's yard and are not worked on.

We are a fourth-generation law firm with over a 100-year family tradition of legal service with the maritime community. We represent clients in a wide variety of maritime and admiralty practice areas, including:

- **Domestic & International Yacht Transactions & Ownership**
- **Yacht Documentation, Classification & Flagging Matters**
- **State, Federal & International Yacht Taxation**
- **Customs & Duty Concerns**
- **New Vessel Construction**
- **Vessel Warranty & Defect Claims**
- **Yacht Charter & Management Contracts**
- **Yacht Captain & Crew Agreement**
- **Maritime Liens, Arbitration, & Litigation**
- **Maritime Injuries and Claims**

The clients we serve include:

- **Yacht Owners**
- **Marine Lenders**
- **Yacht Management Companies**
- **Charter Brokers**
- **Dealers and Yacht Brokers**
- **Marinas & Boat Yards**
- **Yacht Manufacturers**
- **Ship Captains & Crew**
- **Family Offices**

HOW LATENT ARE YOUR DEFECTS

By David M. Bohonnon

Generally defined, a latent defect is one which could not be discovered using ordinary and reasonable care in inspection. It is a hidden or dormant defect in a product that cannot be discovered by observation or a reasonably careful inspection. Typically a new vessel purchase agreement includes some form of manufacturer's warranty which otherwise might cover repair or replacement of defective conditions, equipment or latent defects. In the unfortunate case that a latent defect manifests its presence after the expiration of a manufacturer's warranty and claims against the manufacturer for repair are unsuccessful, we turn our attention as to what role an "All Risk Marine Insurance Policy" may play for coverage and remedy to cure a latent defect.

The most shallow of All Risk Marine Insurance Policies are silent or typically exclude any coverage whatsoever for latent defects. More common, however, we see the disingenuous conventional language in an insurance policy which addresses latent defects:

ALL RISK INSURANCE

This policy covers the insured against all accidental risks of physical loss or damage to the insured property.

<u>Latent Defects</u>*: Latent defects and physical damage or loss caused by latent defects are covered under this insurance policy. "Latent defect" as used in this policy means a hidden physical defect (but not a defect in design) in the material or construction existing at the time of the original build of the insured vessel(s) or manufacture or installation of any additional or replacement parts, components or systems of the insured vessel(s) which are not discoverable by ordinary observation by an experienced marine surveyor or known methods of testing, provided such loss or damage was not caused, in whole or in part, by a lack of due diligence by the insured. Latent defects and any physical damage or loss arising out of or caused by latent defects are covered only if there are no warranties, guarantees or other insurance covering the latent defect or such damages or losses. The coverage provided for latent defects and physical damage or loss caused by such latent defects is subject to an obligation on the part of the insured to identify and enforce any and all rights and claims under warranties, guarantees or other insurance.*

There is no coverage for defects in design, manufacture, construction, workmanship or installation of insured property, other than coverage for latent defects as set forth and limited in this policy. There is no coverage for

the cost of re-designing, correcting, or modifying any defect in design, manufacture, construction, workmanship or installation of insured property. However, physical damage or loss to other parts of the yacht resulting from such defects will be covered.

So…after you discover that your vessel is falling apart due to faulty design and construction, and the yacht manufacturer is now out of business, and after reading the above paragraph five times, you ask yourself, "Am I covered by my insurance?"

We learn in the first paragraph of this policy language that there is an absolute duty by the insured or vessel owner to exhaust its claims for any damages caused by latent defects against responsible parties such as the manufacturer, but in this case such recourse is not available. The second paragraph excludes coverage for defects "*in design, manufacture, construction, workmanship or installation of insured property…However, physical damage or loss to other parts of the yacht resulting from such defects will be covered.*"

My estimation is that the physical damage or loss to other parts of the yacht from the latent defects might be a very difficult claim to prove even with the most understanding adjuster representing the underwriter. Attention should be paid to the fine print of both the Manufacturer's Warranty and your Marine Insurance Policy before you conclude the second happiest day in your life, the purchase of your dream vessel. Be sure to read, review, and understand the terms and conditions of the written language in an effort to avoid the possibility a "latent defect" exists in the terms and conditions of your All Risk Marine Insurance Policy. We have recently experienced an increase in the number of disputes from boat owners originating under Manufacturer's Warranty claims and denials of insurance benefits, and we seek to educate and caution the uninformed accordingly.

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NEW YORK BILL REVISES SALES AND USE TAX LAWS FOR VESSELS

By Steven A. Clark

An exciting change for yacht owners and marine industry constituents in the State of New York was recently signed into law – the new legislation essentially caps the combined state and county sales/use tax liability for the purchase or use of a vessel in the State of New York. New subdivision (JJ) of Section 1115 of the New York Tax Law, to be effective June 1, 2015, will exempt from taxation receipts in excess of $230,000 from every sale or use of a vessel. By way of example, a $1,000,000 yacht that is taxable under the current law (assuming taxable in Suffolk County, a popular yachting destination) would be taxed at 8.625% for a tax liability of $86,250. Under the "new" law,

only the first $230,000 of the $1,000,000 would be subject to tax, resulting in a tax liability of $19,837.50; clearly a significant savings.

We wish to caution vessel owners, however, that sales/use tax liability in the State of New York still remains a complicated matter, especially if a vessel owner has previously operated their vessel in New York waters (i.e. prior to June 1, 2015). Prior presence could subject the vessel owner to potential sales/use tax liability under the old law, which as exemplified, can be a much more significant number.

We wish to further caution vessel owners that any advice to quickly register a vessel with the State of New York and pay sales/use tax under the new law could be misguided and might result in unexpected (and needless) additional tax liability. Each situation must be carefully analyzed.

Our firm would be happy to discuss/review with you the new law, the facts concerning your current ownership and operation of your yacht, the potential implications of the new law based on your situation, and ultimately provide guidance as to how best to address any potential tax liability (and hopefully, tax savings).