



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
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The Honorable

Washington, D.C. 20510-3703

Attention:

Dear _____ :

This letter is in response to your request dated July 3, 2003, for an explanation of the federal tax treatment of payments made to Oregon fishers whose bids are accepted in the Pacific Coast Groundfish Fishing Capacity Reduction Program (the Program). Generally, under the Program, payments are made to eligible fish harvesters in exchange for the permanent relinquishment of certain fishing permits and the permanent removal of their vessels from fishing. I am pleased to provide the following general information, based on our understanding of the facts and how the capacity reduction program works.

The National Marine Fisheries Service (NMFS), Financial Services Division, administers the Program. Our understanding of the Program is based on conversations with NMFS officials and information contained in the final notice issued by the NMFS and published as RIN 0648-AQ99, 68 Fed. Reg. 138 (July 18, 2003). The objective of the Program is to conserve and manage the fishery by reducing the number of permits and vessels endorsed for the operation of groundfish trawl gear. The Program is voluntary, and only eligible harvesters can participate. (The Program is authorized by the Consolidated Appropriations Resolution of 2003, Pub. L. 108-7, Title II, § 212, 117 Stat. 11.)

Background Information on the Program

Eligible harvesters are harvesters who hold limited entry fishing permits endorsed for the operation of trawl gear and issued under the Federal Pacific Coast Groundfish Fishery Management Plan. To prevent capacity from shifting to other fisheries, the Program also involves fishing capacity reduction in the Washington, Oregon, and California fisheries for pink shrimp and coastal Dungeness crab.

Under the Program, eligible harvesters submit to the NMFS irrevocable bids which, if accepted, create binding contracts between those harvesters and the United States, subject only to the contingency of a successful fee repayment referendum. In the referendum, harvesters in the affected fisheries will decide whether harvesters who continue to fish in those fisheries will incur the obligation to repay a federal loan that will be used to fund the Program. (A \$10 million appropriation will fund part of the Program; the remainder will be funded by harvesters remaining in the fishery.) If the harvesters approve the referendum, successful bidders will be notified, and their reduction contracts will become binding. If the referendum is not approved, the Program will terminate, no contracts will be formed, and no parties will be under any further obligation with respect to the Program.

By submitting a bid, a harvester offers to relinquish permanently:

- 1) Certain federally issued Pacific Coast groundfish fishing permits that are endorsed for trawl-gear operation
- 2) All pink shrimp and coastal Dungeness crab permits, issued by Washington, Oregon, and California, that are registered to the bid's fishing vessel
- 3) The worldwide fishing privileges of the fishing vessel registered on the groundfish permit
- 4) Certain federal fishing permits or privileges issued on the basis of ownership or operation of the bid's vessel

By accepting a harvester's bid, and subject to a successful referendum, the United States permanently revokes the harvester's Pacific Coast groundfish permits and any other federal fishing permits or privileges included in the bid. The United States expects that Washington, Oregon, and California will permanently revoke all state pink shrimp and coastal Dungeness crab permits included in accepted bids; in any case, the bidder agrees to be permanently barred from exercising these permits.

If the fishing vessel registered to an accepted bidder's groundfish permit is not federally documented (because, for example, it is documented under state law), it must be scrapped at the bidder's expense. If it is federally documented, the bidder must impose or allow title restrictions that have the effect of permanently revoking or relinquishing the vessel's legal ability to fish. Specifically, the bidder agrees to remove:

- 1) The vessel's fisheries trade endorsement
- 2) Any qualification for present or future federal approval for placing the vessel under foreign registry or operation under the authority of a foreign country
- 3) Any other privilege, right, or entitlement that allows the vessel to fish anywhere else in the world

These restrictions will be recorded with the vessel's title, so that neither the bidder nor future owners may ever use the vessel for fishing. If the bidder violates these restrictions, the vessel may be seized and scrapped at the bidder's expense.

Once contracts are formed between the United States and the harvesters whose bids are accepted, the NMFS will make lump sum payments to those harvesters, equal to their individual bids. Eligible harvesters who want to participate in the program must submit bids to the NMFS by August 29, 2003. Bids are weighted by the capacity of the vessel, as measured by a three-year average of annual groundfish revenues, and will be accepted in reverse order, starting with the lowest.

Federal Tax Treatment of the Payments Made to Successful Bidders

Based on this understanding of the facts and the Program, the lump-sum payment made to a successful bidder must be allocated among the items, or bid components, listed above, that a bidder is relinquishing in return for the payment. These bid components consist of fishing permits and fishing vessel privileges. (For simplicity, I will assume that the bidder owns these items; situations in which "co-bidders" own different components of the overall bid are beyond the scope of this discussion. I also assume that the permits and vessels are used in the bidder's trade or business.)

Fishing Permits

A portion of the payment is for the fishing permits (or licenses) the bidder agrees to give up. Because these are "limited entry" fisheries, and the total number of such permits is restricted, this action is intended to reduce the number of harvesters working the affected fisheries. For federal tax purposes, such a permit is a "section 197 intangible" asset; its cost, or basis, is amortizable under section 197 of the Internal Revenue Code (the Code). The bidder will be treated as selling the permit or permits for the corresponding portion of the payment.

The character of gain or loss on the disposition of a permit depends on how long the bidder held it (counting renewals). If the bidder held it for a year or less, the difference between the amount of the payment allocated to the permit and the bidder's basis, if any, would be ordinary income or loss, reported on Part II of IRS Form 4797.

If the bidder held the permit for more than a year, the sale of the permit would be a "section 1231 transaction," reported on Part I of Form 4797. Section 1231 transactions include sales of real property and depreciable or amortizable property used in a trade or business and held for more than a year. (Note that section 1231 transactions also include gains and losses from casualties, condemnations, and other involuntary conversions. Such gains and losses may be treated differently from voluntary dispositions; for example, under section 1033 of the Code, recognition of gain from an involuntary conversion can be deferred if the converted property is replaced by similar property. Transactions under the Program are not involuntary conversions.)

The character of gain or loss on a section 1231 transaction depends on several factors and on the taxpayer's particular situation. For details, taxpayers should consult Form 4797 and the instructions for that form, as well as IRS Publication 544, *Sales and Other Dispositions of Assets*. These materials are available on the Internet at www.irs.gov.

Generally, if a taxpayer's section 1231 gains and losses result in a net loss, the net loss is an ordinary loss; if they result in a net gain, the net gain is taxed at more favorable capital gains rates.

There are two exceptions to this favorable treatment of a net section 1231 gain. First, a depreciable or amortizable asset, such as a permit of this type, would be "section 1245 property," subject to depreciation "recapture." Generally, this means that the portion of the gain on the asset equal to past depreciation or amortization is taxed as ordinary income; only the excess, if any, is section 1231 gain. See Publication 544, pp. 25-27. Second, if a bidder had net section 1231 losses in any of the previous five years, an amount of the net section 1231 gain equal to those losses might also be recaptured at ordinary rates. See Publication 544, p. 25.

In most cases, the permit or license will have been amortizable under section 197 of the Code. This fact makes the sale of a permit held for more than a year a section 1231 transaction, even if the bidder did not actually amortize the permit because it had no basis. If the permit was not eligible for amortization, under section 197 or otherwise—this would happen if it had an indefinite useful life and was acquired on or before the effective date of section 197, August 10, 1993 (or July 25, 1991, if chosen)—then the sale of the permit would simply be the sale of a capital asset, reported on Schedule D of Form 1040. See Publication 544, p. 22.

Fishing Vessels

The remaining portion of the payment received by a successful bidder is in return for the permanent removal of the vessel as a fishing vessel.

If a bidder's vessel is not federally documented, it must be scrapped. For federal tax purposes, the bidder is treated as having disposed of the vessel in return for the payment. In addition to the allocable portion of the payment, the amount realized from the disposition of the vessel would include the proceeds, if any, from the sale of the vessel materials for scrap. If the vessel was held for a year or less, the resulting gain or loss would be ordinary. If it was held for more than a year, the disposition would be a section 1231 transaction, because the vessel is depreciable property used in a trade or business. The federal tax consequences would be the same as for the fishing permit discussed earlier.

If a bidder's vessel is federally documented, the owner need not scrap the vessel, but must agree to restrictions that prevent the vessel from ever again being used for fishing. Unlike the bidder whose vessel is not federally documented, the bidder in this situation is not relinquishing all rights in the property and may convert or sell the vessel for other uses. However, the fishing restriction is worldwide, is enforceable by the federal government, and will permanently encumber title to the vessel. Based on the facts as I understand them, the payment effectively compensates the bidder for the reduced value of the vessel caused by the permanent relinquishment of a substantial interest in specific property: the right to use a fishing vessel to fish.

Accordingly, for a federally documented vessel, for federal tax purposes the amount of the payment that is not allocated to relinquished permits is first applied to reduce a bidder's basis in the restricted vessel. If the amount of the payment exceeds the bidder's basis, and the vessel has been held for a year or less, the excess is ordinary income. If the vessel has been held for more than a year, the excess is treated as gain from a section 1231 transaction, subject to depreciation recapture and the other tax consequences I described earlier.

The owner of a federally documented vessel could not take a loss deduction for the vessel, even if the owner's basis in the vessel—and, arguably, the vessel's reduction in value—exceeded the allocable portion of the payment. A mere decline in the value of property, not caused by a casualty, is not a closed and completed transaction that gives rise to a loss deduction.

I should stress that the opinions expressed in this letter are based on the facts of this particular program as we understand them. I am aware that there have been, and probably will continue to be, capacity reduction programs of this general nature. I strongly caution against applying the discussion in this letter to other programs without recognizing that the federal tax consequences will depend on the particulars of the program in question.

I hope this information is helpful. If you need further assistance, please contact me or
, at .

Sincerely,

Paul M. Ritenour
Chief, Branch 1
Office of Chief Counsel
(Income Tax & Accounting)