Boat Expenses That Won't Cause Checkbook Grief With The Taxman

by Scott H. Novak

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If the subtlety of the title did not immediately jump out at you, there is a difference between grief with the taxman and checkbook grief. You could still be called out by the IRS or the state tax authorities, but end up with a good or neutral result. Last month, I wrote about a few people who had very specific tax problems related to their boats. All of us would like to reduce our income taxes with at least some of the expenses that our passion requires throughout the year. Many of you are likely familiar with deductions for sales tax at purchase and interest on a boat loan. There are some other deductions available, but for the average boater, the usefulness of these deductions is limited and the IRS looks very closely at them. If you are planning to take additional deductions related to your boat, have bullet proof documentation and talk it over with your favorite accountant or tax attorney. Even then, be prepared to duke it out with the IRS over these expenses.

Sales Tax

Did you buy a boat this year? Neither did I. But for those of you who did, you paid sales tax on it when you registered it. If you traded a boat in, that reduced the amount of sales tax you had to pay, but the rate in NJ is 7% and in most of NY, the rate exceeds 8%. Ouch! The sales tax you paid is deductible, though some of you lose part or all of your deductions due to the amount of income you have or alternative minimum taxes (ok, let's not get technical).

Interest on Your Boat Loan

Interest is deductible the same way that it would be if you owned a second home. If the boat has a head (not a portable one), a galley (again, a permanent fixture) and sleeping quarters, you are entitled to the second home interest deduction. There are some additional rules to consider, so please make sure you are aware of them. The debate over this deduction rages on, however, and this deduction is a favorite target of legislators. One side of the argument is how the deduction came to exist in the first place – why should a second home mortgage interest deduction be available to the person who opted for a beach house and not to someone who opted for a boat of equal value. Is Congress trying to legislate recreational lifestyle choices? The other side of the argument, though, is why should we continue this tax loophole for wealthy yachtsmen? Stay tuned and support the boat lobby.

Commuting

Do you have an office in Haverstraw? Thinking of expanding to Tarrytown? That would make you bi-coastal! The cost of commuting between two offices is usually an allowable business expense, so you may be able to deduct some of the costs. But remember – every business expense must meet the "reasonable and necessary" test.

Entertaining

You have clients and prospective clients who just love to get an invitation to your boat each summer. And while you might not be excited about having a boatful of nonboaters for an evening, you can certainly get excited about the idea of spending 3 or 4 hours promoting your business in a way that they will remember. This will qualify for a deduction as an entertainment expense. On audit, you can expect the IRS to look very closely at business entertainment expenses, particularly if those expenses were incurred on your boat. What will help pass muster? First and foremost, stellar documentation. Who was there, what was the nature of the conversation (must have actual business discussions), did you have a reasonable expectation of deriving business or some other benefit now or in the future?

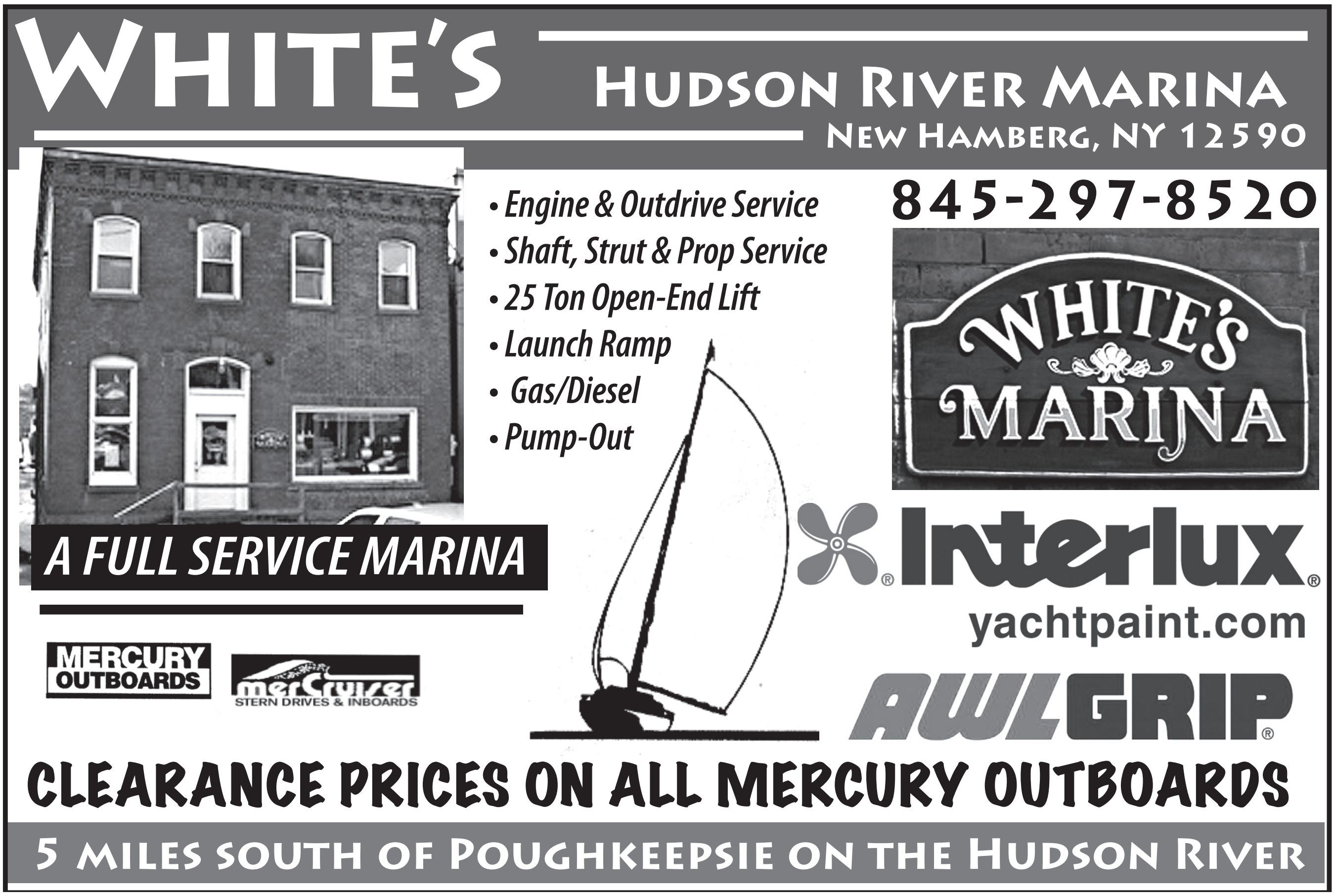
As with any other travel or entertainment expenses, the deduction is limited to 50 percent of the entertainment costs and you cannot include regular maintenance or depreciation for your boat. What you can deduct are the costs specifically related to each particular use of the boat: fuel, food and beverages are the first things that might come to mind, but other expenses qualify also, such as a transient mooring fee, the entry fee to a fishing tournament or the $20 docking fee if you use the dock at Torches and eat elsewhere.

Using Your Newly Minted Coast Guard Captain's License

Thinking about taking paying customers out on a three hour tour? Your endeavor must be seen as a business, not a hobby. It has to be operated like a business with the goal of making a profit in at least three out of five years. If it qualifies as a business, you'll be able to write off the depreciation, maintenance, equipment, fuel and mooring costs. You'll need to keep detailed records of every expense as well as the amount of income. If the boat is used for business, as an example, say, 20% of the time, you may be able to write off 20% of the expenses. When you make a profit, you will pay income tax and self-employment tax on the profit. But beware, because …….

IRS Is Targeting Yacht Chartering

As a result of a tax court case from 2011, the IRS is looking very carefully at tax returns that show a loss from a



yacht-chartering business. In this case, a husband and wife had to pay approximately $295,000 in taxes and approximately $59,000 in penalties because the IRS found that the yacht owner was not engaged in a for-profit trade or business from yacht chartering. This "IRS Audit Compliance Initiative Project" is set to continue until July 31, 2013. The stated goal of this IRS project is to deter taxpayers from using a yacht-chartering business as a way to purchase a yacht for personal enjoyment and deduct losses for chartering activities.

As recently as April 16, 2012, a former partner at a major New Jersey international accounting firm was sentenced to 18 months in prison for tax crimes related to a yacht-chartering business. He had advised a client to reduce his salary from his corporation by making "lease payments" to a company that owned a yacht. The company belonged to the client and the yacht was the personal yacht of the client. But the corporation had never leased the yacht and the client was found to have been using the arrangement to reduce his taxable income by deducting his personal yacht expenses.

Scott Novak is a fellow boater and an attorney who focuses on helping people and companies with tax problems, estate planning, trusts and other matters.