

HOW TO MAKE A DIRECTED TRANSFER OF YOUR FISHING BUSINESS

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Author Biography

Born in Minnesota, Sunny Rice first experienced Alaska and the commercial fishing industry in 1990, when she worked as a summer fish processor while attending college. After graduation, she moved to Petersburg, worked for the Alaska Department of Fish and Game and completed her Masters in Public Administration at the University of Alaska Southeast. She has worked for the Alaska Sea Grant Marine Advisory Program with the University of Alaska Fairbanks since 1998, where she focuses on maintaining the health of Alaska's small boat fishing fleets, communities and natural resources.



Introduction

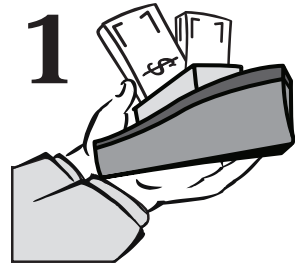
In most of our coastal Alaska communities, the commercial fishing industry is made up of small, family-owned businesses. While each of these individual businesses does not make or break a community's economy, the business decisions the fleet makes, taken together, can have serious implications for coastal towns. Each permit held in and fished from a community represents access to the natural resource of fish. When a permit leaves a community, so do fishing jobs, fish tax revenue, harbor fees, grocery and fuel purchases, processing work, and many other sources of revenue.

This publication was developed in response to concerns raised by a fisherman and fish processor in Petersburg about potential losses to communities as the general population ages and more fishermen retire. Will their permits be sold within or outside the community, region, or state? Are there enough young buyers with enough capital to take over their fishing businesses? If not, will the permits, equipment, and vessels lose value?

Providing information to both the retiring and upcoming generations of fishermen can help address these concerns. New fishermen need to have good business skills, access to capital, and mentoring to get started in this complex business. Established fishermen need to know about their options for retiring and passing on their fishing businesses. This publication addresses the needs of established fishermen by introducing the subject of retiring from fishing, outlining a process for passing the entire business on to one buyer in a directed sale, and identifying additional resources available to all fishermen. By helping established fishermen pass on their business and business skills, it also begins to address the needs of the next generation of fishermen.

While information and resources for generic small businesses about succession planning are available, none address the unique and highly regulated fishing industry. An excellent publication by Gary Hachfeld, published for farmers by the University of Minnesota Extension Service offers many parallels, and was used as a basis for this book. Like Hachfeld's publication, this book is intended as educational information only, not as legal advice. Questions or concerns about how material in this publication applies to an individual business should be directed to an attorney or tax advisor. Similarly, while this publication was up to date in late 2005, it contains several references to specific laws and regulations that are subject to change. The regulating agencies have the most updated information on the status of laws and regulations mentioned here.

Preparing for a Directed Transfer



Introduction

As you think about the future of your fishing business, you should consider the time when you will no longer be able or willing to continue the fishing lifestyle. It is important to begin planning for the transition early. Since entering the fishing business often requires a significant investment of capital, it may be impossible for a new fisherman to buy your entire business in one transaction. With forethought, however, you can still pass all or most of your business assets to one person or group of people in a “directed transfer.”

There are many reasons you might want to engage in a directed transfer. You may want to provide your child with a source of income, ensure that your vessel, quota shares or permits stay in your home community, or take advantage of the increased value your assets have when grouped together. Whatever your reason for directing the transfer of your fishing business, it is best to approach the transfer in an organized and pre-planned manner. This section raises basic questions that you need to ask when considering a directed transfer of your fishing business.

Determining if a directed transfer is right for you

You should consider the following:

1. Your financial security in retirement.

How much do you currently have saved for retirement?

What do you anticipate your living expenses to be after retirement?

Take time to pencil these numbers out, keeping in mind

that people are living longer, and that the cost of health care is high.

2. The financial health of your fishing operation.

What is your business currently worth and how will you determine your selling price?

Will you be passing on a profitable business?

Has your operation kept up with changes in the commercial fishing industry, or can it be upgraded easily?

Most important, does your business generate enough income to support both you and your buyer during the transition period?

3. Your willingness to let go.

If you have been a fisherman most of your life, it may be difficult to leave the lifestyle behind.

Do you have plans for what you'll do after fishing?

Are you ready to see your business run by someone else?

If it is difficult for you to imagine your buyer making the decisions about your boat, or quota, you may not be ready to pass on the business.

Determining if the buyer is right for a directed transfer

Once you have assessed your own position and readiness to transfer your fishing business, you should also determine the readiness and suitability of your intended buyer. A directed transfer requires some risk for both parties. You must both be ready to accept this risk and feel confident that you will be able to work together through any unexpected changes in the business or the transfer plan. Begin by considering the following:

1. Your trust in and relationship with the buyer.

Do you feel that the buyer is capable of running a modern fishing business?

Can you trust your buyer to stick to agreements and consider your interests when making business decisions?

Do you and your buyer have positive, respectful, and considerate attitudes toward one another?

2. Your buyer's financial position.

Will the buyer be able to make payments to you and to other creditors?

Does the buyer have assets or debts of their own that will be brought to the business?

Is your buyer supporting a family and will the business as it presently exists be able to support the family?

3. Your buyer's level of commitment to fishing.

Is your buyer as committed to fishing as you are?

Under what circumstances would it be acceptable to you if your buyer sold selected assets or the entire business?

Does the buyer want to fish because it is his chosen field, or because it is the expectation of family, or because nothing else has worked out?

4. Your buyer's level of experience.

Does the buyer have the business management skills necessary to run a modern fishing operation?

How much experience does the buyer have in these fisheries? Can the buyer gain the needed experience as part of the transfer process?

Many other questions need to be considered when completing a directed transfer of your fishing business. The preliminary questions above can help you decide whether to delve deeper into the research needed to plan the process. After you answer the questions to your satisfaction, you can start planning your transfer in detail.

Knowledge and documents you'll need when meeting to plan a directed transfer

The process of transferring a fishing operation is a business transaction, and needs to be approached with the same amount of research and planning as buying a new vessel or permit. To begin the process, arrange a meeting time with your buyer to start the discussion of how the transfer will take place. You and the buyer will want to know the following information for the initial meeting.

Seller information or documents

- Statement of Income and Expenses for recent years and fisheries and a Balance Sheet showing your assets and liabilities. This will be used to gauge the present and future health of the business.
- Cash Flow Statement for the fishing business. This document can help determine if the business can support both parties during the transition period.
- Record of retirement savings and an outline of your projected retirement income needs. While you don't necessarily need to disclose this information to your buyer, you will need to keep it in mind when determining what you will need to take away when the transaction is complete.

Buyer information or documents

- Balance Sheet showing the buyer's assets and liabilities. This will help outline what debts and assets the business may incur under the new ownership.
- Estimate of total cash income requirements for the entering family. This will help you determine how much income the business will need to generate during the transfer process.

With this information, you can assess where both parties stand at present, and foresee the challenges and advantages you'll have as you begin the transfer process.

Conclusion

The level of detail and the time it takes to complete the directed transfer of all or most of your fishing assets will depend on the size of your fishing business, your readiness to leave commercial fishing, and your buyer's ability to purchase and take over the operation of a modern fishing business. Before beginning to outline how you might pass the business on, think over the above questions carefully. If or when you can answer them to your satisfaction, gather the needed information and arrange a time to meet with your intended buyer to discuss the transfer process. Additional sections of this book provide details you may need as you plan, and the final section outlines the steps for creating your transfer plan document.

For more information

Nonprofit small business assistance centers, such as the University of Alaska Small Business Development Center (800-478-7232 or www.aksbdc.org) and the Alaska Business Development Center, Fisheries Business Assistance Program (800-478-3474) have general information on business succession planning.

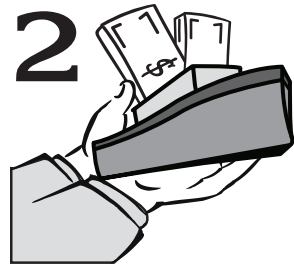
About.com provides a good introduction to retirement planning at retireplan.about.com/od/planning101/index_r.htm.



D. Mercy

Consider your own willingness to let go of the fishing operation when planning a directed transfer.

Directed Transfer Strategies



Introduction

The method you choose for transferring your fishing business depends on many factors, including your relationship with the buyer and their level of experience. If your buyer is your child and heir, you may want to use a strategy that allows opportunities for mentoring, includes gifting your fishing assets, and takes several years. On the other hand, if your buyer is a long-time deckhand or other fisherman, you may want to complete the transfer more quickly and with more financial safeguards built into the process.

In either case, the transfer of your business may include a period of fishing or managing your business together with your heir or buyer. This process may take several years, but the transfer period can be positive for both you and your buyer. Buyers can



Working together during a trial period can help you assess your buyer's readiness to take over the fishing business

gain needed experience in business, boat maintenance, and fishing methods by fishing with you. Both you and your buyer can use the interim period to determine if fishing is truly appropriate for the buyer. Finally, it can give you an opportunity to “ease” into retirement by slowly shedding business responsibilities, building more savings for full retirement, and starting to pursue other interests.

Using a trial period

Having a trial period of working together may be the best way to begin the directed transfer process. If your intended buyer is new to fishing, you may want to hire them as a deckhand for a season, providing a wage or incentive plan. During this trial period, you should both give serious consideration to whether fishing is the right fit for him or her. Will this person be able to contribute to the fishing business and its management? Are you and the buyer able to communicate effectively and work together toward a common goal? You can also use this time to assess the skill level of your buyer to help determine how long the transfer process should take. Establishing this trial period will give both parties a chance to withdraw from the process before entering into a complicated transfer agreement.

Fishing together but apart

Another approach to transferring your fishing business could be fishing together, but with separate business accountability. The entering fisherman could purchase a permit or quota shares, but fish on your vessel or using your equipment. Lease arrangements such as these can also offer an option to buy. Alternatively, the buyer could lease a vessel, but fish alongside you for a period.

Whatever strategy you use, your buyer should take over as much of the business management of the operation as possible. This will give the buyer valuable experience in maintaining business accounts, developing a credit relationship with a lender, and making purchasing and sales decisions. Fishing together may allow you to realize some efficiency with shared equipment or supplies, while allowing the buyer to gain confidence and skills.

This method may also allow you to slowly ease out of the fishing business, by gradually gifting or selling more parts of your business to your successor. As your equipment needs replacing, your buyer may choose to purchase the new pieces. This has the

added benefit of keeping the operation fully modernized, even though you are moving toward retirement.

Corporations or partnerships

When dealing with multiple partners and fisheries, it may be desirable to form a corporation or partnership to ease the transfer. Corporation shares or partnership units can be sold, gifted, or passed through a will to transfer the assets. However, forming another business entity should not be done without a thorough examination of the ramifications. Partners must be focused and committed to the success of the enterprise and good communication is very important. In addition, specific regulations govern the transfer of quota share and limited entry permits. Limited entry permits, for example, cannot be held by or transferred to a partnership. Similarly, most halibut and sablefish quota shares cannot be transferred to a corporation that was not an initial issuee of quota share. Since most possibilities are very complex, you should seek legal and tax advice before beginning the process. See the next section for more detailed information on corporations and partnerships.

Communications

No matter which method you choose to make a directed transfer, it is recommended that you meet regularly with your buyer and, in some cases, your family members, to discuss operations and longer term goals. In addition to daily conversations about fishing operations, include monthly meetings to discuss progress and problems. Quarterly meetings may be held to address short and long term goals and evaluate finances and working relationships. Each year, you should meet to establish goals, review the past year, and discuss other pertinent issues. This is also a time to celebrate the past year's successes.

Whether you are transferring your business to an heir or another buyer, establishing an effective means of communicating is just as important as outlining how the transfer will take place. Here are a few suggestions to improve communications.

- Put all final decisions in writing.
- When speaking, be brief and specific.
- Try to be positive, constructive, and willing to compromise.
- Listen actively. Focus and try to understand what is being

said. Allow the speaker to finish talking before you think about what you'll say next.

- Disregard negative statements. Find points of agreement and state them.

Good communication is not always easy, particularly if you have already established other, more negative patterns with your buyer. If your buyer is your own offspring, remember that you are one of the models he or she will use when establishing ways of communicating with others.

Conclusion

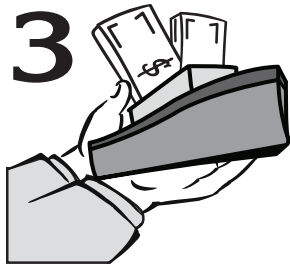
Since few entering fishermen have the resources to buy out an entire fishing operation in one transaction, most transfers will include a period of overlap, when both the buyer and seller are involved in the fishing business. This time can be used to benefit both of you, as your buyer learns new skills and you ease into retirement. Whether you hire your buyer as a deckhand, share or lease equipment, or enter into a formal business relationship, good communication is essential during this period.

For more information

Contact the Alaska Commercial Fisheries Entry Commission (907-789-6150) for detailed information concerning the transfer of Limited Entry Permits.

The Restricted Access Management (RAM) Division of the National Marine Fisheries Service (1-800-304-4846 or www.fakr.noaa.gov/regs/default.htm) can provide specific information on regulations governing the transfer of quota share.

Using Corporations or Partnerships



Introduction

Setting up a formal business entity such as a corporation or partnership can ease the transfer process by allowing you to sell or gift portions of assets, rather than transferring each asset as one piece. These entities can also allow you greater control as you transfer your business to your buyer, which may be desirable when you are unsure of your buyer's credit worthiness or overall operational fit. In this case, the business entity can allow you to safely transfer your business that may have taken a lifetime to build, avoid its possible overnight destruction, and help preserve the profit potential for years to come regardless of the buyer or new partner. However, setting up and operating such an entity has important tax, liability, and control implications. The assistance of a trusted attorney and tax preparer is strongly recommended. Below are descriptions of appropriate business arrangements you might consider in the transfer of your fishing business.

Corporations

A corporation is an independent legal entity, separate from the individuals who own it, work for it, or operate it. Incorporating may provide tax and operating advantages over sole proprietorships or partnerships, in addition to aiding in the transfer of assets from one generation to the next.

Forming a corporation

To form a corporation, you must file Articles of Incorporation with the State of Alaska, which issues a Certificate of Incorporation. A corporation must establish its own name and bank accounts and designate a number of "shares" that will be owned by the "shareholders." It may then become an employer, lessor, lessee, buyer, or seller.

Operation and control in corporations

Owners of a corporation are called shareholders. They are the basic decision-making group. They elect a board of directors, who oversee the operation of the business. If one shareholder owns 51% of the shares, they have control over the corporation. In this case, minority shareholders can be restricted to having little or no say in the activities of the corporation, unless otherwise outlined in the Articles of Incorporation.

Tax implications of corporations

There are two types of corporations, “S” and “C.” S corporations pay no business taxes themselves and avoid most double taxation. Instead, taxes on income are passed directly through to the shareholders according to the percentage of stock held. C corporations pay income tax themselves. There is the potential for double taxation of income with C corporations, since both the corporation and the shareholders pay taxes on income if it is passed to the shareholders through dividends. However, C corporations can also offer fringe benefits to their owners and take those costs as an income tax deduction. Employees of C corporations also pay income tax on their wages.

Liability in corporations

Shareholders are not generally held fully responsible for debts and court judgments against the corporation. However, shareholders may be asked to provide personal guarantees when corporations borrow money.

Advantages to incorporating

- It is easy to transfer shares. Shareholders can gift or sell shares to others as they see fit. As long as you hold 51% of the shares, you have control of the business.
- Similarly, the business may be divided among heirs easily during estate planning.
- Forming a C corporation may lower taxes, since the corporation is a new entity that may be in a lower tax bracket than the owners.
- Costs for benefits such as health insurance are deductible by C corporations, and not taxable to employees.

- Corporations provide some liability protection to individuals.
- Incorporating can provide continuation of the family fishing business through several generations, since they do not dissolve upon the death of the shareholders.

Concerns with incorporating

- It takes considerable planning to dissolve a corporation while minimizing the tax consequences for the shareholders. For this reason, it is not advisable to start a corporation unless you are planning to continue it for many years.
- Profits paid to shareholders as dividends in C corporations are taxed twice, once as income to the corporation, and once as dividend income to the shareholders.
- Corporations are required to hold shareholder meetings, complete corporate income tax returns, submit quarterly tax estimates, and comply with other reporting requirements. This additional work costs time and money.
- Minority shareholders have no power in directing the business. A majority shareholder could determine that no dividends will be paid, for example, despite desires to the contrary from minority shareholders.
- Corporate ownership may reduce individual pride of ownership and independence for the shareholders.
- It can be difficult for some people to view their family business as a corporation. Co-mingling your corporate and personal finances can negate the benefits of incorporating.

Partnerships

Forming a Partnership

To form a partnership, the partners contribute cash or assets that are deposited to a bank account under the name chosen for that partnership. They can then begin borrowing and spending money to operate the business. It is essential to draw up a written agreement stating the purpose and outlining the functions of the partnership. Include plans for how partners may enter or leave the partnership and what will happen if one partner dies. Also, discuss and outline how each partner will be involved, who has decision-making power, who has check-writing authority, and how partners and crew will be paid.

Operation and control in partnerships

Usually, all partners in a partnership make management and policy decisions. Votes may be distributed among partners according to their initial investment, or in some other manner outlined in the initial agreement. This can make partnerships relatively unstable, since all decisions for the business pass through all partners and personal relationships can cause problems.

Tax implications of partnerships

In a partnership, each partner pays the taxes on their income from the partnership at their individual rate. The partnership pays no income taxes, but must file an IRS informational form 1065 by April 15th of each year.

Liability in partnerships

A major drawback of partnerships is that each partner is personally liable for the debts and obligations of the partnership. This means that, in addition to all property of the partnership, creditors may claim all the personal property of the partners to the extent of any debt owed.

Limited Partnerships

Registered Limited Liability Partnerships (RLLP) and Limited Liability Companies (LLC) are entities that attempt to limit the personal liability of the owners, while maintaining the tax requirements of a partnership. In an RLLP, a general partner can be

named who will manage the asset or business, but who will also be responsible for all debts incurred. This is a method that allows you, the seller, to retain control of the business or property while transferring partnership units to your heir or buyer. An LLC may hire a separate manager who is not necessarily a member of the organization. This business structure also allows the manager to choose whether to be taxed as a partnership or corporation.

Transferring assets in corporations and partnerships

Corporations and partnerships can provide flexibility and control the pace of the transfer of fishing business assets. To form these entities, members contribute assets or cash to the corporation or partnership in exchange for a chosen number of unit or stock shares, which can then be willed, gifted, or sold to your heir or buyer. For example, the younger generation can buy or be given a certain percentage interest in the firm to begin with, and then slowly buy out the remaining percent as the parent retires. Not all of the business assets need to be included in the partnership or corporation. You may choose to place only vessels and the money needed to cover their operating costs in your corporation, for example.

Quota share and permits in corporations and partnerships

The advantages to using corporations and partnerships are limited by regulations governing the transfer of quota share and limited entry permits. State of Alaska limited entry permits may not be transferred to a partnership or corporation. Federal halibut and sablefish quota share other than A class can only be transferred to a partnership or corporation if the receiving partnership or corporation was an initial issuee of quota share or is a solely owned corporation formed by an individual who initially received catcher vessel quota share. This means that, in most cases, you will need to transfer your quota shares or permits directly to your individual buyer, outside the partnership or corporate structure.

Note: Information regarding transfer of quota share applies to halibut and blackcod quota share only. For information on Bering Sea and Aleutian Islands crab quota, contact the National Marine Fisheries Service.

Conclusion

Corporations and business partnerships can be useful tools to customize the transfer of your business. Be sure to consider the tax, liability, and control implications before entering into any binding legal agreements. Consulting with your tax preparer and a trusted attorney can help you weigh these options

For more information

State regulations governing the sale and lease of limited entry permits to partnerships and corporations are at www.cfec.state.ak.us/mnu_Regs_and_Statutes.htm. They are under Sections 16.43.140a and 16.43.990b7.

A link to the federal regulations governing the transfer of quota share to partnerships and corporations is at www.fakr.noaa.gov/regs/default.htm, part 679.41.

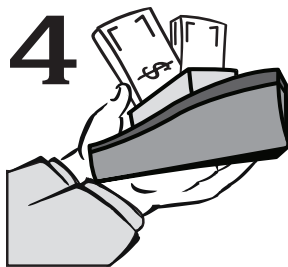
For more information on choosing the form of your business entity, see www.aksbdc.org/library.htm.



D. Mercy

Corporations and partnerships can give you flexibility and control by allowing you to transfer portions of an asset or business over time.

Gifts Fishing Assets 4



Introduction

Gifts your fishing assets can be useful, and may be necessary, when transferring your fishing business to an heir or other buyer. In addition to helping a new fisherman get established, gifting can also be used to pass some tax obligations to the younger fisherman and/or reduce the total estate that will be taxed at your death.

Gift taxes

For tax purposes, gifts are always valued at the fair market value (FMV) of the property at the time of the gift. Gift taxes are paid by the giver (donor), not the receiver (donee) of the gift. Federal law allows you to give up to a certain amount (\$11,000 in 2005) per recipient per year without incurring gift taxes. If you are married, you and your spouse may “split” the gift, allowing you as a couple to gift up to twice that amount (\$22,000 in 2005) to a recipient each year without incurring taxes. In this case, however, you must file a gift tax return (IRS Form 709) and both spouses should indicate their consent with this split on the return.

In addition, every person has a lifetime credit with the Internal Revenue Service of \$1,000,000 that can be used to offset gifts. Each gift over the annual exclusion (\$11,000) reduces this exempted amount. No gift tax is due until the total \$1,000,000 credit is used up, but you must file a gift tax return on gifts over the annual exclusion amount (\$11,000).

Example 1: A husband and wife could gift longline gear worth \$66,000 to their three children in a single year. Each child would receive a gift valued at \$22,000, and the parents would incur no gift tax.

Example 2: Sally Smith gave \$30,000 to her son toward a down payment on a tender in 2005. Subtracting the \$11,000 annual exclusion, there remained a taxable gift of \$19,000. Sally did not need to pay gift tax on this amount, but she did need to file a gift tax return. This \$19,000 was subtracted from her total lifetime credit of \$1,000,000, leaving her with \$981,000 credit to be used for future gifts.

Gifts may be made to your spouse, or to another person for education or medical expenses, without incurring gift tax.

Gifting permits or quota share

You may gift your permit or quota share to your heir or buyer provided you comply with the laws governing the transfer of the permit or quota share created by the regulating agencies.

In the case of halibut and sablefish quota share, this includes completing an "Application for Transfer of QS/IFQ" form. Your intended transferee will need to submit an "Application for Eligibility to Receive QS/IFQ," and document that he or she has at least 150 days experience working as part of the harvesting crew in any U.S. commercial fishery. For more information contact NMFS RAM Division at 1-800-304-4846.

Similar regulations apply when transferring State of Alaska limited entry permits. In this case, you will need to file a "Holder's Notice of Intent to Permanently Transfer Entry Permit Form" 60 days before you give the permit to your heir or buyer. Limited entry permits may not be transferred with any retained right of repossession or encumbrances. As part of completing the transfer, you and your recipient will complete a "Request for Permanent Transfer of Entry Permit" together. For more information contact the Commercial Fisheries Entry Commission at 907-789-6150.

Gifting vessels or equipment

Gifting a vessel or equipment to the next generation can provide advantages to you and your buyer or heir. Equipment gifted to the buyer can provide much needed equity on the buyer's balance sheet. It can also reduce your tax burden; since gifted assets are never recorded as "sold" on your tax return, you do not incur taxes on those items.

Any of your remaining tax basis for depreciation on the gifted equipment passes to the receiver of the gift.

Example: You give your daughter a vessel that has \$20,000 of value left to be depreciated. You lose the \$20,000 deduction, but your daughter can claim depreciation on the remaining \$20,000 basis.

If the remaining debt on the gifted asset exceeds the donor's basis, the excess is considered a taxable gain to the donor.

Example: Bob gives his long-time deckhand, Joe, completely depreciated shrimp pots valued at \$15,000. Joe assumes the \$5,000 debt that Bob had on the pots. Bob has \$5,000 of taxable gain and has made a \$10,000 gift to Joe.

When you gift a vessel or equipment, document the gift in writing, stating the value of the gift and to whom it was given. Sign and notarize the document effective the date of the gift. See the discussion of "basis" in section 6 to determine the value of the gift.



D. Mercy

Be sure that insurers and permitting authorities are informed of the gift of an asset as soon as the transfer is complete.

Gifting cash

Gifts of cash under \$11,000 are neither deductible to the donor, nor taxable to the donee. They have no income tax consequences. Example: You give each of your children \$6,000 for Christmas. No one has any income tax consequences.

Forgiving payments on contracts for deed

At some point after entering into a contract for deed with an heir or buyer, you may decide to forgive annual payments or discontinue the contract. If finances permit, the best procedure in this case is to collect a check from your buyer for the principal and interest payment and then issue a check to them for any gift you wish to make. This provides evidence that your buyer indeed “paid” for the property. You must declare payments received on a contract for deed on your tax return, even if you forgive the payment.

Conclusion

Gifting can be a useful tool for transferring your fishing business, or for estate planning. However, do not gift an asset unless you can afford to lose its value. Once an asset is gifted, you have no control over it, and can expect no income from it. In addition, be sure that insurers, lenders, service providers, and vessel documentation authorities are informed of the transfer of an asset as soon as the transfer is complete. Until the vessel documentation changes are completed, the donor retains liability for the vessel, including any damage it may do to other vessels, pollution, etc.

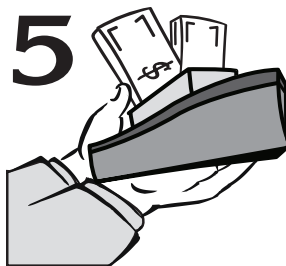
For More Information

Federal “Application for Transfer of QS/IFQ” and “Application for Eligibility to Receive QS/IFQ” forms are available at www.fakr.noaa.gov/ram/applications.htm#Link_7.

The Commercial Fisheries Entry Commission’s “Holder’s Notice of Intent to Permanently Transfer Entry Permit” and “Request for Permanent Transfer of Entry Permit” forms may be downloaded at www.cfec.state.ak.us/mnu_Forms.htm.

For more information on estate and gift taxes, check out the Internal Revenue Service’s publication “Introduction to Estate and Gift Taxes,” at www.irs.gov/publications/p950/index.html.

Managing Risk



Introduction

Fishing is a business that is full of risk. Start-up costs in fishing can be very high and new fishermen entering the business may be required to incur significant debt or allocate large amounts of their savings to get started. Sellers may help their buyer by financing sales at reduced interest rates, gifting fishing assets to the buyer, charging lower vessel lease fees, or making other financial concessions.

These economic realities bring up several important considerations.

- Buyers and their families are likely taking significant financial risks to enter the business and need some protection from unexpected injuries or deaths.



Photo courtesy of Alaska Seafood Marketing Institute

Purchasing insurance on the buyer or seller can help manage risk during the transfer process.

- Sellers using a directed transfer to a buyer who is not a family member may want added protection from buyer default.
- If the family business will be transferred through gifts or in a will to a son or daughter, non-fishing siblings may feel they are not being treated fairly by their parents.

While addressing some of these issues may bring up difficult questions related to estate planning and family relations, there are several tools that you can use to help ensure a successful business transfer and provide for non-fishing heirs. This section outlines some of these tools.

Protecting yourself during the transfer process

Depending on your relationship with your buyer and when you enter the transfer process, you may want to include protections for yourself in your agreements and plans. Three ways you may want to ensure your own financial future include

1. Use bank-assisted financing

Local banks that are familiar with fishing operations can help you enter into “buy” agreements that will help protect you from buyer default while you transfer your business. For example, you may guarantee a note through a lending institution that allows the buyer, who may not have enough historic income to qualify for the loan, to purchase the operation. You will still get paid for the assets, but if the buyer defaults, you are responsible for the repayment. However, you can reclaim most of the assets and sell them again, retaining the equity that was built into the operation by the new operator.

Note: Halibut or blackcod quota share other than A class may not be leased subject to repossession or resale, so you will need official documentation of the default to reclaim the assets. In addition, Alaska law prohibits the transfer of Limited Entry Permits with any retained right of repossession, so this type of arrangement cannot include Alaska Limited Entry Permits.

2. Purchase disability insurance on yourself or your buyer

Like other self employed persons, your sweat and skills are the engine of the business. If you or your heir or buyer become injured and unable to work, you may have to accelerate, alter, or cancel your transfer plan before it is complete. Disability insurance can be purchased to cover the additional costs that you or your buyer will incur if this happens.

3. Purchase life insurance on your buyer

If you are transferring your operation to a buyer who is not your heir, or if you will be entering into binding legal partnership agreements as part of the transfer process, you may want to consider using life insurance as a way to protect yourself if the buyer dies during the transfer process. You can either purchase life insurance on your buyer yourself, or have him purchase his own and name you as the beneficiary. This policy can ensure that you have sufficient funds to buy back the assets you have sold or gifted to your buyer.

Protecting your fishing heirs or buyer during the transfer process

1. Develop a written transfer plan

Create a transfer plan that all involved parties, including spouses and in-laws, agree to. Sign it and begin working from it. This will demonstrate your commitment to the transfer to yourself and your heir or buyer.

2. Create a purchase option document

If you have no other commitments to sell your assets, consider offering your heir or buyer a notarized purchase option. This will give your buyer the right to buy your vessel or equipment at a later date. They will not be obligated to make that purchase, but will have the right of first refusal. Price, method of payment, and date of sale should be agreed upon and recorded in this document. This agreement is binding on the spouse and other heirs. This may prevent your intended buyer from being forced to buy out the other heirs under unfavorable conditions after your death.

3. Provide protection in your will or living trust

Similar protection for your buyer may be provided in your will or living trust. Having a current will is always a good idea, and can help prevent ugly family disputes upon your death. In your will, you may outline how, and at what price and terms, your buyer can buy out other heirs or buy your business from your trust. In addition, you may use the processes created by the CFEC and RAM to designate a specific beneficiary for your permits and quota share. See “For more information” below for links to these forms.

4. Purchase life insurance

If you have outstanding loans on your fishing assets, you can purchase a life insurance policy on yourself to provide money for debt repayments and tax obligations. This will prevent your heir from having to sell off fishing assets to repay these debts.

5. Pass your fishing knowledge on to your buyer

It is important to share your knowledge of the fishing business with your buyer. While some lessons can be learned only through experience, you can give your buyer a competitive advantage by teaching them what you already know.

- Pass on your mechanical, navigation, and fishing skills. For example, if you are fishing together and a piece of equipment needs repair, explain what you are doing to your buyer as you repair it.
- Your buyer needs to know how to manage the fishing business. Explain how you make business decisions and whom you turn to for advice. It is important that your heir understand that fishing is a business that needs to be managed with attention to detail and planning.
- Share your wisdom. Tell them your “rules of thumb.” Help them avoid the mistakes you may have made by telling them your stories of early problems, while also sharing your successes.

Protecting non-fishing heirs

Passing on your fishing business to an heir or other buyer while ensuring that your non-fishing heirs feel that they are being fairly treated can be complicated. For this reason, it is important to discuss the reasons for your transfer and estate planning decisions with your buyer and your non-fishing heirs. Treating all heirs fairly is not always the same thing as ensuring they all receive assets of equal value from your estate. You may want to consider the following questions when making these decisions:

- Did you pay for a college education for non-fishing heirs?
- Has your fishing heir contributed toward the family income and estate by working as an unpaid or underpaid deckhand for many years?
- Does your family place a high value on keeping your vessel and/or permits “in the family?”

There are several ways you can transfer your assets to your heirs fairly, although not necessarily equally, among fishing and non-fishing heirs.

- Carry enough life insurance on yourself to provide cash at your death to your non-fishing heirs while leaving your fishing assets to your fishing heirs.
- Gift money to your fishing heirs, which they use to buy life insurance on you. This would provide money to buy out non-fishing heirs at your death.
- In your will and trust, will all cash and non-fishing assets to your non-fishing heirs, while transferring all fishing assets to your buyer.
- Pass all your assets onto your heirs equally, but provide reasonable terms in your will for your fishing heir to buy out your non-fishing heirs.

Whatever your decisions regarding your estate, be sure to include them in your written transfer plan. Although it may be difficult, remember that taking time to plan your estate and discuss your decisions with all your heirs can help avoid catastrophic family controversy at your death.

Conclusion

While commercial fishing can be a risky business, you can take steps to protect yourself, your buyer, and your other heirs during the transfer process. Some, such as purchasing insurance, require additional cash. Creating a will or purchase agreement, on the other hand, is relatively cost-free. While it may be uncomfortable, expanding your discussion of the transfer process to include these protections should allow all parties to feel that their interests are considered and protected, and make them more comfortable with the process in the long term.

For more information

The Commercial Fisheries Entry Commission's "Designation of Permit Recipient upon Holder's Death" form can be downloaded at www.cfec.state.ak.us/mnu_Forms.htm.

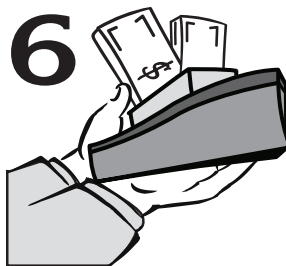
The National Marine Fisheries Service's form to designate a beneficiary for QS or IFQ is available at www.fakr.noaa.gov/ram/beneficiary_form.pdf.



Photo courtesy of Alaska Seafood Marketing Institute

Estate planning is an important part of the transfer process. Explaining your decisions to the entire family can help avoid catastrophic family controversy later.

Major Tax Considerations



Introduction

Most decisions you make regarding the transfer of your fishing business will have implications for your taxes, and for the taxes of your buyer or heir. The U.S. tax code is complicated and you will most likely want to hire an accountant or financial advisor to help you understand and file your tax returns. However, you still need a basic understanding of the taxes that will affect you as you outline the process for transferring your fishing business. This section provides that understanding.



Photo courtesy of Alaska Seafood Marketing Institute

Installment sales can spread out your income for tax purposes and give your buyer additional time to pay off the full value of the asset.

Tax basis

The basis of an asset is very important to its holder because it will determine the amount of income tax they will be required to pay when they sell the asset. When you sell an asset, you pay tax on the difference between the selling price and the tax basis of the asset.

Example: If you sell your vessel for \$35,000 and your tax basis for the vessel is \$15,000, your taxable gain is \$20,000.

Tax basis is determined by how you acquired the asset.

Assets that you purchased

If you purchased an asset, your tax basis is the amount you paid for it minus any depreciation you've claimed on it.

Example 1: You purchased an engine for \$25,000 and depreciated it for 3 years, claiming a total of \$12,000; your tax basis would be \$13,000.

Example 2: If you purchased a permit and claimed no depreciation on it, your tax basis would be the same as the purchase price.

Assets that you inherited

Your tax basis for assets that you inherited is the fair market value (FMV) or special use value assigned to the asset as it passed through the estate.

Example: You inherited halibut quota share from your father, which was valued in his estate at \$10,000. Your tax basis is \$10,000.

The FMV of an asset that passes through an estate may be higher than the tax basis it had when the owner was alive. For this reason, holders of assets may want to hold low basis property until death so that the heirs will receive the "stepped up" valuation.

Example: If John sells his quota share, which has a taxable basis of \$100,000 for \$300,000, he will have a taxable gain of \$200,000. If he retained the quota share until his death, however, the estate would assign the "stepped up" basis at the FMV, or \$300,000. His heirs could then sell the quota share for up to \$300,000 and incur no tax.

Assets that you received as a gift

Generally, your tax basis is the same as your donor's.

Example: You receive the gift of sablefish quota share valued at \$200,000 with a tax basis (purchase price) for the donor of \$50,000. Your tax basis is then \$50,000.

Spreading out your income

As you retire and begin selling assets, you may incur larger tax bills because of the increased income you gain from those sales. Planning ahead to spread the sales over two or three year periods can help level your income and result in lower taxes.

Installment sales

One method for spreading out your income from sales to your buyer is to sell items on the installment method. This can also benefit your heir or buyer by spreading out their required payments. When payments are spread out, so is taxation on the principal payments that are made, which may keep the income in a lower tax bracket.

Note: Determine what your tax liability will be in the first year of the sale before finalizing the terms. The first payment you receive may need to be high enough to cover the taxes you'll incur with the sale of the asset.

Income averaging

Income averaging may reduce your taxes in years with larger incomes due to sales or other changes in your business. This computation method allows you to pay taxes at a lower rate by averaging a big year with the two previous lower years. Income averaging applies to ordinary fishing income, as well as to the sale of fishing assets. It also applies to an owner's share of net fishing income from an S corporation, partnership, or limited liability company and wages received by an S corporation shareholder from the S corporation.

Tax free exchange

If your heir or buyer has a vessel or equipment, you may be able to use a Section 1031 like-kind exchange to transfer assets to them without incurring taxes. Traded items do not need to be of equal value to qualify and cash may also be exchanged in this transfer. One example could involve exchanging your larger vessel for your buyers' smaller one. While possibly useful, this method is a complicated tax move that will probably require advice from a tax professional or a like-kind exchange broker.

Capital construction funds

If you have a capital construction fund (CCF), it is important that you start planning early for retiring from the fishing business or transferring your business to your heir or buyer. Nonqualified withdrawals from your CCF bear significant tax penalties. They may be taxed separately from your other gross income and at the highest marginal tax rate in effect for the year of withdrawal. Keep in mind that amounts left in your CCF account for more than 25 years are nonqualified when they are withdrawn, as are amounts remaining in the account after you terminate your CCF agreement with NMFS.

Bearing these restrictions in mind, using a CCF may be advantageous to your buyer. This program allows fishermen to defer paying income tax on deposits made to the fund for use later in building, rebuilding, or acquiring a fishing vessel. Contact the National Marine Fisheries Service, the Internal Revenue Service Web page, or an accountant for information when considering this option.

Conclusion

You may see major changes in your tax situation as you begin transferring your fishing business. Understanding basic principles of the tax code will help you make better decisions about the timing and method of selling or gifting your assets. Your tax preparer will also be instrumental in helping you understand the tax implications of your decisions.

For more information

The Internal Revenue Service has many publications that may be useful, including

- Publication 551, “Basis of Assets,” at www.irs.gov/pub/irs-pdf/p551.pdf.
- Publication 537, “Installment Sales,” at www.irs.gov/pub/irs-pdf/p537.pdf.
- Publication 595, “Tax Highlights for Commercial Fishermen,” at www.irs.gov/pub/irs-pdf/p595.pdf. This includes information on capital construction funds.

Information from the National Marine Fisheries Service on capital construction funds is available at www.nmfs.noaa.gov/mb/financial_services/ccf.htm

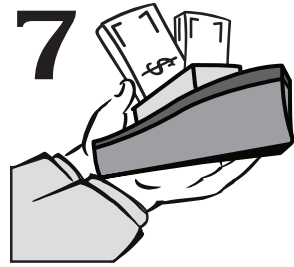
For more information on like-kind exchanges, see *Trading Up, Saving Taxes*, an Alaska Sea Grant publication available at www.uaf.edu/seagrant/bookstore/pubs/ASG-32.html.



Photo courtesy of Alaska Seafood Marketing Institute

Plan your transfer and retirement process carefully, particularly if you have a Capital Construction Fund.

Financial Help for Your Buyer



Introduction

Getting started in commercial fishing requires a significant financial investment. Finding sources for financing of vessels, permits, quota share, and equipment can be a difficult and daunting process for individuals entering the fishing business. You may consider lending money directly to your buyer, or help direct them to state and federal programs as possible sources of capital.

Parental financing

In addition to gifting needed assets to their children, parents may help finance new fishing businesses more directly by lending money for down payments or purchases. However, loans among family members can lead to strained relationships and hurt feelings and should be entered into very carefully.

When lending money to children (or other buyers), you should

- Write and sign a promissory note outlining the terms of the agreement, including interest rate, repayment schedule, and default remedies.
- Charge a reasonable interest rate similar to other commercial loans. You can charge less than commercial interest rates, but not less than the applicable federal rates (AFR). If you are audited and have not charged the appropriate interest rate, the IRS can require that you pay taxes on the interest you should have received. Ask your accountant about the AFR or search for them at www.irs.gov.
- Expect and demand payments when they are due.
- Pay tax on the interest you receive.

- Be prepared to write off loans to children if they are not repaid. Most bad debts to family members are considered gifts by the Internal Revenue Service and are not deductible to you as the lender.

You may also choose to help your child or buyer by cosigning a loan for them or by assigning collateral to secure a loan. This choice carries with it the risk that you will be required to make the loan payments if your buyer defaults and that your personal credit will be negatively affected. Limiting the amount that you will guarantee is a way to limit your risk when entering into this financial agreement. You may also ask the lender to notify you immediately if payments are not made on schedule.

Local banks

Young fishermen will be most successful getting loans from local banks if they have a good credit history. If possible, your heir should establish a good relationship with the local bank early by maintaining a savings or checking account, or borrowing and repaying money in a responsible manner. Money owed to the IRS for non-payment of taxes will be considered by banks, and reflects poorly on the buyer. Remind your children that the financial decisions they make early in life, even in high school, can impact their chances of obtaining financing when they are ready to invest in the fishing business.

Alaska Division of Investments loans

The State of Alaska encourages investment in the fishing industry by providing loans through the Division of Investments. These loans are available for financing vessels, permits, quota shares, vessel or gear upgrades, refinancing, tax obligations, and product quality improvement upgrades. Loans are available only to Alaska residents. All loans have lending limits and, in some instances, borrowers will be required to provide proof that they have been refused financing by another institution. Contact the Division of Investments at 907-465-2510 or www.commerce.state.ak.us/investments for more information.

Commercial Fishing and Agriculture Bank

The Commercial Fishing and Agriculture Bank (CFAB) is a member-owned lending cooperative that makes loans in commercial fishing, agriculture, natural resource development, and tourism. They provide financing for vessels, permits, quota share, fishing gear, processing equipment and shore-based facilities. Loans are available to Alaska residents only and most are made at a variable rate of interest. For more information, contact CFAB at 1-800-544-2228 or www.cfabalaska.com.

Note: The Alaska Division of Investments and CFAB are the only programs allowed to place liens on Alaska limited entry permits. Contact these institutions if your buyer needs to use another permit, or the permit being purchased, as collateral on a loan.

NOAA Fisheries Finance Program

The federal government also has a loan program. It is designed to provide long-term loans to the aquaculture, mariculture, and commercial fishing industries. Eligible projects include vessels (some restrictions apply), quota share in the halibut and sablefish fisheries, equipment, and real property. More information is available at 206-526-6122 or www.nmfs.noaa.gov/ocs/financial_services/ffp.htm.

Applying for a loan

It is a banker's job to protect the bank from taking bad risks. When approaching a loan officer, the borrower must make a convincing case that he or she is a good risk and will repay the loan in good faith. In addition to establishing a good credit rating early on, borrowers can provide evidence that they are good risks by being prepared when they approach the lender. Making an effective presentation of their financial standing and plans for how the money will be used requires time and research. Some things to be prepared in advance include the following:

- A financial statement listing all assets and liabilities
- The previous three years' income tax returns
- Projected cash flow
- A business plan outlining goals and accurate cost data for items to be purchased

- Copies of other business records to demonstrate business skills

Requirements to get a loan

When reviewing applications, they like to see

- A down payment. Most business loans require a certain percentage (normally 20-30%) of the total purchase price as a down payment. By committing some of their own money, borrowers share in the risk when making purchases.
- A strong credit rating. Lenders most often use credit-reporting agencies to determine the borrower's payment history on other loans and obligations. Paying off loans, credit cards, and other bills on time protects your buyer's credit rating.
- Adequate cash flow. Projects need to be able to earn enough money to cover loan payments.
- Other assets or collateral. Lenders want to see assets that can be converted to cash to pay off the loan if the business takes a sudden downturn.
- The ability to obtain insurance on the asset. Keep in mind that some assets might not be insurable by a new buyer, and insurance rates may change depending on the experience of the owner.

Conclusion

Preparing your heir or buyer to take over your fishing business includes training them to borrow and save responsibly and represent themselves and their business effectively to lenders. There are many sources of financing available to new fishermen, including private banks and government programs. You can help them access these sources, cosign loans for them, or provide financing yourself to help them access the capital they may need to get started. Be aware of the financial risk you may be incurring when you cosign or lend money yourself, however.

For more information

Many organizations and agencies in Alaska are available to help with business planning decisions and loan applications. These include

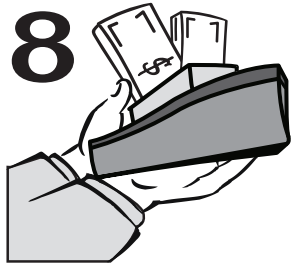
- The Alaska Business Development Center. Fees for counseling are based on the services provided and are negotiable. Contact 907-562-0335 or www.abdc.org.
- The Alaska Sea Grant Marine Advisory Program (MAP). MAP provides business development and tools created specifically for commercial fishing businesses. Contact 907-274-9691 or www.marineadvisory.org.
- The University of Alaska Small Business Development Center provides seminars, networking events and business counseling. Contact 800-478-7232 or www.aksbdc.org.
- The USDA Rural Development program helps independent producers with loans, grants, and technical assistance. Contact 907-761-7705 or www.rurdev.usda.gov/ak/offices.htm.



Photo courtesy of Alaska Seafood Marketing Institute

Establishing a good credit rating early in life will help your heir or buyer when she approaches lenders for financing.

Drafting a Written Transfer Plan



Introduction

The directed transfer of a modern fishing business is not a simple or quick process. It requires planning, commitment, and patience by all parties. While it is impossible to plan for all contingencies, formulating a concrete plan of how the transfer will take place can provide a sense of ease and commitment to both buyer and seller. A written transfer plan can act as the foundation for future business decisions, even though you may veer from its outlined path as the fishing industry changes. Remember that the transfer process can take years, so start planning early to help your heir or buyer grow into the fishing business.

Whom to involve

While the buyer and seller are the major parties involved in the transfer process, their families should be included in discussions about how to pass on the business, as well. Spouses of both parties have important stakes in these decisions, and will be more supportive if they have active input into the planning process.

Non-fishing heirs also have a stake in transfer plans. Explaining the reasons for your decisions up-front and sharing the final plan with them can help ease family tensions later. The process of outlining your transfer plan may inspire you to do additional estate planning, which may be discussed with the entire family at the same time as you explain the transfer plan.

Your accountant or tax preparer will be an important source of advice as you make your plans. Most decisions carry tax implications, and you want someone who knows the twists and turns of the tax code to help you take advantage of tax benefits and avoid negative consequences.

Legal advice is a crucial part of transferring a business in the highly regulated fishing industry. While many legal concerns are highlighted in this book, you need someone with intimate knowledge of laws and regulations to examine your transfer plan. Your attorney will also be needed to draft the final transfer documents. Doing as much research as possible ahead of time and having a nearly complete plan before going to the attorney will help save you money.

Other individuals can also be helpful when you are writing your transfer plan. These include your banker, insurance agent, industry representative, and financial planner. In addition, do not be afraid to approach regulatory agencies with questions about laws and regulations when making decisions. It is their job to help you understand how the regulations apply to you.

What to include in the plan

A transfer plan is only as useful as you make it. It needs to be detailed and geared to your specific situation. While we have outlined many possible transfer scenarios, you will need to thoroughly analyze your business to determine which courses of action will work best with you, your buyer, your fisheries, and your business. As you draw up your plan remember that you will be returning to the document when questions and decisions arise in the future. Some things to think about as you draft your written plan include

- What vessels and equipment will be used to fish your permits and IFQs? Will you need a bigger or different vessel at some point? Who will be responsible for the costs of vessel maintenance during the transfer process? How will the gear be transferred? Will it be included in the sale or transfer of the vessel? If new gear is needed, who will buy it? When will the gear be transferred?
- Will your heir or buyer work on your vessel during the transfer process? How will their labor count toward purchase of the business? How will the business pay for additional labor needed? How will you, the seller, be compensated for your labor during the transfer process?
- How will limited entry permits be transferred? At what point will each transfer take place?

- Is halibut or blackcod quota share involved in the business transfer? Will the buyer retain some shares for future income generation? If so, will the fishing business be profitable without those shares? Are there risks of one party or entity exceeding the legal limits of shares during the planned transfer?
- Have arrangements been made to protect the buyer and seller during the process? Has a will been created or other estate planning been done? Is life or health insurance included in your transfer plans?
- During the transfer process, who will be responsible for what parts of the business? For example, will the buyer make financial calculations for the entire operation, or just one fishery? How will work on the vessel be divided? Who will be responsible for doing maintenance on the vessel and gear? Think through a typical fishing season, imagining how tasks might be divided. Once you have agreed on the separation of duties, write it down.
- How will debt be handled? Does the buyer assume existing debt? Are provisions made in the will to help the buyer pay it off?
- Who will decide where and when to fish if you are fishing together? Who has final decision-making power for the fishing business? When will that power transfer to the heir or buyer?
- How will the transfer plan change if there are dramatic changes in regulations, values, or prices? Will the buyer and seller stick to the original agreed-upon values despite market fluctuations, or will there be an option to amend the plan? If it will be amended, what process will you use?

When to write the transfer plan

Some people like to do all the necessary research before writing down a plan. Others may use the process of writing the plan as a way to guide their research. Whichever way you choose, start the process of writing the plan as soon as you have decided to transfer your fishing business.

Why write the plan down?

The transfer plan may cover up to ten or more years from start to finish, and it will be impossible to remember all the details originally discussed after several months or years. Writing the details down will prevent disputes in the future about what was promised or agreed to. Having the plan in writing will also provide assurance to both parties that the other is committed to the transfer process.

Start this process by writing a draft of the plan. Each party should then review the plan with their spouse, tax preparer, and other advisors. After everyone has agreed to the draft plan, a final written plan can be drafted and signed. An attorney can help with this process.



Photo courtesy of Alaska Seafood Marketing Institute

Write down the details of your transfer plan – it will be impossible to remember them several years later.

Conclusion

Your written transfer plan will be the guiding document for the process of transferring your fishing business. Be sure to keep it up to date by reviewing the document at your yearly meetings to determine if the transfer is proceeding on schedule or if modifications need to be made. Revise the written plan as needed, having all parties sign off on any changes.

Finally, don't forget to congratulate yourself for making a strong commitment to the future of your heir or buyer, your community, and your fishing business.

Acronyms Used in this Book

ABDC – Alaska Business Development Center

AFR – Applicable federal rate

AKSBDC – Alaska Small Business Development Center

BSAI – Bering Sea/Aleutian Islands

CCF – Capital construction fund

CFAB – Commercial Fishing and Agriculture Bank

CFEC – Commercial Fisheries Entry Commission

EA – Enrolled agent

FMV – Fair market value

IFQ – Individual Fishing Quota

IRS – Internal Revenue Service

LLC – Limited Liability Company

MAP – Marine Advisory Program

NMFS – National Marine Fisheries Service

NOAA – National Oceanographic and Atmospheric Administration

QS – Quota share

RAM – Restricted Access Management Division of the National
Marine Fisheries Service

RLLP – Registered Limited Liability Partnership

USDA – United States Department of Agriculture