

# Fishing Audit Technique Guide

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**Revision Date** - August 2011



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# Chapter 1 - Income

## Background

A fishing business is defined as the conduct of commercial fishing via definitions detailed in the Magnuson-Stevens Fishery Conservation and Management Reauthorization Act of 2006, 16 U.S.C. §§ 1801-1884 (2011) ("Sustainable Fisheries Act"). Commercial fishing is fishing in which the fish harvested is entered into commerce through sale, barter or trade. Fishing income is defined as income from catching, taking or harvesting of fish (this includes all forms of aquatic life).

The National Oceanic and Atmospheric Administration's National Marine Fisheries Service (NMFS), a division of the Department of Commerce, is the federal agency responsible for the management, conservation and protection of living marine resources within the U. S. Exclusive Economic Zone (water three to 200 miles offshore). Its six Regional Offices and eight Regional Fishery Management Councils have oversight of fishing activities and compliance with fisheries regulations. NMFS publishes information in its annual statistical report, Fisheries of the United States. For 2009, the report states that commercial landings by U.S. fishers at ports in the 50 states were 7.9 billion pounds valued at \$3.9 billion. Over 1/3 of both the catch and the value was caught in Alaska. The next three states based on dollar value were Massachusetts, Maine and Louisiana, respectively. The type of vessel and gear, size of crew, and fishery regulation will vary based on location and species.

## Types of Fishing Operations

Generally, there are two types of fishing operations - shore-based and offshore. Shore-based operations use a net from shore to catch fish, dig, or pick aquatic life. Offshore operations use fishing vessels and either nets, lines, pots, traps, or diving gear to catch finfish, shellfish or other aquatic life. There are two basic types of nets used - encircling nets and entangling nets. The encircling nets are purse seine, haul seine, or trawl seine. The fishing vessel circles around the target fishing area, dropping the net in a circular pattern. Once the net is in place, the net is closed, trapping the catch in the net. Entangling nets, also known as gill or trammel nets, catch the fish when the fish try to swim through the nets.

The many types of fishing vessels used in the variety of fisheries use different gear and equipment. Some vessels participate in more than one kind of fishery. Some vessels solely catch fish, some vessels catch and process fish, some vessels solely process fish, and some vessels transport fish from the vessel catching the fish to a processing vessel or a shore-based processor.

All states have reporting requirements for estimating the landing of aquatic harvests. Vessel owners or operators are generally required to maintain a daily logbook or trip logbook. These logbooks contain the information used to submit weekly or monthly landing reports to a state agency. A few states have voluntary reporting only. Each state decides the form of the report and the state agency that handles the reporting documents varies from state to state. State statutes sometime protect access to these reports. The statistical data collected are funneled to the NMFS, which posts a summary of this information on its website. Monthly reports may also be required from the initial buyers, dealers and processors of the aquatic harvest in terms of dockside value and weight of commercially-harvested species. This can be an important source of information regarding purchases by a specific dealer or processor.

Most state websites will provide information regarding reporting requirements, licensing and permit information, and the state's commercial fishing laws.

What follows is a limited description of fishing around the country to aid in understanding that not all fishery operations are alike.

## **New England**

New England's fishing business consists primarily of owner-operated vessels. The largest are approximately 100 feet long, and most are less than 50 feet long. In spite of the various regulatory agencies, many of the fishing areas are undersupplied, resulting in declining income for the fisherman. The New England Area is primarily known for harvesting the following species - lobster, scallops and ground fish. Income is also derived from seaweed and sponges.

Licenses are required in New England for harvesting various sea "products" - lobster, crab, shellfish, quahog, mussels, marine worms, commercial fish, commercial shrimp, and seaweed. The Maine Department of Marine Resources issues lobster licenses, which determine the number of individuals permitted to harvest lobster under the license. A Class 1 license allows only the license holder to harvest lobster. A Class 2 license allows the license holder and one crewmember to harvest. A Class 3 license permits the license holder and two crewmembers to harvest.

A single operator license covers the licensed activity for the license holder only. The crew license covers the licensed activity for the license holder as well as all crewmembers. The number of crewmembers allowed to fish under one fishing crew license is unlimited. As long as the fishing license is on the boat, the license holder is not required to be present.

The City of Portland, Maine owns a Fish Exchange, which provides seller representation through daily auctions and handles over 90% of Maine's total catch of regulated ground fish. The Exchange weighs, grades, and sells fishery products, and services financial accounts. Sellers from all over Maine maintain control of their products up to the point of sale. Daily and weekly price reports are available on the Exchange's website.

## **Alaska**

Commercial fisheries in Alaska fall within the mixed jurisdiction of state and federal management authorities. In general, the state has management authority for all salmon, herring and shellfish fisheries, whereas the federal government has management authority for the majority of ground fish fisheries, except for those within three nautical miles of shore and a few others.

Commercially important species of seafood from Alaska include five species of salmon, five species of crab, walleye, pollock, Pacific halibut, Pacific cod, sablefish, herring, four species of shrimp, several species of flatfish and rockfish, lingcod, geoducks, sea cucumbers, and sea urchins.

The Alaska Department of Fish and Game website is an excellent resource for Alaska fishing information. It provides details on the season, licensing, vessels, gear, catch and ex-vessel price (the price sold by the fishers). The website has descriptions accompanied by pictures of vessels and gear.

## **Gulf Coast**

All of the Gulf Coast States harvest shrimp from the Gulf of Mexico, commonly referred to as the Gulf. Brown shrimp and white shrimp are most common, although pink, river, rock, roughneck and Royal Red varieties can also be found. Shrimp are sold wholesale by size grade, expressed as the average number of shrimp per pound. The lower the number of shrimp per pound, the larger the average shrimp. For example, 16-20 grade shrimp are larger than 21-25 grade shrimp. Larger shrimp command a higher price than smaller shrimp. Shrimp are sold "head-on" or "headless." Headless shrimp are more expensive because more are required to make a pound and "heading" shrimp (removing the heads) is labor-intensive.

Specialized boats (trawlers) use large nets that are dragged through the water to scoop up the shrimp. Due to the type of trawl net used, a variety of other species of aquatic life, called bycatch, is also scooped up. Federal law protects certain species of shark, turtle and dolphin, and requires the use of turtle excluder devices (usually called TEDS). Limited bycatch of some species, such as swordfish, may be retained. Depending on what bycatch occurs, it may be retained for sale to the wholesaler/buyer, eaten by the crew while on the water, or frozen and taken home by the captain and/or crew for personal consumption or casual sale.

Catfish are also common to all the Gulf Coast States. In the wild, commercial fishers generally harvest fresh or saltwater catfish by stringing a "trotline" from which are suspended large multi-barbed hooks (treble hooks). The fisher baits the hooks with "trash fish" and "runs the line" morning and evening to pick up the catfish caught by the treble hooks. Sales to the wholesaler/buyer/processor are usually of whole, fresh, not frozen, fish.

The blue-point crab is found all over the Gulf, but is fished primarily in Louisiana and Florida. Commercial crab traps are usually made of chicken wire (normally coated with tar to slow rusting) to which is attached a buoy for easy location of the trap by the fisher. Each fisher has a distinctive color code or markings for his/ her buoys. Crab is generally sold to the wholesaler/ buyer/processor by the pound, but to the consumer by the dozen or fraction thereof.

Oysters are found off the Gulf shores within approximately 200 miles of the mouth of the Mississippi River, which area covers Louisiana, Mississippi, Alabama and Western Florida. The largest oyster harvests are in Louisiana and Florida. These states own established oyster beds located off the coast. Individuals lease these oyster beds from the state, and the oyster leases are often passed down from father to son or sold. Oysters are harvested either by a dredge, which is a bucket dragged through the bed, then hauled up to the boat, or by using traditional oyster tongs, which look like a pair of opposing rakes joined at a pivot point and operated in a manner similar to using scissors. Processors or bars and restaurants purchase the oysters by the sack. Many restaurants use only a particular source for their oysters.

Crawfish (known as crayfish in some areas) harvesting was for many years the exclusive domain of Louisiana. In recent years, the expansion of this market segment has created additional demand (and correspondingly higher prices). Crawfish are currently harvested from East Texas to Mississippi. The method of harvesting crawfish is the same, whether from the wild or a farm pond. A crawfish trap is fashioned from chicken wire (coated with tar or plastic to resist rust) and a short length of four-inch PVC pipe. The traps are set with bait specifically designed to attract crawfish. This bait is locally available from crawfish processors or feed stores. The fisher generally runs his traps once a day.

The fisher sells crawfish by the sack (approximately 20 or 40 pounds depending on the sack size) either retail to individuals and/or restaurants or wholesale to a processor. Buyer/wholesalers generally grade the crawfish into "select" (larger crawfish) and "peeler" (small crawfish) categories, sometimes by hand or, more recently, by means of a mechanical grader. Generally, fishers sell "select" crawfish to restaurants for boiling whole, similar to lobster. They sell "peeler" grade crawfish to processors who boil the crawfish and "peel out" the tail meat, which is then packaged and sold by the pound.

Various Gulf finfish are harvested throughout the Gulf Coast States. Among the most commonly harvested commercially are saltwater catfish, amberjack, bluefin and yellowfin tuna, flounder, garfish, king and Spanish mackerel, mahi, shark (various), tilapia and southern king fish (channel mullet). The buyer/wholesaler/processor generally purchases these as whole fish.

Generally, a state agency charged with oversight of fishing receives monthly reports from initial buyers, such as dealers or processors, of the species, dockside value and weight of all commercially harvested species. This can be an important source of information on purchases of a specific dealer or processor.

## Determining Income from the Catch

Following the procedures for minimum income probes is important to determine whether the income from fishing has been reported properly. The first step in any audit is to do a financial status analysis of the taxpayer's cash flow to estimate whether there are sufficient funds to cover the taxpayer's expenses. The purpose is to determine the depth of the examination and to determine the likelihood of unreported income. If the taxpayer files a business return, an interview of the taxpayer will help gain an understanding of the business and determine the taxpayer's financial history.

Many individuals reside in a different location during the off-season, often in another state. You may be examining an individual who filed a return in Montana but earned his income in Alaska.

The descriptions above lead to some basic questions for discussions and items to request.

- For what did you fish?
- When did you fish?
- Did you fish in more than one fishery?
- What was the season for each fishery that you fished?
- What type of licenses and permits were required (vessel, owner, crew)?
- Who controls and regulates the fishery (the state or the NMFS)?
- What type of vessel and gear were used to catch the fish?
- Who owned the vessel and gear?
- Were there any leases?
- Was any processing done to the fish prior to sale (whole or headed)?
- To whom did you sell (processor, auction house, restaurants)?
- Was there a change in catch or prices from the prior or subsequent year or within the year under exam?
- How were you compensated (is there a contract)?
- Did you receive any income in addition to the sale of the fish such as from the sale of assets, a buy back or settlement payments?

With respect to a business return, one of the minimum income probes is to test the sales. For the sale of fish, there are processor statements (fish tickets) and settlement statements. The processor statements will identify the type and quantity of the catch as well as the price. Pricing information may be available on the state's regulatory website, the NMFS and/or a purchaser or auction house website. The NMFS provides links to pricing on its page titled Fishery Market News. The price is also called the ex-vessel price.

The gross receipts from fishing should be reconciled to data provided from the fish trip settlement sheets. Generally, the boat owners provide settlement sheets for each departure. Forms 1099-MISC are not always provided to captains and crewmembers for payment verification. Settlement sheets contain the following information:

- Name of the vessel
- Trip number (the number of the trip assigned to the ship)
- Date in - date the ship returned to the pier
- Trip Length - number of days the ship was at sea during the trip
- Trip expenses - amount paid by the boat owner
- New Catch - value of the catch net of allocated trip expenses
- Catch % - percentage each crewmember receives of the net catch

Income can be determined based on a review of the settlement sheets. When the company that purchases the catch pays the boat owner, the boat owner in turn pays the crew settlements.

## **Type of Vessel**

In your pre-audit analysis, you should review Accurint for business information. As part of the search, obtain a watercraft report. It will provide the vessel name, number, make, use, year, type, length, breadth, depth, gross tons, net tons and propulsion type.

Based on information obtained during the initial interview, determine the number of days offshore and the type of vessel(s), and reconcile that information to fuel consumption.

Determine the vessel types in service. Processed catch will sell for a different price than catch sold whole.

## **Licenses/Permit Data**

The state fisheries regulators and the NMFS Regional Offices will have information with respect to licensing and permit requirements. You can obtain this data from most states. If the permit was issued by the NMFS, you can go to its permit page and search types of permits by vessel name.

## **Fishing Season**

Each fishery has a specific season for each location and species harvested. It is important to understand this in relation to your taxpayer. Does the reported fishing activity correspond with the season? If not, why not? The answer may simply be that the quota for the fishery had been met. See the Alaska Fish and Game website for Commercial Fishing Seasons in Alaska for a good example of fishing seasons, species and permitted method of catch.

## **Contracts**

Generally, the crewmember enters into a contract that outlines the terms of the trip - percentage of catch, expenses paid by boat owner, and termination point. Members of the

crew are seaman for Jones Act purposes, but independent contractors for income tax, social security and withholding tax. Contract terms should be reconciled to the amounts reported on the return.

## **Third Parties**

Third parties are an excellent resource for issue development. Examples of useful contacts include bait sellers, regulatory agencies, boat owners, and websites. Ask the taxpayer to provide the records. If records are inadequate, ask the taxpayer to provide a release to obtain records from third parties. If appropriate, consider issuing a summons. The NMFS is restricted by the Sustainable Fisheries Act (the Act) from disclosing fishing statistics and information collected pursuant to the Act without a court order. The NMFS interpretation of "court order" does not encompass an IRS administrative summons. Furthermore, states that collect information required by the Act are also subject to its confidentiality provisions and are prevented from disclosing such information. The type of information actually collected varies by state, fishery and sometimes species. There will be information collected that falls outside the protection of the Act. Thus, depending on the case, the information we seek may or may not be confidential under the Act. NMFS, in conjunction with the state, can help make this determination. You should request Counsel's guidance prior to issuing a summons to a state.

## **Other Fishing Income**

An individual may leave the fishing industry due to age, the economy or forces beyond his control. If the individual is no longer fishing and owned a vessel or gear, determine what happened to these assets. Were they sold to a related party? Was there a foreclosure? If so, was the income taxable or excludible under the forgiveness of debt rules?

In order to manage fish capacity, the NMFS has offered buy backs. Each program generally entails a specific fishery location, catch and terms. Under one such program, the fisher was required to submit a bid to permanently relinquish a permit and fishing vessel privileges. If the vessel was undocumented under Coast Guard rules, the program required it to be scrapped. If a vessel was documented, it did not have to be scrapped but was permanently restricted from fishing worldwide.

For tax purposes, the relinquishment of a permit is a sale of the permit.

The payment allocated to a scrapped vessel is a sale. If the vessel was restricted rather than scrapped, the basis is reduced and any payment beyond the basis is income.

As a result of the Exxon Valdez oil spill, taxpayers received payments for lost fishing income as well as payments for the cleanup. In addition, some individuals received settlement payments for punitive damages and interest. In re Exxon Valdez, No. 89-095-CV (HRH) (Consolidated) (D. Alaska). Payments for lost fishing income are taxable as

fishing income with respect to the plaintiffs and qualified beneficiaries who were included by special legislation for income averaging purposes.

Due to the Deepwater Horizon Oil Spill, claimants are receiving payments for lost wages or income. Such payments are taxable in the same manner that the lost income was taxable. The payments are income from fishing and subject to self-employment tax if the fisher was previously considered self-employed. Payments for property damage are nontaxable, if the payment does not exceed the taxpayer's adjusted basis in the property. Payments for personal injury are nontaxable.

Payments made for participating in the cleanup are not income from fishing, but will be taxable to the recipient. If you are auditing an individual who participated in the cleanup, you will need to determine if he/she was an employee or self-employed and the nature of the compensation. In addition to compensation for services, there may be payments for the use of a vessel and/or per diem payments.

## **Methods of Underreporting Income**

Payments in the fishing industry are frequently made in cash. Forms 1099- MISC for crew shares and fish purchases as well as employment tax reporting and withholding may be nonexistent or understated. You should review the audit technique guide that deals with auditing cash intensive businesses.

In the fishing industry, buyers and processors often aid fishers in understating income. Various methods are employed, and are equally applicable to sole proprietorships, partnerships and corporations. Common examples are:

- To avoid fish exchange and regulation in general, many individuals fish in one state and drop their catch in other ports or engage in "boat hopping", the practice of switching at sea and thereby becoming crewmembers in various boats and fishing activities. Such practices make it difficult to determine unreported income.
- The processor at a local bank or cooperating merchant cashes a single check or multiple checks payable to the individual or boat name. The fishers receive the cash thus avoiding any deposit to a business or personal account.
- A single check or multiple checks payable to the individual or boat's name are endorsed back to the seafood processor and cash is paid for the catch. No deposit is made to the fisher's business or personal account.
- A single or multiple checks are written to cash by the seafood processor. The recipient is not identified.
- Checks are written in names of various family members of the fisher, making it appear that the individual did not receive the full compensation.
- Checks are written to the fisher to structure transactions in avoidance of IRC § 6050I (Form 8300) or 31 U.S.C. (Bank Secrecy Act) regulations.
- Two checks and two invoices are written by the buyer/processor for the fisher: the first invoice and check payable to the fisher and the second invoice and check payable to a fictitious owner. The fictitious owner does not file a return

and cannot be found since he does not exist. The processor or a local merchant cashes the second check for a fee.

- The fisher may generate two invoices, one for a certain grade of catch and a second for a different grade. The fisher reports the income from one but not the other.
- The buyer/processor writes two checks, but generates only one invoice. One check is written to the fisher, usually for half of the purchase invoice amount, and a second check is written to a different, usually fictitious name for the balance, making it appear that the fisher earned only a share of the catch, not the full amount of the catch.

If there appears to be a discrepancy or something you expect to see is missing (such as certain time periods or grade of catch), offer the taxpayer an opportunity to explain. In some cases, it may be that the owner reported the catch after reduction for crew shares. As long as the total catch is reflected in the shares and there are no double deductions (for example, reporting the net catch after crew shares and then claiming a deduction for crew shares), there is no underreporting.

## **Documents to Request**

The initial request for documents issued to the taxpayer should ask for copies of fishing licenses issued, contracts, settlement sheet data, vessel licensing documents, Forms 1099 received, list of assets, and any fishing equipment owned by the taxpayer.

## **Supporting Law**

IRC § 61

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# Chapter 2 - Package Audit and Penalties

## Required Filing Checks

The analysis and pickup of prior, subsequent and related returns, when warranted, is a primary responsibility of the examiner in every examination. This analysis is designed to answer three primary questions:

- Has the taxpayer under audit filed all required returns?
- Do any of the returns controlled by the taxpayer warrant examination?
- Do the workpapers sufficiently document that the required filing checks were performed?

Examiners are to verify that all returns within the taxpayer's sphere of influence have been filed. To decrease taxpayer burden, examiners should use internal sources of information. Filing should be verified for prior and subsequent year returns, related returns, information returns, employment tax returns, gift tax returns, excise tax returns, pension plan returns, etc.

There are IRC sections that provide specific information reporting related to the fishing industry. It is important to understand them with respect to reporting income, claiming expenses, and reporting requirements.

## Fishers Compensation

An employer of fishers, such as a boat owner or operator, is required to file Forms W-2 with respect to employees. The exception for fishers who are treated as self-employed is discussed in detail in Chapter 3. If a fisher is treated as self-employed, then the employer will issue a Form 1099-MISC and enter the amount of compensation in Box 5, Fishing boat proceeds, including the additional cash remuneration which does not exceed \$100. Amounts received by sellers from purchasers of fish for resale are reported to sellers in Box 7, Nonemployee compensation.

The owner or operator is required to file the applicable form with the IRS and to provide a copy to the crewmember. The amount should generally correspond to the amount deducted by the payor for wages or nonemployee compensation paid. A crewmember may have both Forms W-2 and Forms 1099-MISC due to changes in status during the year or from voyage to voyage.

## **IRC § 6050A Reporting requirements of certain fishing boat operators**

(a) reports.--The operator of a boat on which one or more individuals, during a calendar year, perform services described in [section 3121\(b\)\(20\)](#) shall submit to the Secretary (at such time, and in such manner and form, as the Secretary shall by regulations prescribe) information respecting-

(1) the identity of each individual performing such services;

(2) the percentage of each such individual's share of the catches of fish or other forms of aquatic animal life, and the percentage of the operator's share of such catches;

(3) if such individual receives his share in kind, the type and weight of such share, together with such other information as the Secretary may prescribe by regulations reasonably necessary to determine the value of such share;

(4) if such individual receives a share of the proceeds of such catches, the amount so received; and

(5) any cash remuneration described in [section 3121\(b\) \(20\) \(A\)](#).

Treas. Reg. § 1.6050A-1 provides that the boat operator may file a separate Form 1099-MISC for each crewmember for each voyage, or the operator may aggregate the information required for each individual for all and any part of a return period in which the type of catch (if required) and the percentage due the crewmember remain the same.

Thus, a fisher may have multiple Forms 1099-MISC and Forms W-2 from the same or different vessels depending on the number of voyages, the type of catch and his employment status.

## **Fish Purchases**

Every person engaged in business that purchases fish for resale is required to file a Form 1099-MISC and include all purchases in excess of \$600 during the calendar year. This includes payments to corporations.

## **IRC § 6050R Returns relating to certain purchases of fish.**

(a) Requirement of reporting.

Every person-

(1) who is engaged in the trade or business of purchasing fish for resale from any person engaged in the trade or business of catching fish; and

(2) who makes payments in cash in the course of such trade or business to such a person of \$600 or more during any calendar year for the purchase of fish, shall make a return (at such times as the Secretary may prescribe) described in subsection (b) with respect to each person to whom such a payment was made during such calendar year.

(b) Return.

A return is described in this subsection if such return-

(1) is in such form as the Secretary may prescribe, and

(2) contains-

(A) the name, address, and TIN of each person to whom a payment described in subsection (a)(2) was made during the calendar year,

(B) the aggregate amount of such payments made to such person during such calendar year and the date and amount of each such payment, and

(C) such other information as the Secretary may require.

(c) Statement to be furnished with respect to whom information is required.

Every person required to make a return under subsection (a) shall furnish to each person whose name is required to be set forth in such return a written statement showing-

(1) the name, address, and phone number of the information contact of the person required to make such a return, and

(2) the aggregate amount of payments to the person required to be shown on the return. The written statement required under the preceding sentence shall be furnished to the person on or before January 31 of the year following the calendar year for which the return under subsection (a) is required to be made.

(d) Definitions

For purposes of this section:

(1) Cash. The term "cash" has the meaning given such term by [section 6050I \(d\)](#).

(2) Fish. The term "fish" includes other forms of aquatic life.

There are no regulations for IRC § 6050R. Under IRC § 6050I the term "cash" means U.S. and foreign coin and currency, cashier's check, bank draft, traveler's check or money order. Cash does not include a check drawn on a personal or business account.

The instructions to Form 1099-MISC require the payor to include the aggregate amount on the form and to keep the underlying records showing the date and the amount of each cash payment.

It should be noted that a fisher might receive a Form 1099 for the receipt of catch as compensation as well as one for the sale of the fish. Such a duplication will need to be reconciled during the audit.

## **IRC § 6050I Cash Receipts in Excess of \$10,000**

While all reporting requirements are important, there are two additional provisions that are especially important in the fishing industry.

It is not uncommon for the sale of the catch from a voyage to exceed \$10,000. If cash is paid, the reporting requirements under IRC § 6050I are applicable. Each person engaged in a trade or business who, in the course of that trade or business, receives more than \$10,000 in cash in one transaction or in two or more related transactions, must file Form 8300. Any transactions conducted between a payer (or its agent) and the recipient within a 24-hour period are deemed to be related transactions. Transactions are considered related even if they occur over a period of more than 24 hours if the recipient knows, or has reason to know, that each transaction is one of a series of connected transactions.

The boat operator is responsible to file the Form 8300 with respect to the purchase if paid in cash for the catch. In some instances, purchasers have split the payments to avoid the reporting requirements. In other cases, checks have been issued by the purchaser and then endorsed back by the fisher to avoid the reporting requirement. This may be evidence of unreported income of the fisher. Any party to these activities could be subject to penalties for aiding and abetting in the understatement of a tax liability.

## **IRC § 3406 Backup Withholding**

Another compliance issue is the application of the backup withholding provisions of IRC § 3406, which may be applicable if:

1. The payee fails to furnish his/her TIN to the payer in the manner required;
2. The Secretary notifies the payor that the TIN furnished by the payee is incorrect;
3. There has been a notified payee underreporting with respect to interest and dividends; or
4. There has been a payee certification failure with respect to the interest and dividends paid on new accounts and instruments.

If this occurs, the payor shall deduct and withhold from such payment a tax equal to 28 percent of the payment. If the payor fails to withhold, he/she becomes liable for the tax under IRC § 3406. This assessment can be abated by proving that the payee reported the compensation.

## Penalties

The United States tax system is based on voluntary compliance. For most taxpayers, voluntary compliance consists of preparing an accurate return, filing it timely, and paying any tax due. Efforts made to fulfill these obligations constitute compliant behavior. Most penalties apply to behavior that fails to meet any or all of these obligations.

As part of your examination of a tax return, you must determine if all required returns have been filed timely, if they are accurate and if the tax has been paid.

In the event that a return is not filed, it is your responsibility to secure any delinquent return or file a substitute for return. The accuracy of return information must be determined.

Consider and develop penalties in cases where returns are not timely filed or are incorrect. The facts supporting the decision whether or not to assert the penalties should be included in the workpapers, along with the taxpayer's explanation and consideration of reasonable cause. If any penalty is determined to be applicable, it needs to be fully addressed in the report.

IRM § 20.1, the Penalty Handbook, provides detailed guidance with respect to penalty application and relief.

The following IRC sections provide penalties that may be applicable with respect to individuals or entities engaged in the fishing industry. References to the related IRM sections are included.

<b>IRC Section</b>	<b>Penalty</b>	<b>IRM</b>
6651(a)(1)	Failure to file (Delinquent and non-filed returns)	20.1.2.3
6651(a)(2)	Failure to Pay tax when due	20.1.2.4
6698	Failure to File Partnership Return	20.1.2.9

6699	Failure to File S Corporation Return	20.1.2.10
6654	Estimated Tax - Individual	20.1.3.2
6651(f)	Fraudulent Failure to File, Civil	20.1.2.7
6662(a)	Accuracy Related Penalty	20.1.5.1.1
6694	Preparer Penalties	20.1.6.3.3
6701	Aiding and Abetting Understatement of Tax Liability	20.1.6.13
6721	Information Return Penalties	20.1.7

For details with respect to the estimated tax requirements for individuals engaged in the fishing industry, see Chapter 14 Miscellaneous Provisions.

## Examination Techniques

- Determine facts and circumstances of the case that indicate it is appropriate to assert a penalty. Verify that your understanding of the facts is in agreement with the taxpayer's version of the facts. Reconcile any differences.
- Once you have ascertained the facts, ask the taxpayer why the act or failure to act occurred.

## Resources

IRM 4.10.5, Examination of Returns, Required Filing Checks.

IRM 20.1, Penalty Handbook

# Chapter 3 - Employment Classification

Examiners and other IRS representatives are sometimes faced with the difficult task of making a determination as to the classification of workers who provide services for others. The status of a worker as either an independent contractor or employee must be determined accurately to ensure that workers and businesses can anticipate and meet their tax responsibilities timely and accurately. The tax obligations of an employer of employees include income tax withholding, Federal Insurance Contributions Act (FICA), and Federal Unemployment Tax Act (FUTA) taxes (collectively, employment taxes).

In determining a worker's status, the primary inquiry is whether the worker is an independent contractor or an employee. Generally, where the owner of a vessel contracts with the captain, who staffs and provisions the vessel and manages its day-to-day operations, both the captain and crew are employees of the owner. See *United States v. Webb, Inc.*, 397 U.S. 179 (1970), (holding that the employment status of captain and crew is determined under the standards of maritime law, which is the common law of seafaring enterprises); [Cape Shore Fish Co. v. United States](#), 330 F.2d 961 (Ct. Cl. 1964) (holding that the captain and crew were employees of the boat owner when the boat owner had control over the performance of services). An exception to this general rule is where the owner of a vessel surrenders entire command and possession of the vessel, and consequent control over its navigation, to the charterer. See *The Norland*, 101 F.2d 967 (9th Cir. 1939) and *Webb*, 397 U.S. at 192. In this case, the captain would be the employer.

Where the owner of the vessel is also the captain, and the captain contracts with the processor to provide services for a fee or a share of the catch, the examining agent should consider whether the captain is an independent contractor under the standard set forth in *Webb*. If the captain is an independent contractor, the crewmembers are probably employees of the captain. However, if the crewmembers are paid by the processor, [IRC § 3401\(d\)\(1\)](#) may operate to make the processor the employer for employment tax purposes.

Under IRC § 3401(d)(1), a person other than the common law employer (that is, the person with direction and control over the services) will be treated as an employer for employment tax purposes if (a) the common law employer does not have control of the payment of the wages; and (b) the third party does have control of the payment of the wages. "Control" over the payment of the wages for purposes of IRC § 3401(d)(1) means legal control. See *Treas. Reg. § 31.3401(d)-1(f)*. See also *Winstead v. United States*, 109 F.3d 989 (4th Cir. 1997).

Once it is determined that the workers are employees, it must be determined whether the employees' services are excepted from the definition of employment for employment tax purposes. IRC § 3121(b)(20) provides an exception from the FICA definition of employment for service on a catcher vessel that normally has fewer than ten crewmembers where the crewmembers are only paid a share of the boat's

catch, Exceptions from the definition of wages for purposes of income tax collection at the source and from the FUTA tax definition of employment are made by cross-references to [IRC § 3121\(b\)\(20\)](#) found, respectively, in [IRC §§ 3401\(a\)\(17\)](#) and [3306\(c\)\(18\)](#). If the services of crewmembers are excepted from the definition of employment, then the workers are deemed to be self-employed for purposes of the Self-Employment Contributions Act (SECA). See [IRC §1402\(c\)\(2\)\(F\)](#).

The employer must issue a Form W-2 to each employee whose service is not excepted from the definition of employment and a Form 1099-MISC to all other payees.

## Crewmembers

Individuals who work on fishing vessels as crewmembers are considered employees based on the standard common law rules. Crewmembers' duties involve assisting with the functions of the fishing operation in the taking and catching of aquatic life. Under IRC § 3121(b) (20), these crewmembers may be considered self-employed for purposes of health insurance, pension plans, and employment taxes.

Under IRC § 3121(b)(20), a crewmember who would otherwise be classified as an employee is considered self-employed for purposes of self-employment taxes, health insurance, and pension plans, only if he meets all of the following conditions:

1. He does not receive any cash remuneration for his work, other than his share of the catch or of the proceeds from the sale of the catch, unless the pay meets **all** of the following conditions:
  - a. He does not get **more** than \$100 per trip;
  - b. He is paid the additional amount only if there is some minimum catch;
  - c. He is paid solely for additional duties (such as for services performed as mate, engineer, or cook) for which additional cash payments are traditional in the fishing industry.
2. He receives a percentage share of the catch or a percentage share of the proceeds from the sale of the catch.
3. His share depends on the amount of the catch (percentage).
4. He receives his share from a boat (or from each boat in the case of a fishing operation involving more than one boat) with an operating crew that is normally made up of fewer than ten individuals. This requirement is considered to be met if the **average** number of crewmembers on trips the boat made during the last four calendar quarters was less than ten.

**Example 1.** A boat owner hires a captain, a mate, an engineer, a cook, and five other crewmembers to work on his fishing boat. The proceeds from the sale of the catch offset boat operating expenses such as bait, ice, and fuel. The owner divides 60% of the balance among the captain, the mate, and the crewmembers. He divides the other 40% between himself and the captain. The mate, the engineer, and the cook also each receive an extra \$100 for each trip that brings back a certain minimum catch. The crewmembers do not

receive any additional pay between voyages, but they must do certain work, such as repairing nets, splicing cable, and transporting the catch.

For purposes of employment and self-employment taxes, each crewmember (including the captain, mate, engineer, and cook) is considered self-employed. The owner must file Forms 1099-MISC to report amounts paid to them.

During the same return period, service performed by a crewmember may be excepted from employment by IRC § 3121(b)(20) and Treas. Reg. § 31.3121(b)(20)-1(a)(4) for one voyage and not excepted on a subsequent voyage on the same or a different boat.

During the same voyage service performed by one crewmember may be excepted from employment by IRC § 3121(b)(20) and Treas. Reg. § 31.3121(b)(20)-1(a)(5) but services performed by another crewmember may not be excepted.

**Example 2.** The facts are the same as in Example 1 except that all the crewmembers but the captain receive an extra \$100 for each trip that brings back a certain minimum catch. For purposes of employment and self-employment taxes, the captain, the mate, the engineer, and the cook are self-employed individuals. The other five crewmembers who receive this extra payment in addition to the proceeds from the sale of the catch are **employees**. They are employees because the \$100 payment is not paid solely for additional duties for which additional cash pay is traditional in the fishing industry.

Because the determination of whether the size of the crew is normally made up of fewer than ten individuals is based on the average size of the operating crew on trips made during the preceding four calendar quarters, an individual may be considered self-employed for a trip even though there are ten or more individuals on a trip. Conversely, if during the preceding four calendar quarters the average size of a crew was ten or more individuals, an individual may be treated as an employee even though there are only nine individuals on a trip.

An officer or member of the crew of a vessel engaged in 1) the catching or taking of salmon or halibut for commercial purposes and 2) on or in connection with a vessel of more than ten net tons is **not** excepted from unemployment taxes under IRC § 3306(c)(17). However, an officer or member of the crew may be exempt under IRC § 3306(c)(18) under the same standards that apply to except the individual from FICA under IRC § 3121(b)(20).

A crewmember who physically takes a share of the actual catch and sells it to his own buyers is taking on a business risk and would qualify as being self-employed for all purposes. If the crewmember is simply allocated his share of the catch and sells his share to the same buyer as the boat, then he is not taking on a business risk and would not be considered self-employed unless he was considered self-employed based on the exception contained in IRC § 3121(b)(20).

Crewmembers who are employees deduct business expenses as itemized deductions on Schedule A subject to the 2% AGI limitation. Self-employed fishers deduct their expenses on Schedule C.

Some crewmembers are charged for their share of bait, fuel and supplies which is deducted against their earnings. Their taxable gross income is the amount after the bait, fuel, and supplies (such as ice) have been deducted. If the supplies deducted are for special clothing, gear, special tools needed for the job, or any other personal items used by the crewmembers, then these amounts must be included in the crewmember's gross income and deducted on the appropriate line of the individual's income tax return.

## **Corporate Officers**

A corporate officer is an employee of his corporation. A corporate officer may also be considered a crewmember if he/she is paid under the qualifications of IRC § 3121(d). In order to qualify under the crewmember exception, the officer must be working on the boat for each qualifying fishing trip. If the officer does receive remuneration other than crew shares and the usual "pers" (see glossary) for a fishing trip, then all the pay for services rendered for that fishing trip will be considered wages and employment taxes must be collected.

The officer may be compensated for services as an employee of the corporation for duties performed in keeping the fishing enterprise functioning. The payment for these services could be based on a weekly, monthly, or an annual lump sum, or could consist of sporadic payments throughout the year. These payments are wages subject to the usual FICA and FUTA taxes.

If a corporate officer/owner is receiving as compensation only a percentage of the catch, then you should establish what is done to earn these payments. If the corporate officer is performing any duties outside of those associated with the duties of a crewmember, then an allocation has to be made for some compensation as a corporate officer and classified as wages. This should be done based on the facts and circumstances of each individual case. The allocation of compensation to wages can be made based on the amount of time spent as a crewmember versus as a corporate officer, or any other reasonable method determined to be valid.

## **Spouse as a crewmember**

A spouse who actually works on a fishing vessel as a crewmember and qualifies under the requirements of IRC § 3121(b)(20) is considered self-employed and must pay self-employment tax. The spouse is issued a Form 1099-MISC.

If the payments for services as a crewmember do not meet the exception of IRC § 3121(b)(20), then the spouse is an employee and the payments for services are wages. The wages for the services of an individual who works for his/her spouse in a trade or

business are subject to income tax withholding and social security and Medicare taxes but not unemployment taxes. See IRC § 3306(c)(5).

## **Husband and wife as partners**

If a husband and wife join together in the conduct of a business and share in the profits and losses, a partnership has been created. NOTE: The spouses may elect not to treat the joint venture as a partnership. They would then report their share of income and expenses on separate Schedules C.

Spouses may operate a fishing business as a partnership. The spouses must report the business income and expenses on Form 1065, U.S. Return of Partnership Income. (The income should not be reported on a Schedule C.) For more information, see Pub. 541, Partnerships.

## **Children as crewmembers**

Payments for the services of a child under age 18 who works for his or her parent in a trade or business are not subject to social security and Medicare taxes if the trade or business is a sole proprietorship, or a partnership and each partner is a parent of the child. A child employed by a corporation, even if the corporation is owned by a parent, does not qualify for the social security and Medicare tax exception. See IRC § 3121(b)(3)(A) and Treas. Reg. § 31.3121(b)(3)-(1)(c). The wages of a child may be subject to income tax withholding.

A child who receives a crew share as defined by IRC § 3121(b)(20) is subject to self-employment tax, regardless of whether he or she crews for his or her parents. There is no family employment exception from self-employment tax under IRC § 1402.

## **Tender Vessels**

A tender is a vessel which hauls fish from the catcher vessel to the processing site. The processor may be land-based or sea-based. The tender operator in most cases acts as a purchasing agent for the processor. The operator has a duty to reject damaged catch. The operator may also run provisions and fuel from the processor to the fishers. Tenders in the North Pacific are essential to the salmon and herring fisheries where the highly migratory nature of the fish require the fishers to stay at sea. Tenders are not used in the pollock, whiting, black cod, Pacific cod, or any of the crab fisheries.

A tender may use a "fish pump" to extract the fish from the fisher's net while the fish are still in the water or may utilize the same method to extract the fish from the hold of a fishing vessel. This method is utilized in the herring fishery. Other methods include the transfer of the "cod end" of the net from the fishing vessel to the tender, leaving the tender to haul the net from the water or offloading from the hold of the fishing vessel.

A tender may have an "observer" on board to verify the quality and amounts of fish. The observer is also the arbitrator between the fisher, the tender and, ultimately, the processor in disputes over poundage and species.

A tender will generally have fewer than six crewmembers, including the captain.

The contractual arrangement between the tender and the processor takes various forms. The nominal arrangements are that the processor contracts for the tender to perform services over a certain geographical location for a specified number of days. The tender will be paid for fuel and other variable costs associated with the operations of the vessel and, in addition, will be paid either a daily rate or a poundage rate.

Other tender agreements may provide for a charter of a vessel and a full crew.

These contracts may be thinly veiled employment agreements. Although they may state that there is a nonemployee relationship, the contracts have strongly worded paragraphs giving considerable control to the processor.

Tender operations may settle with the crew in the form of crew shares. This method provides a share of the profits for the season or voyage on a predetermined basis. The shares need not be equal. Most frequently, distributions call for the vessel itself to receive a 25-percent share, the captain to receive a 20-percent share, and the crew to split the remaining 55 percent, depending on their skills and responsibilities.

Each operator will have crew settlement statements which should be reviewed by the examiner. A settlement statement will show gross receipts of the vessel, less shared expenses, fuel, etc. The remainder multiplied by the share will equal the net check to the crewmember.

The accounting for a tender is frequently provided by the processor in its final settlement. The processor will provide advances to the crew and captain, cover costs associated with the operations of the vessel, and take possession of the fish for processing. The largest costs not borne by the processor are the mortgage on the vessel, insurance, and the travel. The processor provides the vessel owner an accounting of all expenses with a final settlement check. The processor frequently advances more than is due the owner of the vessel and will have a credit held over to the next season.

The payor must issue Form W-2 to each employee and Form 1099-MISC to all other payees.

## **Foreign Crewmembers**

Special consideration must be given to fishing activities which occur outside the jurisdiction of the United State or within the jurisdiction of another country (as recognized by the United States).

Foreign individuals who work aboard fishing and processing vessels may or may not be subject to U.S. income and employment taxes. Likewise, the companies who utilize this labor may be subject to withholding and/or payment of some or all of these taxes depending upon facts and circumstances.

In general, if there is an employee relationship the following rules apply:

- A resident alien carrying a "green card" is treated as any U. S. Citizen. All taxes apply
- A non-resident carrying an H-1 Visa is treated as any U.S. Citizen if the vessel is operated within the United States. All taxes apply. If the vessel is operated outside the United States, but touches U.S. ports, FICA and FUTA are applicable. If all operations are outside the United States, no taxes apply.

If there is a non-employee relationship,

- A resident alien receives a Form 1099 and is responsible for income and self-employment tax.
- A non-resident alien is subject to 30% withholding or the lower treaty rate, if applicable. A non-resident alien must file a Form 1040NR and claim any treaty exemptions.

## **Other Employment Tax Issues**

Income derived by Indians from exercise of fishing rights may be exempt from income and employment tax under IRC § 7873. See Chapter 6.

Leasing of personal property may be considered a trade or business subject to self-employment tax. This would include the rental of a fishing boat, equipment, and or a fishing permit. See Chapter 3.

Income received as the result of lost fishing income generally will retain its character as fishing income. If it is replacement for lost income subject to self-employment, it will be treated as income from self-employment. See Rev. Rul. 91-19, 1991-1 C.B. 186. Income received as the result of cleanup efforts is not income from the taking or catching of fish, but rather is income as an employee subject to withholding,

## **Examination Techniques**

- Review Schedule C on the return and consider the potential for the operation to be that of a crewmember.
- Use the interview to establish the facts and circumstances of the particular case to make a determination as to whether the taxpayer is actually a crewmember as defined under IRC § 3121(b)(20) or is actually an employee.

- If a child is paid for services working for the fishing enterprise, ascertain that the child is actually working as part of the business operation.
- Determine the child's duties with regard to the fishing enterprise.
- Review the loan account for cash "loans" over and above a crew share that may actually be disguised compensation for the corporate officer or owner.
- If the officer or business owner owns the fishing vessel and is leasing it to the corporation, ensure that the fair rental value is being charged and is reported on the officer's Schedule C as self-employment income. The fair rental value for fishing vessels may be determined by going to various websites that deal with boat brokers. Review the ads for current asking prices which will provide comparisons. Rental prices may also be established in a similar manner.
- Ascertain that the spouse is actually working as part of the business operation if both are reporting self-employment income.
- Determine whether the spouse qualifies as a self-employed crewmember and is indeed paid a percentage of the catch.
- If a corporate officer is receiving only a percentage of the catch as compensation, expand the interview to include questions regarding the duties performed to receive that compensation. Generally, corporate duties are included in this compensation and an allocation can be made to classify a portion of the compensation as wages.

## **Issue Identification**

- In general, crewmembers should be reflecting the gross proceeds from the fishing operation as income subject to self-employment tax. The agreement between the vessel owner and the crewmember will determine the amount that to be included in income. If the vessel owner is responsible for the expenses then the amount reported by the crewmember should be net of the cost of ice, bait, fuel, and other such expenses of the boat. If the crewmember is responsible for a share of the expenses, then the gross amount should be included in income and the expenses deducted on the crew members return as appropriate.
- Payments of more than \$100 in addition to payments for a percentage of the catch will result in the fisher being classified as an employee.
- A corporate officer is often also the owner of the business enterprise. Check expenses for personal items.
- Reasonable compensation of the corporate officer should be reviewed. Compensation may be disguised as a loan or a higher than standard percentage of the catch.
- If the corporate officer is also the owner of the boat being used in the fishing enterprise, determine if fair rental is being charged. If the fair rental value is lower than the amount received, there may be an employment tax or dividend issue on the excess. If the fair rental value is higher than the amount received, payments may be for the personal expenses of the officer.

## Documents to Request

- The names of the boats on which the crewmember worked during the year; the number of crewmembers on each of the boat trips; list of the dates that the taxpayer worked on each of the boats;
- Settlement sheets for each trip;
- Forms 1099-MISC or W-2 from each of the boats and buyers as applicable;
- List of the buyers to whom the crewmember sold his catch.

## Interview Questions

- As a crewmember, how was your pay for working on each fishing boat determined? Was there a minimum amount paid, per trip, percentage of the catch, hourly, daily, etc?
- As a crewmember, what were your duties on each of the boats?
- As a crewmember, did you perform any other duties for which you were paid additional funds such as fixing nets, cooking, being first mate? If yes, how much were you paid for these additional duties?
- As a crewmember, did you receive cash or a check for your services? Did you take an actual percentage of the catch and sell it yourself? If yes, did you sell it to a different buyer than the rest of the boat catch? Did you physically take possession of the catch and transport it to your own buyer?
- As a crewmember, did the boat owner provide you with food and beverages for day trips? For overnight trips?
- As a crewmember, did the boat owner deduct the cost of food, beverages, and any other expenses from your proceeds of the catch? If so, what expenses were deducted? Is the amount reflected on the Form 1099-MISC net of expenses or the gross amount of the share of the catch?
- As the owner or corporate officer, do any of your children work for you in your fishing enterprise? What are your child's duties regarding the business operation? Does your child work on the boat during regular fishing trips? Does your child run errands? Does your child help with repairs?
- How do you pay your child for the work he/she does? Does your child receive a crew share when he or she works during a fishing trip? Is your child paid a salary for the other work he or she does? (hourly rate?)
- How many hours a week does your child work for the fishing operation?
- Does your spouse work for the fishing operation? What are your spouse's duties with regard to the fishing operation? Does your spouse maintain the books? Does your spouse pay the bills? Does your spouse take care of the banking for the fishing operation? Does your spouse take wages or any kind of payment for these activities?
- As the owner or corporate officer, do you go out on the boat for each fishing trip? What are your duties on the boat? Do you take a percentage of the catch as your payment for the fishing trips?

- As the owner or corporate officer, what are your duties regarding the business operation? Do you take care of paperwork? Do you go for parts? Do you take care of the banking needs - make deposits, pay the crew, etc.?
- As the owner or corporate officer, are any of your personal expenses paid through the business account?
- As the owner or corporate officer, do you ever borrow money from the corporate account? For what purpose?
- Who owns the boat in the fishing operation? Whose name(s) is on the title?
- How is the rental value for the fishing vessel determined?
- As the officer or owner or spouse, how are you paid for the work you do? Do you receive a crew share when you work during a fishing trip? Are you paid a salary for the record keeping or bookkeeping work that you do?

## Supporting Law

IRC § 162(a) Deductions allowed for ordinary and necessary business expenses

IRC § 262 No deduction allowed for personal expenses

IRC § 274(d) Substantiation requirements for travel, meals

IRC § 1402(c)(2)(F) Self-employment tax section under which crewmembers fall

IRC § 3121(b)(3)(A) Service performed by a child under the age of 18 in the employ of his father or mother

IRC § 3121(b)(20) Crewmember, size of crew; minimum catch; \$100 or less per trip additional cash

IRC § 3121(d)(1) Classification of a corporate officer as an employee

IRC § 3306(c)(5) The term "employment" does not include service performed by an individual in the employ of his son, daughter, or spouse and service performed by a child under the age of 21 in the employ of his father or mother.

IRC § 3306(c)(17) Unemployment tax does apply to individuals (officer or member of the crew) involved in the catching or taking of salmon or halibut for commercial purposes or performing services in connection with a vessel of more than ten net tons.

IRC § 3306(c)(18) Unemployment tax exemption for crewmembers qualifying under 3121(b)(20)

IRC § 3401(a)(17) FICA section from which some crewmembers are exempted because of IRC § 3121(b)(20)

IRC § 3401(c) "Wages" means all remuneration for services performed by an employee; the definition of an employee includes a corporate officer.

Rev. Rul. 91-1 Amounts paid to commercial fishing boat owners and operators and crewmembers as compensation for losses suffered because of alleged negligence are includible in net earnings from self-employment for purposes of the Self-Employment Contributions Act.

*Anderson v. Commissioner*, 123 T.C.12 (2004) Taxpayer's share of proceeds from sale of boat's catch depended solely on amount of that catch even though operating expenses were subtracted in computing his share. Income and expenses were reportable on Schedule C.

*Anderson vs. Commissioner*, T.C. Memo 2010-1. Taxpayer's activities of repairing and maintaining fishing boat between voyages were not related to his activities as crewmember, and thus compensation for repair services did not change his self-employment status and he was liable for self-employment tax.

## **Resources**

Publication 15 (Circular E) Employer's Tax Guide

Publication 541, Partnerships

## **Glossary of Terms**

**"pers"** - traditional flat amount paid to some crewmembers for certain duties, such as cook, mate, engineer, etc.

**lay(s)** - share of the catch

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# Chapter 4 - Leasing/Rental Activities

## Background

Some fishers lease assets that may include fishing vessels, equipment, and fishing permits to their corporation or other persons/entities, report the activity on Schedule E, and fail to pay self-employment tax (SECA).

Fishing vessels, nets, automobiles, equipment, and fishing permits are personal property. The rents received from leasing of these types of assets should normally be reported on a Schedule C. Self-employment tax is due on the net profit. Since this is a passive activity, any loss claimed by the taxpayer on the rental cannot offset any other Schedule C profit.

In order for income to constitute net earnings from self-employment, it must be derived from the carrying on of a trade or business. Whether an individual is engaged in a trade or business for self-employment tax purposes must necessarily depend upon the facts existing in the particular case, such as the continuity of the enterprise, the regularity with which it is pursued, and whether it is conducted for profit.

## Issue Identification

The examples that follow frequently occur in the fishing industry. Self-employment tax is applicable in each example except for one because these taxpayers are engaged in the activity for profit purposes and with continuity and regularity.

### **Example 1. Boat Rental & Permit Rental to Closely Held Corporation**

A fisher, who previously operated a fishing business as a Schedule C activity, sets up a closely held corporation (100% owned or 50% owned by each of the spouses and may be either a C or S corporation).

In an IRC § 351 transfer the taxpayer transfers fishing gear and other minor assets to the corporation. The fisher retains the fishing boat and Limited Entry Fishing Permit (LEFP) as personal assets.

After the IRC § 351 transfer the fishing activity is conducted by the corporation. However, the fisher/shareholder is actively involved in all aspects of the corporation's fishing activity as a corporate officer, skipper and/or crewmember. In addition, at all times when the corporation fishes using the taxpayer's LEFP, the fisher/shareholder is on board the boat as is required by state law.

The corporation leases the fisher/shareholder's fishing boat and LEFP. The fisher/shareholder receives a percentage of the catch, typically 30 percent, for the boat

rental. The fisher/shareholder receives a similar amount for the LEFP rental. The rents received are at fair market value. The vessel lease is typically a "bare boat" lease in which the boat owner has transferred sufficient control of the vessel to the corporation leasing and operating the boat so that the corporation is the common law employer of crewmembers under maritime law. The fisher/shareholder only pays interest on the loans for the purchase of the boat and LEFP (until the loans are paid off). The fisher/shareholder also claims boat depreciation until the boat is fully depreciated. If the LEFP qualifies for amortization under IRC §197, the fisher/shareholder claims amortization until the LEFP is fully amortized. The fisher/shareholder generally pays hull insurance.

The corporation pays repairs and maintenance for the boat, umbrella and other insurance for liability purposes, and all other operating expenses.

The rental activity has been in place for several years and is expected to continue in subsequent years.

### **Tax treatment**

Self-employment tax applies to the fisher's boat rental activity. The activity is conducted with a profit motive, and occurs on a continual and predictable basis. The activity is neither sporadic nor a hobby, but rather a scheduled and profitable business arrangement intended to supply the fisher with a large portion, if not the majority, of his income.

At least one state statute provides that an LEFP may not be "pledged, mortgaged, leased or encumbered in any way" except under limited circumstances. Therefore, the payments to the fisher for the use of the LEFP are not rental payments. The payments are for services rendered on the boat because the holder of the LEFP is required to be present on the boat at all times and actively engaged in the fishing operation.

Because the holder of the LEFP provides services on the boat, the holder of the LEFP should be treated like a corporate officer. Although sections 3121(d) and 3401(c) of the Code provide that the officer of a corporation is an employee, section 3121(b)(20) applies to a corporate officer if the requirements are met. See Chapter 7 for additional information.

If the fisher is compensated "one flat fee" for the boat rental, the use of the LEFP, and the crew share, section 3121(b)(20) will not apply unless the payment is a percentage of the catch.

### **Example 2. Boat, LEFP & Asset Rental**

The facts are the same as in as Example 1 except that the fisher also rents out fishing equipment.

The equipment rental is handled in one of two ways. The fisher has extra nets and crab pots that he leases to the same fisher (not the corporation) for three different crab seasons each year. The fisher leases the extra nets whenever possible, depending upon the needs of other fishers. Alternatively, the fisher leases the crab pots to different fishers between years and within each year of the three different crab seasons, depending upon the needs of other fishers.

### **Tax treatment**

The discussion of the boat rental and LEFP is the same as in Example 1. The rental of the crab pots and the extra nets should be viewed as one business activity subject to SECA tax.

### **Example 3. Boat & Permit, to a Related Partnership**

Two individuals enter into a joint venture. They file a partnership return. One partner owns a fishing permit, but no fishing boat. The other partner owns a fishing boat, but no fishing permit. The boat and permit are not transferred to the partnership but are retained by each partner as personal assets. The partnership agreement requires net profits and losses to be shared by each partner on a 50/50 basis. The partnership agreement specifies a 30% guaranteed payment for each partner for the partnership's use of the partners' assets in the partnership fishing activity (the boat and permit). These guaranteed payments are deductible in arriving at the partnership's ordinary income. Both partners are active in the partnership's fishing activity.

The fishers/partners only pay interest on the loans for the purchase of the boat and permit (until the loans are paid off). One fisher/partner also claims boat depreciation until the boat is fully depreciated. Every few years the fisher/partner, instead of the partnership, pays hull insurance. If the fishing permit qualifies for amortization under IRC §197, the other fisher/partner claims amortization until the permit is fully amortized.

The partnership pays all operating expenses, repairs and maintenance for the boat. In most years, the partnership pays the hull insurance. However, the lease may require the owner to pay the hull insurance and major repairs.

The rental activity has been in place for several years and is expected to continue in subsequent years.

### **Tax treatment**

Self-employment tax applies to the rental activity no matter who is responsible for the hull insurance or major repairs. In making a determination, partnership provisions must be considered. The example assumes that both partners are general partners.

## **Payments to a Partner in his Capacity as a Partner**

The SECA tax is imposed upon self-employment income, which IRC § 1402(b) defines generally as net earnings from self-employment, subject to certain exceptions. Section 1402(a) defines net earnings from self-employment generally as the gross income derived by an individual from any trade or business carried on by such individual, less applicable deductions.

In the case of a general partner, net earnings from self-employment include the distributive share of the income or loss from a trade or business carried on by the partnership, Treas. Reg. § 1.1402(a)-2(d). Guaranteed payments under IRC § 707(c) to a general partner for services rendered to the partnership or for the use of capital by the partnership are also gross income derived by an individual from a trade or business.

## **Payments to a Partner Other than in his Capacity as a Partner**

IRC § 707(a) provides for the treatment of a transaction between a partner and a partnership if the partner is acting in a capacity other than as a partner. Rental of property to a partnership may be a type of transaction to which IRC § 707(a) applies. Rental payments covered by IRC § 707(a) cannot be guaranteed payments under IRC § 707(c) because only a partner acting in his or her capacity as a partner can make guaranteed payments.

## **Use of the LEFP**

Since an LEFP generally cannot be leased to another, a partner holding the LEFP is not leasing the LEFP to the partnership in a status as other than a partner. Rather, the use of the LEFP is part of the partner's services as a partner. Because the payments for the use of the LEFP are guaranteed payments for services provided by the partner to the partnership, the payments are included in net earnings from self-employment and are subject to SECA tax.

## **Leasing the Boat**

If a partner is treated as acting in a capacity other than as a partner of the partnership in leasing the boat to the partnership, IRC § 707(a) provides that the transaction is treated as occurring between the partnership and a non-partner. Therefore, whether or not the rental payments are included as self-employment income must be analyzed from the perspective of the partner as an individual, and not as a partner. That is, the payment will be includible in self-employment income only if it is received from an activity of the individual that constitutes a trade or business, without consideration of the trade or business of the partnership. See Rev. Rul. 69-84, 1069-1 C.B. 282 (income received from partnership by a partner acting in the capacity of an independent contractor is included in

self-employment income). Because the boat rental activity constitutes a trade or business, the boat rental income will be subject to SECA tax.

If the partner is treated as acting in his or her capacity as a partner, the payments for the boat rental constitute guaranteed payments to a general partner for the use of capital. Therefore, income from the boat rental activity is included in the net earning from self-employment and is subject to SECA tax.

#### **Example 4. Boat Rental**

An individual owns a fishing boat but no fishing permit. The boat is leased to an unrelated fisher who owns a permit and needs a boat. The boat owner/lessor is not actively involved in the fishing activity of the lessee at all. The boat owner will receive 40% of the gross catch for the boat lease. The lease is a "bare boat" lease where the boat owner is not required to pay any boat operating expenses.

The boat owner pays the mortgage on the boat (until the loan is paid off), and depreciates the boat until the boat is fully depreciated.

The lessee pays for all operating expenses of the boat and must maintain it in the same standard of repair.

The lessor typically negotiates the lease for a specific fishery during the year (weeks or months) instead of the entire season. In some years, the lessor leases the boat to the same lessee for the entire fishing season. In other years, the lessee may lease the boat to two or three lessees throughout the fishing season.

During the off-season, the owner will store the boat and perform any necessary engine overhauls or upgrades. Hydraulic work is generally done annually outside of the lease period. The work during the off-season may be done by the owner or the owner may hire someone to perform the work.

When the lease is a related party lease, the lessee generally picks up more insurance, repairs and maintenance. In addition, the lessor typically leases the boat to the related party for the entire fishing season or year instead of for a specific fishery.

The rental activity has been in place for several years and is expected to continue in subsequent years.

#### **Tax treatment**

Self-employment tax applies to the rental activity.

## Example 5. LEFP Rental

(a) An individual, for health reasons, is unable to fish his State LEFP for the 2010 fishing season. State LEFPs require the owner to be on board the fishing vessel while fishing. Since the fisher is unable to be on board, the individual applies for and receives approval from the State's Limited Entry Fishing Commission (LEFC) for an emergency transfer for the 2010 year. The taxpayer leases his fishing permit for the 2010 fishing season. In the year 2011, the taxpayer's health improves and he is able to resume fishing his permit.

(b) The taxpayer's spouse passes away during the 2010 fishing season. The surviving spouse inherits the spouse's State LEFP. The surviving spouse does not wish and is unable to fish the permit so applies for and receives an emergency transfer for the 2010 year. The spouse leases the permit during 2010. In 2011, the spouse receives permission for an emergency transfer. The spouse leases the permit in the 2011 year. At the end of the 2011 season, the spouse sells the permit.

(c) The same as 5(b), except that the spouse does not sell the State LEFP. Instead, the spouse continues to apply for and receives permission for an emergency transfer. The spouse leases the permit in all years where an emergency transfer is approved. This is expected to go on indefinitely.

### Tax treatment

**Example 5(a).** The leasing of the permit is arguably a continuation of the fishing activity. In [Rev. Rul. 91-19, 1991-1 C.B. 186](#), the Service considered whether amounts received by fishing boat owners and operators and crewmembers in settlement of certain claims were includible in net earnings from self-employment. The revenue ruling concludes that the amounts received by the fishers are includible in their net earnings from self-employment for SECA purposes. The ruling states that whether a payment is derived from a trade or business carried on by an individual for purposes of IRC § 1402 depends upon whether, under all the facts and circumstances, a nexus exists between the payment and the carrying on of the trade or business. The ruling states that it is not essential that the individual be engaged in the day-to-day conduct of the trade or business. Rather, the required nexus exists if it is clear that a payment would not have been made but for an individual's conduct of the trade or business. Applying [Rev. Rul. 91-19](#) to the facts in Example 5(a), payments received under the fishing permit lease were arguably derived from the fishing activity. Even though temporarily unable to fish, the fisher remained in the trade or business of fishing. Moreover, the lease payments would not have been received but for the fishing activity, inasmuch as it is a requirement that the holder of the permit be actively engaged in the fishing operation.

However, the Ninth Circuit (which includes Alaska) provided standards contrary to those provided by [Rev. Rul. 91-19](#). In [Milligan v. Commissioner, 38 F.3d 1094 \(9th Cir. 1994\)](#), the Court considered whether termination payments paid to former insurance agents were derived from a trade or business. The court held that the payments were not subject to self-employment. The IRS did not acquiesce in the Milligan case.

## Whether the Leasing Activity Itself Is a Trade or Business

Thus, to be subject to SECA tax, the leasing activity must independently rise to the level of a trade or business. To be considered engaged in a trade or business, the individual must (1) be involved in the activity with continuity and regularity, and (2) be engaged in the activity with the primary purpose of income or profit. [Commissioner v. Groetzinger, 480 U.S. 23, 35 \(1987\)](#).

Application of these standards requires examination of all the relevant facts and circumstances. For example, if the illness appears long-term (for example, expected to continue at least two years), and the fisher intends to lease the permit during the entire period, and in fact leases or attempts to lease the permit for the entire period of disability, then this suggests the leasing activity is a trade or business for purposes of SECA tax. But if the fisher does not expect to be disabled for a long-term period, or the fisher does not intend to lease the permit during the illness except on a sporadic basis, and in fact only leases the permit sporadically, then the leasing activity will not constitute a trade or business for purposes of SECA tax.

**Example 5(b).** In this example, the fisher dies and the surviving spouse obtains an emergency permit to lease the fisher's permit. After two years of leasing the permit, the spouse sells the permit.

If the spouse always intended to sell the permit, and the leasing period is brief (for example, two years or less) during which the spouse is locating a buyer and arranging for the sale, then the leasing activity will not be continuous and regular, and thus will not constitute a trade or business for purposes of SECA tax.

If the spouse did not intend to sell the permit when she entered into the leasing activity, but intended instead to lease the permit indefinitely, or if the spouse reasonably expected that the leasing period would be lengthy (for example, two or more years) due to difficulties in locating a buyer or other reasons, then the leasing activity will constitute a trade or business for purposes of SECA tax.

**Example 5(c).** SECA tax applies to the leasing activity

### **Examples 6(a) and 6(b).** Gear Rental

Examples 6(a) and 6(b) involve two different individual taxpayers. They are identical except for the length of the lease. All items below apply to both individuals except where indicated.

An individual owns crab pots and nets and leases them to fishers. The owner is not engaged in fishing; he just owns the assets and leases them to fishers. Generally, the

owner does not carry insurance on the assets. The owner may lose his investment if the lessee cannot repay the lessor/owner for the loss of the pots and/or nets.

The lessee is responsible for any cleaning or repairs and maintenance needed during the lease period.

The rental activity has been in place for several years and is expected to continue in subsequent years.

**Example 6(a).** The individual leases the crab pots to the same fisher for the three different crab seasons each year. The individual leases nets whenever possible, depending upon the needs of fishers.

**Example 6(b).** The individual leases the crab pots to different fishers between years and within each year for the three different crab seasons. This is speculative since the lessor hopes that fishers need the crab pots. The individual leases nets whenever possible, depending upon the needs of fishers.

### **Tax treatment**

**Example 6(a).** It must first be determined whether the leasing of crab pots and the leasing of nets are separate activities. Even if the leasing of the nets would not itself constitute a trade or business, with the leasing of the crab pots, it may constitute one activity that would constitute a trade or business. To constitute one business activity, the two activities must be sufficiently related. For example, if the individual generally leases both types of items to the same individuals at the same time, advertises and markets the products together, and provides package deals, the activity generally would constitute one activity. See Treas. Reg. [§ 1.183-1\(d\)](#) (providing that for purposes of determining whether multiple undertakings constitute a single activity it is appropriate to look to the "degree of organizational and economic interrelationship of the various undertakings.") The facts strongly suggest that these activities together constitute a single activity. The activities described in the activities described in Example 6(a) constitute a trade or business for purposes of SECA tax.

**Example 6(b).** The facts strongly suggest that these activities constitute a single trade or business. Similar facts and circumstances to those discussed for Example 6(a) would be relevant in further developing a particular case. Based on the facts stated, the activity is subject to SECA.

### **Example 7. LEFP and IFQ Rental**

An individual owns an Individual Fish Quota (IFQ) in which he/she is not required to be involved in the fishing activity. The individual is allowed to lease the IFQ and does in fact lease the IFQ each year. The individual is not involved in any direct fishing operations. He/she only receives IFQ lease income based upon a percentage of the catch.

The individual does not amortize the IFQ because he/she received it as part of the original issue of IFQs. There was no payment and he/she has no basis.

### **Tax treatment**

The activity constitutes a trade or business and earnings are subject to SECA tax.

## **Passive Activity Loss Rules**

Losses from passive activities are deductible to the extent of passive income.

A rental activity is a passive activity even if the taxpayer materially participated in that activity, unless the taxpayer materially participated as a real estate professional. An activity is a rental activity if tangible property (real or personal) is used by customers or held for use by customers, and the gross income (or expected gross income) from the activity represents amounts paid (or to be paid) mainly for the use of the property. It does not matter whether the use is under a lease, a service contract or some other arrangement.

Neither the active participation standard nor the material participation standard applies. The \$25,000 allowance for rental real estate activities cannot be used for equipment rentals.

There are six exceptions to the rental definition:

1. The average period of customer use of the property is seven days or less. If the lessee (renter) has a recurring right to use property, the average lease period is the entire year.
2. The average period of customer use of the property, as figured in (1) above, is 30 days or less and the taxpayer provides significant personal services with the rental. Significant personal services do not include services needed to permit the lawful use of the property or service to repair or improve property that would extend its useful life for a period substantially longer than the average rental.
3. Extraordinary personal services in making the rental property available for customer use and the use of the property is incidental to the services received.
4. The rental is incidental to a non-rental activity. The rental of property is incidental to a trade or business activity if all of the following apply: the taxpayer owns an interest in the trade or business activity during the year, the rental property was used mainly in that trade or business activity during the current year, or during at least 2 of the 5 preceding tax years; and the gross rental income from the property is less than 2% of the smaller of its unadjusted basis or fair market value.
5. The rental property is available during defined business hours for nonexclusive use by various customers.
6. The property is used in a non-rental activity in the capacity as an owner of an interest in the partnership, S corporation or joint venture conducting that activity. This exception applies only if the property is contributed to a partnership or S

corporation. If property is leased to the partnership or S Corporation, the exception does not apply.

Fisher's equipment and permit rental is generally long-term and will not meet the exceptions to the passive activity rules. If the fisher is claiming a loss from the activity, make sure that the loss is reported as passive. If the property generates income, make sure that the self-employment tax rules are applied and consider reclassifying the income as non-passive if the rental is considered to be a self-rental under the passive activity loss rules. If you identify an issue with respect to passive activities, see Pub. 925, Passive Activity Loss and At-Risk Rules, and the Audit Technique Guide for Passive Losses.

## **Examination Techniques**

- Review the tax return for Schedules C or E or flow-through entities and consider potential self-employment tax, compensation and passive activity loss issues.
- Use the interview to establish the facts and circumstances of the particular case to make a determination as to whether the fisher is engaged in the activity for profit purposes and with continuity and regularity.
- Verify what assets the fisher owns. Does he/she own fishing vessels, nets, equipment, vehicles, and/or fishing permits? Is the fisher currently fishing and using all of his/her permits and assets? Is the fisher a shareholder in any corporations or a partner in any partnerships? If so, are assets leased to these entities?
- If the fisher is renting/leasing any of these assets to others, obtain copies of the rental/lease agreements for review. Determine whether he/she is renting to a related party. Is the rent/lease agreement at FMV? If the fisher is renting to a related party, scrutinize the agreement to make sure the agreement is for FMV and not additional compensation to the fisher or dividends. For example, if the fisher is leasing his fishing vessel to his closely held corporation at far above the normal rents charged in his area, the examiner would adjust the lease income to the normal rents charged in the area and the additional amount would be either wages or dividend income.
- Verify that the fisher is reporting the total income received from the rental activity. He/she should report it on a Schedule C unless it is a one-time event.
- Verify what assets the fisher is renting or leasing. If the fisher is renting/leasing any assets from others, get copies of the rental/lease agreements for review. Verify the fisher is filing Forms 1099 for the rent paid.

## **Documents to Request**

- Rental/Lease agreements
- Forms 1099 received and filed

## Interview Questions

- Do you own any fishing assets such as permits, vessels or gear?
- Do you rent/lease any assets used in your fishing operation? If so, do you have rental/lease contracts?
- Do you rent/lease any assets to others? If so, do you have rental/lease contracts?
- How often do you rent out your assets?

## Supporting Law

IRC § 1401 Provides the rate of tax on net self-employment income.

IRC §1402 Defines net earnings from self-employment as the gross income derived by an individual from any trade or business carried on by such individual, less certain deductions that are attributable to such trade or business, plus the distributive earnings from a partnership activity.

IRC § 1402(a)(1) Excludes from this definition the income and deductions from the rental of real estate and from personal property leased with the real estate, unless such rentals are received in the course of a trade or business as a real estate dealer.

IRC §§ 1402(a) (2) - (17) Provide exceptions for other categories of income. However, there is no specific exception from self-employment for the rental of personal property and intangibles that are not leased with real estate.

IRC § 1402(c) States that the term "trade or business", when used with reference to self-employment income or net earnings from self-employment, shall have the same meaning as when used in section 162 (relating to trade or business expenses).

Treas. Reg. § 1.1402(c)-1 States, in part, that for an individual to have net earnings from self-employment, he must carry on a trade or business, either as an individual or as a member of a partnership.

IRC § 469(c) (2) & (4) Provides that rental activities are passive regardless of whether the taxpayer materially participates.

Treas. Reg. § 1.469-1T (e) (3) (ii) (A)-(F) Sets forth six exceptions to the definition of rental. If an exception applies, the rental activity is treated as a business and the material participation rules apply.

Treas. Reg. § 1.469-1(e) (3) (iii) Provides that each period during which a customer has a continuous or recurring right to use the property is a separate period. For example, if the property is used only a few hours at a time, but the lessee has a recurring right to use the property all year, the period of customer use is a year.

Treas. Reg. § 1.469-4(d) (1) (i) Gives the general rule that rentals may not be grouped with businesses.

## Revenue Rulings

Rev. Rul. 58-112, 1958-1 C.B. 323 "In determining the existence or nonexistence of a trade or business, certain factors are taken into consideration, such as (1) continuity and regularity of activities, as distinguished from an occasional action, and (2) the purpose of livelihood or profit from the activity in which the individual is engaged."

Rev. Rul. 69-278, 1969-1 CB 148. "The rental of personal property unless leased with realty has consistently been treated as the conduct of a trade or business, whether with respect to exempt organizations or taxable entities."

Rev. Rul. 91-19, 1991-1 CB 186. The revenue ruling was written to require self-employment tax with respect to settlement payments for lost fishing income for tax years beginning after December 31, 1990. The revenue ruling states that

There must be a nexus between the income received and a trade or business that is, or was, actually carried on. (citing *Newberry v. Commissioner*, 76 T.C. 441, 444 (1981). ¶)

Generally, the required nexus exists if it is clear that a payment would not have been made but for an individual's conduct of a trade or business. The fact that a payment represents compensation for lost income of a trade or business rather than income generated directly by the day-to-day conduct of the trade or business is generally irrelevant in determining whether this required nexus exists. ¶

Even though the fishers were temporarily unable to fish due to the alleged negligent acts of X, they remained in the trade or business of fishing. The payments they received, measured by historical profits, were conditioned on this fact and represented income that would have been derived by them from the season's catch. Thus, there was a nexus between the payments and their current conduct of a trade or business.

## Court Cases

*Estate of Gibney v. Commissioner*, 4 TCM (CCH) 878, 1945 PH TC Memo 45,290.

A taxpayer foreclosed on rental properties (real estate) and operated the properties as rentals until they were sold. The Tax Court determined that the rental activity was a trade or business, holding that ordinarily the operation of rental property constitutes a trade or business, and the property itself is not a capital asset.

This case states the basic rule that real estate rental is a trade or business. It is only because of the exception in IRC § 1402(a) (1) that this type of trade or business is not subject to self-employment tax.

*Commissioner v. Groetzinger*, 480 U.S. 23 (1987)

The Supreme Court held that a full-time gambler who makes wagers solely for his own account is engaged in a "trade or business", within the meaning of Code §162(a) and 62(1).

We accept the fact that to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and that the taxpayer's primary purpose for engaging in the activity must be for income or profit. A sporadic activity, a hobby, or an amusement diversion does not qualify.

107 S.Ct. at 987.

*Johnson v. Commissioner*, 60 T.C. 829 (1974)

The Court held that income from boat shed rentals did not constitute rentals from real estate, and was therefore subject to self-employment tax. While this case deals with the real property rental exception, it is significant in that it summarizes the congressional intent of the self-employment tax as follows:

Since the old age survivor, and disability insurance provisions of the Social Security Act were enacted to protect workers and their dependents from the risk of loss of income due to the worker's old age, death, or disability, the courts have concluded that Congress intended that the coverage provisions of the Social Security Act should be construed in such a manner as to insure maximum coverage. Accordingly, the rental exclusion contained in section 411(a) of the Social Security Act and the accompanying regulation (i.e., section 404, 1053(d)(2), Social Security Administration Regulations), has been strictly construed to prevent this exclusion from interfering with the congressional purpose of effectuating maximum coverage under the social security umbrella. (citing *Delno v. Celebrezze*, 347 F.2d 159, 165 (9th Cir. 1965) for the congressional purpose of maximum coverage under social security.

60 T.C. at 832.

*Lagreide v. Commissioner*, 23 T.C. 508 (1954)

This case involved a net operating loss carryback and recomputation of the correct net operating loss. The taxpayer did not reduce the business loss by the amount of wages and rental real estate net income received. The Court upheld the Service's position that the

taxpayer must reduce the net operating loss since the rental real estate net income and the wages each constituted a "trade or business." Regarding the rental, the Court stated that

It is clear from the facts that the real estate was devoted to rental purposes, and we have repeatedly held that such use constitutes use of the property in trade or business, regardless of whether or not it is the only property so used. (citations omitted) We add that the use of the property in trade or business was, upon the facts, an operation of the trade or business in which it was so used (citation omitted). It is clear, also, that the business was "regularly" carried on, there having been no deviation at any time, from the obviously planned use.

23 T.C. at 512.

*Stevenson v. Commissioner*, T.C. Memo. 1989-357, 1989 PH TC Memo 89,357

In this case the Tax Court determined that the petitioner's rental of portable advertising signs was a trade or business. The Tax Court stated that

The stipulated facts show that petitioner's rental and sale of advertising signs and the sale of related supplies was a trade or business, and net earnings from any trade or business are self-employment income under the definition in section 1402(a). Petitioner carried on this activity with a profit objective (citation omitted).

Petitioner advertised in the Yellow Pages Directory, newspapers and on portable signs the goods and services he was prepared to provide to the public. His work in buying assembling, storing, renting, selling, repairing and maintaining the portable signs required him to devote a substantial amount of time on a regular and continuous basis. See *Commissioner v. Groetzinger*, 480 U.S. 23 (1987). As income derived from a regular, continuous, and profit-motivated activity in which customary services were provided, his earnings fall within the section 1402(a) definition of "net earnings from self-employment." See *Johnson v. Commissioner*, 60 T.C. at 833.

*Kenneth & Delores Hairston*, T.C. Memo. 2000-386, 80 T.C.M. (CCH) 905

Losses from leased construction equipment are a passive activity and nondeductible currently. Taxpayers personally owned construction equipment and leased it to their C Corporation all year long.

*Paul Kessler, et ux. v. Commissioner*, T.C. Memo 2003-185, 85 T.C.M. (CCH)

The Court held that taxpayer's rental of trucks, excavation and office equipment to his own C Corporation was a passive activity. Taxpayer argued that he fell outside the rental

definition under the incidental exception in Treas. Reg. § 1.469-1T(e) (3)(ii)(D). However, he presented no evidence that rental income was less than 2% of the unadjusted basis or FMV of the property. Taxpayer also argued that the activity fell outside the rental definition under the extraordinary personal services exception in Treas. Reg. § 1.469-1T(e)(3)(ii)(C). However, the Court pointed out that the lease plainly provided that the lease was net of all costs to taxpayers personally. In other words, taxpayer's C Corporation was responsible for all costs. The taxpayers personally were not obligated as owners of the equipment to provide any services to their corporation. Finally, the Court held that the leasing activity could not be grouped with other activities under Treas. Reg. § 1.469-4. It pointed out that Treas. Reg. § 1.469-4(d)(5)(ii) provides that a C corporation can be grouped with another entity but only for purposes of determining material participation in the other activity. The Court stated, "[t]he grouping rules are inapplicable because they only determine whether a taxpayer materially participates in an activity, not whether an activity is excepted from the definition of a rental activity."

*Frank v. Commissioner*, T.C. Memo. 1996-177, 71 T.C.M. (CCH) 2748

Losses from an airplane lease were not allowed, as it was a passive activity. The fact that it was subsequently subleased to customers learning to fly for short periods is irrelevant. Payments were principally for use of tangible property, and services were not a dominant element.

## Resources

Publication 334, Tax Guide for Small Business

Publication 925, Passive Activity and At-Risk Rules

## Glossary of Terms

**Bare boat** - Bare boat lease means that the boat owner has transferred sufficient control of the vessel to the individual/corporation leasing and operating the boat so that the individual/corporation is the common law employer of the crewmember under maritime law. See *U.S. v. Webb*, 397 U.S. 179 (1970)

**Guaranteed payment** - Payment made by a partnership to a partner that is determined without regard to the partnership's income. A partnership treats guaranteed payments for services, or for the use of capital, as if they were made to a person who is not a partner.

**Off season** - The time that a fisher is not commercial fishing.

**Related party** - An individual and his or her spouse, ancestors, and lineal descendants. For example, family members, such as brothers, sisters, children, and parents are related persons. Corporations, partnerships, or an estate or trust with which the taxpayer has a connection can be considered a related person.

**Lessee** - one granted a lease

**Lessor** - one granting a lease

**Limited entry fishing permit** (also referred to as LEFP) - this permit entitles the holder to operate a unit of gear in a specific commercial fishery. These fisheries are in turn defined by a combination of fishery resource, gear type and area. Permits vary in scope and can be valid statewide for some species but restricted to specific areas of the state for other species.

# Chapter 5 - Fishing Permits

## Background

Fishing permits and/or licenses allow fishers to harvest aquatic life. The permits are issued according to geographic location, species, and gear type. These are government permits (state licenses) to fish commercially. Limited entry permits generally designate the area that may be fished and when it may be fished. Some states place restrictions on permit ownership. Most permits do not have an expiration date and may be transferred to another person.

Another type of permit, the Individual Fishing Quota (IFQ), is issued to manage certain fisheries. The National Marine Fisheries Service (NMFS) is responsible for implementing and administering the IFQ program. The program is a quota system that gives shares in the amount of species a fisherman may catch. Each type of quota share permit is defined by species, IFQ regulatory area, vessel category, and block status. The federal regulations for the IFQ Program can be found in 50 CFR 679 and in the Federal Register at 61 FR 31228.

Permit holders do not necessarily own or operate a vessel. They may be leasing a boat. However, in certain fisheries the permit holder must be on board the vessel for the sale of the catch to occur. Depending on the type of permit, holders may use several vessels to catch and sell fish. Some permits also do not require a vessel, for example; a fisher may set nets from a beach.

In some states, an individual can only own "limited entry" permits, but the permit holder may operate in corporate or partnership form. Thus, fishing income may be reported on a Form 1120 or Form 1065, rather than a Schedule C. Very often income reported for a permit may be divided and reported separately by permit holder, boat owner, captain, and crewmembers. Consequently, a permit holder may not be reporting, for tax purposes, the total fishing income allocated by the State to his or her permit, but rather the amount after "commissions" and "crew shares" are deducted from the total fishing income. The result is the same and the permit holder has not underreported income. Permit holders should be charged with the total income unless they can substantiate these payments or distributions to others. An annual renewal fee is charged for limited entry permits.

The other category of "permit" is the interim use license which may be restricted as to time, area, and transferability.

In some states, anyone who participates in any way in the operation of the vessel or in the fishing operation, and who does not have a limited entry permit, must have a valid crew license. Crewmember licenses are usually renewable annually and are non-transferable. Most fishing vessels must secure a license annually. In general, vessel licenses are non-transferable, but some can be sold along with the sale of the vessel.

State commercial fishing licenses are generally issued according to species such as shrimp, crab, finfish, oyster, etc. Often, commercial fishing gear also requires a license, and multiple gear licenses may be required if different types of gear are used such as commercial rod and reel, slat trap, seine, etc. Additional endorsements, or special permits, may be called permits or stamps, and may be required for specialty fishing, such as eel, mullet, pompano or shark. Some states issue a permit which is attached to a particular license. For example, anyone who harvests whelks must obtain a commercial fishing license with a whelk permit attached to it.

Some commercial permits issued are limited access in that they can only be renewed or transferred. Permits for king mackerel, gulf reef fish, red snapper, South Atlantic snapper-grouper, swordfish and shark are limited in this way. Some species, such as South Atlantic wreck fish, have quota shares for the license period issued to each fisherman. Some species are controlled by limiting the catch to specific times of the year. For instance, shrimp seasons are highly flexible each year, dependent on estimation of supply.

## **Amortization**

The Revenue Reconciliation Act of 1993, Pub. L. 103-66, 107 Stat. 312 (RRA '93) added IRC § 197, which allows a taxpayer to elect an amortization deduction with respect to the capitalized costs of certain intangible property that is acquired by a taxpayer and that is held by the taxpayer in connection with the conduct of a trade or business or an activity engaged in for the production of income. The amount of the deduction is determined by amortizing the adjusted basis of the intangible property ratably over a 15-year period that begins with the month that the intangible is acquired.

The term "section 197 intangible" is defined to include "any license, permit, or other right granted by a governmental unit or any agency or instrumentality thereof." Thus, for example, the capitalized cost of acquiring from any person a liquor license, a regulated airline route, or a television or radio broadcasting license is to be amortized over a 15-year period. Consequently, the definition of an amortizable intangible is interpreted to include a fishing permit since it is issued by a government agency.

This provision generally applies to property acquired after the date of enactment of the 1993 bill. However, a taxpayer may elect to apply the provisions of the bill to all property acquired after July 25, 1991. "Anti-churning" rules prevent taxpayers from converting an existing IRC Section 197 intangible for which depreciation or amortization is not allowable under present law into amortizable property to which the bill applies. "Existing Section 197 intangibles" are intangibles held by the taxpayer on the date of enactment of RRA '93.

Under the anti-churning rules, a fishing permit cannot be amortized if:

- the taxpayer or a related person held or used the fishing permit at any time during the period that begins on July 25, 1991, and ends on August 10, 1993, OR

- the taxpayer acquired the fishing permit from a person that held it at any time during the period that begins on July 25, 1991, and ends on August 10, 1993, and, as part of the transaction, the user of the fishing permit does not change, OR
- the taxpayer grants the right to use the fishing permit to a person (or a person related to such person) that held or used the fishing permit at any time during the period that begins on July 25, 1991, and ends on August 10, 1993.

See IRC § 197(f)(9). In addition, Congress gave the Department of the Treasury the authority to issue regulations to carry out the purposes of this section, including such regulations as may be appropriate to prevent avoidance of the purposes of this section through related persons or otherwise. The "anti-abuse" portion of the regulation states that

The rules in this section shall be interpreted and applied as necessary and appropriate to prevent avoidance of the purposes of Section 197. If one of the principal purposes of a transaction is to achieve a tax result that is inconsistent with the purposes of Code Section 197, the Commissioner can recast the transaction for Federal tax purposes as appropriate to achieve tax results that are consistent with the purposes of Section 197, in light of applicable statutory and regulatory provisions and the pertinent facts and circumstances.

Treas. Reg. § 1.197-2(j)

## Questions and Answers - Transfers of Fishing Permits

**Question 1.** If spouses transfer an amortizable limited entry permit between themselves, what, if any, change in the permit basis, and thus amortization, occurs? Assume the husband originally owned a limited entry fishing permit and transferred it to his wife.

Under IRC § 1041, no gain or loss is recognized on a transfer of property from an individual to a spouse. In addition, the property is treated as if acquired by the transferee (wife) by gift and the basis of the transferee in the property is the same as the adjusted basis of the transferor (husband). So, if a husband transfers to his wife a fishing permit that has a basis to the husband of \$100,000, there will be no gain or loss on the transfer. In addition, the wife's basis in the fishing permit will be \$100,000, the same as the husband's basis, regardless of any amount she may have paid to the husband for the permit (assuming the transfer was in the form of a sale as opposed to a gift).

Section 1041 applies to any transfer of property between spouses regardless of whether the transfer is a gift, a sale, or an exchange between spouses acting at arm's length. Section 1041 applies whether or not a divorce or legal separation is contemplated between the spouses at the time of the transfer. Section 1041 applies whether or not a divorce or legal separation ever occurs.

The anti-abuse rules prevent a taxpayer from transferring a fishing permit that does not qualify for Section 197 amortization (because it was purchased prior to the effective date of the Section 197 law change) for the purpose of converting it into one that does qualify. The wife will be unable to amortize the fishing permit. It will also have the same basis as the husband's basis immediately prior to transfer.

**Question 2.** As fishers get older, it is common for them to sell or transfer their permit to a sibling or non-spouse relative. If these were originally **pre-1991 permits**, would they then qualify for amortization after such a transfer? Would there be any affect on amortization if the sale of the permit was on an installment agreement as opposed to a cash sale?

The method of sale (cash vs. installment sale) has no affect on the amortization of the permit.

If after August 10, 1993 (or after July 25, 1991, if a valid election is made), a taxpayer acquires a permit from a person considered to be related to the taxpayer under IRC § 267(c) (4), and this related person held or used the permit at any time prior to the effective date of the section 197 law change, then the acquiring taxpayer will not be eligible to amortize the permit. If the related person did not hold or use the permit at any time during this period, then amortization will be allowable to the acquiring taxpayer.

Also, if the taxpayer acquires the permit from a family member who is other than a brother, sister, spouse, parent/grandparent, and child/grandchild, the permit will be amortizable. However, the anti-abuse rules will operate to disallow amortization in a situation where person #1 transfers a permit to person #2, a family member who is not considered to be related to person #1 under IRC § 267(c)(4), such as a cousin, niece, or nephew, then "unrelated" person #2 transfers the permit to person #3, someone who is a related person under the IRC § 267(c)(4) definition, to person #1. If the purpose of this intermediary transfer to person #2 is to achieve a tax result that is inconsistent with the purposes of Section 197 (such as making the permit amortizable to person #3 when it wouldn't have been amortizable if transferred directly from person #1 to person #3), the Commissioner can recast the transaction for Federal tax purposes as appropriate to achieve tax results that are consistent with the purposes of section 197. See Treas. Reg. § 1.197-2 (h); and IRC § 267(b) and (c) (4).

**Question 3.** Assume that one spouse, by death or disability, transfers a **post-1991** permit to the other spouse. The same basis for that permit will transfer with it to the new fishing spouse. Will annual amortization remain as it was, or does the transfer create a new start for the 15-year amortization period using the transferred basis?

The answer depends upon whether the permit is transferred between spouses due to death or for any other reason. If it is transferred for any reason other than death, annual amortization remains as it was.

**Example:** For disability reasons, a husband who is the sole owner of the permit (no joint ownership with the wife), transfers the permit, which was purchased by the husband for \$150,000 on July 1, 2000, to his spouse on May 1, 2005, instead of selling it to a third party. The husband will be entitled to 4 months of amortization on his 2005 tax year Schedule C, or \$3,333 ( $\$150,000/15 \text{ years} = \$10,000/\text{year} \times 4/12 \text{ year} = \$3,333$ ).

If the wife uses the permit in her fishing business, it will be amortizable to her as well. In the 2005 tax year, if her fishing business originates on or before May 1, 2005, she will be entitled to \$6,667 of amortization on her Schedule C ( $\$150,000/15 \text{ years} = \$10,000/\text{year} \times 8/12 \text{ year} = \$6,667$ ). As of January 1, 2006, the wife has 9 1/2 years left to amortize the permit. The amortization will be \$10,000/year for the 2006 through 2014 tax years. Tax year 2015 is the last year in the 15-year amortization period, and \$5,000 will be allowed in this year as only a half-year of amortization is left for this year. In the initial year, 2000, the husband was allowed only 6 months of amortization.

If the transfer of property is due to the death of a spouse, generally IRC § 1014 is applicable. IRC § 1014 is entitled "Basis of property acquired from a decedent." The section lists ten different situations in which property is determined to be acquired from or to have passed from the decedent, such as by bequest, devise, inheritance. Under section 1014, the basis of property acquired from a decedent is the fair market value of the property at the date of the decedent's death, or the fair market value of the property on any available alternative valuation date, if elected by the decedent's estate.

If the spouse uses the permit in her Schedule C fishing business she will be entitled to amortize the permit's fair market value over 15 years under IRC 197 of the Code. Section 197(f) (9) (D) states that the anti-churning rules do not apply to the acquisition of any property by the taxpayer if IRC § 1014(a) determines the basis of the property in the hands of the taxpayer. Under IRC § 197(f) (9) (D), the spouse is able to fully amortize the permit.

The above example assumed that the husband was the sole owner of the permit. If both spouses owned the permit, then only one-half of the permit would receive a fair market value with a new 15-year amortization period if acquired upon the death of the spouse. This is the half to which IRC § 1014(a) applies and is the portion the wife acquired from the husband after his death. The other half will continue to be amortized with the original basis and the remaining number of years as it remains the wife's portion of the asset. Note: Check state community property laws. In the State of Washington, which has community property laws, taxpayers normally receive a stepped-up basis for both the deceased and the surviving spouse's interest in property pursuant to IRC § 1014(b)(6).

## **Sales, Exchanges, Transfers, and Buy backs of Fishing Permits**

When a fishing permit or license is disposed of, the fisher may have a gain or loss that should be reported on his/her tax return. However, in some cases there may be a gain that is not taxable or a loss that is not deductible. The following discussion covers sales, transfers and buy-backs of fishing permits/licenses, how to figure the gain or loss, and where to report the gain or loss.

A disposition of property includes the following transactions:

- Selling property for cash or other property
- Exchanging property for other property
- Transferring property to satisfy a debt
- Foreclosure on the mortgage or repossession of property by a bank or other financial institution
- Condemnation of property, or disposition of property under threat of condemnation, where the taxpayer receives property or money in payment.
- Abandonment of property
- Gift of property to someone else

### **Fully or partially nontaxable exchanges**

Certain exchanges of property are not taxable. This means that any gain from the exchange is not recognized and no loss is deductible. An example of this is a transfer of property incident to divorce. Where a disposition meets the requirements of a like-kind exchange, the gain or loss will not be recognized until the taxpayer sells or otherwise disposes of the property received. Where a sale meets the requirements of an installment sale, the gain is postponed until the taxpayer receives payments.

### **Like-kind Exchanges**

A like-kind exchange is the exchange of business property for similar business property rather than cash. It is the most common type of nontaxable exchange.

The exchange of a fishing permit/license for another fishing permit/license qualifies for nontaxable exchange treatment under IRC § 1031, regardless of whether the permit is for a different fishery, a different species of fish, or a different type of fishing gear.

Any time a fisher sells his permits/licenses for more than the current adjusted basis (purchase price minus claimed amortization), he incurs a tax liability. For example, if Captain Fisher buys a fishing permit for \$100,000 in April 2002 and sells it in May 2010 for \$150,000, he must pay taxes on the \$50,000 capital gain. In addition, because he has amortized the permit/license (taken a deduction on his returns), he would also be liable

for taxes on the amortized amount claimed of \$53,336 (8 years @ \$6,667). This amount would be reported as an ordinary gain.

If the fisher does a like-kind exchange under IRC § 1031 he can defer the capital and ordinary gains. This code section allows owners to defer the gain on the disposal of business property if, rather than selling for cash, they **trade** it for another item of business property of a similar type, i.e., a fishing permit for a fishing permit. The tax liability is not eliminated, but rather is deferred until the sale of the newly acquired fishing permit/license.

**Example:** If Captain Fisher's original \$100,000 fishing permit has a current value of \$150,000 and he trades it for another, the \$50,000 capital gain and \$53,336 ordinary gain can be deferred until he sells the new fishing permit. Basis in the new permit is adjusted by the gain deferred.

To qualify for treatment as a nontaxable exchange under IRC § 1031:

- The property must be business or investment property.
- The property must not be property held for sale (acquired specifically for resale).
- There must be an exchange of property.
- Tangible personal property can be either "like-kind" or "like-class."
- Intangible personal property must be "like-kind."
- The taxpayer must identify the property to be received within 45 days after the date he/she transfers the property given up in the exchange.
- The exchange must be completed by the earlier of the following dates:
  - 180 days after the transferred property was given up
  - The due date (including extensions) of the tax return for the year in which they transferred the property given up

If a fisher receives money or unlike property as part of the trade, or his permit had a note that the other party assumed, he might have to report a gain to the extent of the money or unlike property received.

Exchanges of like-kind properties are reported on Form 8824. For more information about exchanges, see Publication 544 and IRC § 1031.

## **Installment Sales**

An installment sale is a sale of property where at least one payment is received after the tax year of the sale. If the taxpayer finances the buyer's purchase of the permit, instead of having the buyer obtain a loan or mortgage from a third party, the exchange is likely through an installment sale. The installment method is a special method of reporting gains (not losses) from sales of property where at least one payment is received in a tax year after the year of sale. Under the installment method, gain from an installment sale is prorated and recognized over the years in which payments are received.

The amount of gain from an installment sale that is taxable in a given year is calculated by multiplying the payments received in that year by the gross profit ratio for the sale. IRC § 453(c) The gross profit ratio is equal to the anticipated gross profit divided by the total contract price. However, gain from installment sales of depreciable property subject to recapture under IRC §§ 1245 or 1250 (i.e., ordinary income) is to be recognized in the year of the disposition, and any gain in excess of the recapture income is to be reported under the installment method. IRC § 453(i).

**Example:** On December 1, 2010, Captain Fisher sells his salmon fishing permit for \$50,000. He receives a \$15,000 down payment, with the balance due in monthly installments of \$1,000 each, plus interest at the applicable federal rate, beginning on January 1, 2011. His anticipated gross profit from the sale is \$10,000. Under the installment method, the taxpayer must report \$3,000 ( $\$15,000 \times \$10,000/\$50,000$ ) as income in 2010, \$2,400 ( $\$12,000 \times (\$10,000/\$50,000)$ ) in 2011 and 2012, and \$2,200 ( $\$11,000 \times \$10,000/\$50,000$ ) in 2013.

Income from an installment sale is reported on Form 6252 that must be filed with the tax return in the year of sale and in each year payments are received. Form 4797 is used to calculate and report the amount of recaptured depreciation. For more information about installment sales, see Pub. 537 and IRC § 453.

## Taxable Exchanges

When a taxpayer disposes of business property, his/her taxable gain or loss is usually an IRC § 1231 gain or loss. Its treatment as ordinary or capital is determined under rules for section 1231 transactions.

Gain or loss on the sale or exchange of amortizable intangible property held longer than 1 year, other than an amount recaptured as ordinary income, is a section 1231 gain or loss. Gain or loss on dispositions of other intangible property is ordinary or capital depending on whether the property is a capital asset or a noncapital asset. Section 197(d) (1) (D) allows amortization of permits and licenses. Fishing permits and licenses acquired after 8/10/93 are eligible for amortization and subject to the applicable recapture provisions when sold. The same is true for permits or licenses acquired after 7/21/91 where the taxpayer has made an appropriate election under Section 197. A fishing permit acquired before the amortization rules changed is a capital asset and any gain or loss remains capital.

### Gains

If the sale of a fishing permit or license results in a profit or **gain**, the gain is taxable. For example, assume the following facts:

Permit purchased for \$50,000

Amortization claimed on returns \$26,665

Remaining basis \$23,335 (\$50,000 cost minus \$26,665 amortization = \$23,335 remaining basis)

**Example 1:** If the permit is sold for \$40,000, there will be a gain of \$16,665 (\$40,000 selling price minus \$23,335 basis = \$16,665). Since amortization recapture is treated as ordinary income, the gain is not eligible for the more beneficial capital gain treatment. The rate of tax that must be paid on this \$16,665 will depend upon the taxpayer's other income and the tax bracket at which this income is taxed.

**Example 2:** Assuming the same facts as above, if the permit is sold for \$60,000, there will be a gain of \$36,665 (\$60,000 selling price minus \$23,335 basis = \$36,665). In this situation, the amount of the gain representing the prior amortization claimed, or \$26,665, will be taxed at the ordinary income rates as explained in Example 1. The remaining \$10,000 gain, representing the amount received in excess of the original cost of the permit, is taxed at the capital gain rates.

**Example 3:** The following example changes the facts and shows the amortization calculation.

Taxpayer purchased and placed in service a limited entry fishing permit on July 1, 2005 (a year in which section 197 amortization is applicable), for \$150,000.

The taxpayer amortized the permit for 6 months in 2005, and claimed a \$5,000 deduction ( $\$150,000/15 \text{ years} = \$10,000/\text{year} \times 1/2 \text{ year} = \$5,000$ ). The taxpayer claimed a \$10,000 section 197 amortization deduction in each of the 2006, 2007, 2008, and 2009 tax years.

On October 1, 2010, the taxpayer sold the permit for \$160,000.

The taxpayer will be eligible to claim amortization of \$7,500 for the 2010 tax year (3/4 of the full year amortization). The total amortization for the 2005 through 2010 years was \$52,500 ( $\$5,000 + \$40,000 + \$7,500 = \$52,500$ ).

At the time of sale, the taxpayer's basis in the fishing permit is \$97,500. This is computed by subtracting the Section 197 amortization from the original cost of the permit ( $\$150,000 - \$52,500 = \$97,500$ ).

The total gain is \$62,500, which is computed by subtracting the basis from the selling price ( $\$160,000 - \$97,500 = \$62,500$ ). Of the \$62,500 gain, the first \$52,500 will be ordinary income (the amount of Section 197

amortization claimed), and the \$10,000 excess will be capital gain proceeds.

The sale of a fishing permit is reported on Form 4797, Part III. If the form is properly completed, the \$10,000 capital gain will be carried forward to line 6 of the Form 4797, and the \$52,500 ordinary income will be carried forward to line 13 of the Form 4797. This will result in the \$10,000 being treated as capital gain and the \$52,500 being treated as ordinary income.

**Example 4:** If the taxpayer sells the permit in Example 3 for \$140,000 instead of \$160,000, the total gain would be \$42,500 (\$140,000 - \$97,500), all of which would be ordinary income due to the Section 197 amortization recapture rules.

## Losses

If the taxpayer's sale of her fishing permit/license results in a **loss**, the loss is deductible.

For example, assume the following facts:

Permit purchased for \$50,000

Amortization claimed on returns \$26,665

Remaining basis \$23,335 (\$50,000 cost minus \$26,665 amortization = \$23,335 remaining basis)

**Example 5:** If the permit is sold for \$20,000, there will be a loss of \$3,335 (\$20,000 selling price minus \$23,335 basis = \$3,335). The loss is deductible as an ordinary loss.

**Example 6:** Assume the permit was purchased in 2001 and no election was made to amortize the permit. If the permit is sold for \$20,000, there will be a loss of \$30,000 (\$20,000 selling price minus \$50,000 basis = \$30,000). A fishing permit is a capital asset. IRC § 1221 defines "capital asset" to mean property held by the taxpayer whether or not connected with his trade or business, but does not include IRC § 1221(a)(2) property used in his trade or business which is subject to the allowance for depreciation (Section 167 or 197). In this situation, the sale remains as Section 1221 property and the loss must be reported on Schedule D as a long-term capital loss.

The sale of business assets is reported on Form 4797 as discussed under **Gains**, above.

## Buy back of Fishing Permits/Licenses

Money received for the buy back of a fishing license is sale proceeds, and must be reported on the taxpayer's tax return. The money may be taxable income or a loss as explained in the prior examples. There is no exclusion for these funds.

The amount that would be reported is computed as follows:

**Sales Price** (buy back amount)  
- **Cost** (purchase amount)  
- **Amortization Claimed**  
= **Gain/Loss to report.**

Normally if the taxpayer did not purchase the permit, then the total buy back amount would be taxable income in the year received.

## Condemnations

If a fishing permit or license is condemned, then follow the rules under Involuntary Conversions, IRC § 1033. See discussion of Gain or Loss from Condemnations in Publication 544 for more information.

If a taxpayer's property was condemned or disposed of under the threat of condemnation, compute the gain or loss by comparing the adjusted basis of the condemned property with the net condemnation award. See prior examples to compute gain or loss.

If the net condemnation award is more than the adjusted basis of the condemned property, there is a gain. The taxpayer can postpone reporting gain from a condemnation if she buys replacement property. The replacement period starts with the date of disposition and ends not earlier than two years after the close of the first taxable year in which any part of the gain from the condemnation is realized.

If the net condemnation award is less than the adjusted basis, the taxpayer has a loss, and must report any deductible loss in the tax year it happened.

If money is received in a condemnation meeting the requirements of IRC § 1033, a taxpayer could exchange one permit for another, like permit. Depending on the cost of the "new" permit purchased, the taxpayer may or may not have to pay taxes on the gain.

## Examination Techniques

- Verify what type of permits, licenses, or stamps the fisher holds or has held.
- Verify that the income from each permit is reported. See Chapter 1, Income for techniques.
- If amortization is deducted in relation to the purchase of a permit, verify the date the permit was purchased, the amount, and from whom the permit was purchased.

- Were any permits sold? How were the sales reported on the tax return? A buy back by a government agency is treated as a sale. Verify that the income received is for the permit and not for lost income. Legislation in this area varies from state to state. Information on various programs is available on the internet or through state and federal agencies with oversight of the industry. Check with the fishing coordinator for potential information.
- Annual license fees are currently deductible on a Schedule C, Form 1120, or Form 1065 if the fisher is currently fishing and actively operating as a business. If not for fishing, the permit may be held for investment which may require other reporting requirements. For example, an individual who holds the permit for investment should report the fee as an investment expense deductible on Schedule A, subject to the 2% limitation. These fees are not added to the basis of the permit when the permit is sold even if the fees are not deducted in prior years, and even if there is no tax benefit due to the limitation.
- Review any state laws and any federal laws that apply to the type of permits the fisher owns.

## Documents to Request

- Purchase and sale documents, including purchase and sale contracts and any state or federal agreements transferring the permit
- Loan documents associated with the purchase or sale
- Receipts and cancelled checks to verify the transactions

## Interview Questions

- What permits do you own? Types? Fishing areas? Any restrictions?
- When were the permits purchased and from whom? Related party?
- Do you lease any permits? Types? Fishing areas? Any restrictions?
- Leased from whom?
- Was a Form 1099-MISC issued and filed for the rents paid to the permit owner?
- Did you sell or transfer a permit?

## Supporting Law

IRC § 197(d) (1) (D) Allows amortization of permits/licenses acquired after 8/10/93 or, if an election was made, property acquired after 7/21/91 is eligible for amortization.

IRC § 1031(a) Provides that no gain or loss is recognized when property held for productive use in a trade or business, or for investment, is exchanged solely for property of a "like kind" that is also to be held either for the productive use in a trade or business or for investment.

Treas. Reg. § 1.1031(a)-2(c)(1) An exchange of intangible or non-depreciable personal property qualifies for non-recognition of gain or loss under IRC § 1031 if the exchanged properties are of a like kind.

IRC § 1221 Defines capital asset to mean property held by the taxpayer whether or not connected with his trade or business, but does not include IRC § 1221(a)(2) property used in the taxpayer's trade or business which is subject to the allowance for depreciation under IRC § 167.

IRC § 453 Provides rules and definitions for installment sales.

IRC § 453(b) (1) The term "installment sale" means a disposition of property where at least one payment is to be received after the close of the taxable year in which the disposition occurs.

IRC § 453(c) The term "installment method" means a method under which the income recognized for any taxable year from a disposition is that proportion of the payments received in that year which the gross profit (realized or to be realized when payment is completed) bears to the total contract price.

## **Resources**

Publication 544, Sales and Other Dispositions of Assets, provides further explanations on how to treat sales of business assets.

Publication 535, Business Expenses, and Publication 946, How to Depreciate Property, provides more information on amortizable intangible property.

Publication 537, Installment Sales, provides more information about installment sales.

[NOAA Fisheries/National Marine Fisheries Service](#)

## **Miscellaneous**

Individual Fishing Quota (IFQ) Information & Law:

- The federal regulations for the IFQ Program can be found in 50 CFR 679 and in the Federal Register at 61 FR 31228.
- A freezer vessel refers to any vessel that has the capacity to freeze or otherwise process some or all of its catch. A catcher vessel refers to any vessel that is used to catch fish which are then headed, gutted, bled, and iced, or otherwise retained as unprocessed fish on board.
- A Quota Share (QS) is a permit that indicates the fisher's share of the Total Allowable Catch (TAC). The QS is used as the basis of the annual calculation of the fisher's Individual Fishing Quota (IFQ). The Quota Share Pool (QSP) is the

total of all QS issued for a species of fish. The IFQ is the allowable pounds of fish that the fisher is allowed to harvest for a specific year. It is calculated annually on January 31, according to the following formula:  $(QS/QSP) \times TAC = IFQ$ . The remainder of this section will use "IFQ" in the discussion, but QS and IFQ go hand-in-hand.

- Freezer vessel IFQ may, without exception, be fished by hired masters on behalf of IFQ holders.
- Any amount of freezer vessel IFQ may be leased, on an annual basis, upon approval by the Regional Director of NOAA/NMFS.
- IFQ holders that are not individuals (such as corporations, partnerships, estates, etc.) must designate a hired skipper (master) to fish their IFQ. Such an IFQ holder must demonstrate that he/she holds an ownership interest of at least 20% in the vessel upon which the designated skipper is going to fish his/her IFQ.
- If a catcher vessel IFQ holder received her catcher vessel IFQ upon initial issuance, and the catcher vessel IFQ holder holds at least a 20% ownership interest in the vessel on which the IFQ halibut or sablefish are harvested, she may hire a master to fish her IFQ. In Southeast Alaska (halibut area 2C and sablefish area SE east of 140 degrees west longitude), only corporations or partnerships with initial issuance IFQ may hire masters. Other than these exceptions, the catcher vessel IFQ holder must be physically on board the vessel harvesting her IFQ halibut or sablefish.
- If an IFQ holder can demonstrate a minimum 20% ownership of the vessel upon which a hired skipper is to fish (and is otherwise eligible to hire a skipper), an application for a hired skipper card will be approved. This is true even if ownership of the vessel is "indirect." For instance, an individual IFQ holder, who owns 20% (or more) of a corporation or partnership that owns a vessel, may hire a skipper. Likewise, a non-individual IFQ holder may hire a skipper to fish on a vessel owned by one of its individual members, provided that the ownership levels are at least 20%.
- Generally, a catcher vessel IFQ may only be transferred to an individual. An exception to the prohibition of transferring IFQs to persons other than individuals is the transfer of catcher vessel IFQs to the holder's solely owned corporation. Such a transfer, however, does not exempt the catcher vessel IFQ holder from the requirement to be physically on-board the vessel when fishing with catcher vessel IFQ for halibut in area 2C or with catcher vessel IFQ for sablefish in the Southeast (SE) area of Alaska.
- Catcher vessel IFQ holders could only lease 10% of their catcher vessel IFQs for the 1995, 1996, and 1997 tax years. After 1997, catcher vessel IFQ holders could not lease their IFQs. The only exception is for an IFQ holder who holds the IFQ as a "surviving spouse" who may lease her annual IFQs for a period of 3 years.
- IFQs were originally issued to individuals who were able to demonstrate past personal efforts in the halibut and/or sablefish fishing industries.

The United States District Court for the District of Alaska ruled in March of 1992 that a limited entry permit is property or rights to property within the meaning of 26 U.S.C. § 6321. *Lorentzen v. United States*, Case No. A90-446 Civil (D. Alaska Mar. 11, 1992). A

limited entry fishing permit is a "use privilege" per Alaska Stat. § 16.43.150(e) and is to be treated as ordinary personal property for the purposes of inheritance. *Wik v. Wik*, 681 P.2d 336 (Alaska 1984). Permits are freely transferable.

## **Glossary of Terms**

**Slat basket:** a trap designed to catch catfish made of wood or plastic slats in a boxlike or cylindrical shape; may be up to six feet long and fifteen inches in width and height (for box shape), or fifteen inches in diameter for cylindrical shaped traps.

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# Chapter 6 - Depreciation and Amortization

## Depreciation

MACRS is mandatory for most tangible depreciable property placed in service after December 31, 1986. This includes, but is not limited to, fishing vessels, vessel equipment not permanently attached to the vessel, trawls and related equipment, nets, pots, and traps, oyster tongs and dredges, and longline or trotline equipment.

## Vessels: Descriptions and Depreciable Lives

Fishing vessels can be divided into the following six basic categories, although hybrids of these categories exist:

- Small fishing vessels, (e.g. salmon harvesters, oyster harvesters, lobster boats, line fin fishing boats, etc.) are usually less than 50 feet long with an average cost basis of \$200,000. These are purely catching/harvesting vessels with no processing capabilities. Generally, these boats must stay relatively close to shore since few have any storage capability or living quarters. Crew size is generally not more than five, and usually only one or two.
- Medium size fishing vessels (e.g. shrimp trawlers, lobster boats, scallopers, etc.) which are generally 60 to 90 feet long. Newer vessels made of steel cost from \$250,000 to \$500,000, but older, smaller wood vessels can be purchased for \$50,000 or less. These boats generally have refrigerated storage for the catch powered by a diesel generator and storage for large quantities of ice, and may stay offshore for three to seven days. Crew size normally ranges from four to eight, but may be as many as 12. No processing takes place, but shrimp crews often grade the shrimp by number per pound and "head" (remove the head, increasing the value per pound) shrimp when not busy with other duties.
- Larger catcher/harvester vessels average 150 feet in length with an average cost basis of between \$1 and \$5 million. These vessels have the capacity to "head and gut" and freeze fish. This activity does not constitute processing under Coast Guard or Department of Commerce regulations. size and cost.
- Factory trawlers that harvest and process fish. These vessels range from 250 to 400 feet in length and may cost \$25 million to \$80 million, depending on size and processing capability. Up to a hundred plant employees process catch during the trip, and may even process fish from other catcher vessels due to short seasons of ground fish or operational difficulties.
- Processor vessels without harvesting capacity that may cost in excess of \$50 million and can range in length to over 600 feet. These vessels have factory "crews" consisting of hundreds of processing employees.

- "Tender" vessels are primarily used to transport fish to a shore-based or floating processor, but they may operate fish pumps to take another vessel's catch from the water. Although vessel size varies, crew size is generally fewer than ten people.

## **Depreciable Life**

Under MACRS, assets are classified according to the class life set by Rev. Proc. 87-56, 1987-2 C.B. 674. That revenue procedure lists "vessels, barges, tugs and similar water transportation equipment" as having a class life of 18 years and a MACRS recovery period of 10 years. Title 46 U.S.C. § 2101 defines many types of "vessels" including fishing vessels, fish tender vessels, and fish processing vessels. However, a commercial fishing vessel does not qualify as "transportation" equipment. Since the revenue procedure is silent regarding class lives of commercial fishing vessels, the MACRS classification of property without a class life or otherwise classified must be used. Accordingly, the MACRS recovery period of fishing vessels is seven years. Fish tender vessels and fish processing vessels are generally considered water transportation equipment and have a ten year MACRS recovery period.

Nets, pots and traps are generally seven-year MACRS recovery property, unless they do not last more than one year in use. If so, the cost is currently deductible. In the Northeast, lobster traps have been determined to have a three year useful life based on a National Marine Fisheries study.

Fish processing equipment (belts and screws, holding bins and tanks, washes, climate control devices, screens, separators, automatic deheaders/filleters, waste product recovery systems) that may be carried on fishing vessels, tender vessels or processing vessels fall into ADR Asset class 20.4 (food production and manufacturing equipment) rather than asset class 20.5 (special handling devices) which includes returnable pallets, palletized containers or boxes, baskets, carts and flaking trays. Asset class 20.4 requires a seven-year MACRS recovery period, while asset class 20.5 requires a three-year recovery period.

## **Capitalization vs. Repair**

Whether an asset must be capitalized and depreciated depends upon whether the asset is expected to last more than one year. Generally, all nets, pots, and traps last substantially beyond the year they are placed in service.

A taxpayer must acquire fishing pots, traps and nets when he begins a fishing enterprise. Complete nets (e.g., webbing, cork, buoys, lead lines, etc.) are acquired by outright purchase, self-construction or contractual construction. If an asset such as a net is constructed, the entire cost must be capitalized and depreciated (including the webbing, cork, buoys, lead lines, etc.).

If all pots are purchased annually, but discarded at the end of the fishing season, and new pots purchased at the start of the next fishing season, then the cost of the pots is deductible in the year placed in service. If only some of the pots are discarded and some are retained for use in the next fishing season, then the pots in general are not deductible in the current year and must be depreciated. The cost of the actual pots that are discarded in the same year they are placed in service will be deductible in that year. The same will apply to traps, nets and other fishing gear.

After initial purchase of nets, net repairs may be performed each year. The cost of incidental repairs that neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinary efficient operating condition, may be deducted as an expense. If the repair or replacement increases the value of the property, or makes it more useful or lengthens its life, the repair or replacement must be capitalized and depreciated.

Gillnet fishers will initially purchase new gear and then often re-hang new webbing each year on the same cork and lead lines. When the new net is initially purchased, the entire cost will be depreciated over seven years. The entire cost includes the entire purchase price if purchased, or the cost of all of the components, as discussed above, if self-constructed. If the webbing is replaced each year, the cost of the replacement webbing is a deductible expense each year. However, the initial cost of the complete net, which includes the initial webbing, will continue to be depreciated over seven years. Only when the entire net system (webbing, cork, buoys, lead lines, etc.) is discarded will the remaining undepreciated cost of the net be deductible in the year of disposition.

## **Section 179 Depreciation**

Boats and equipment are tangible personal property subject to the election to expense under IRC § 179.

## **Coordination with Capital Construction Fund**

If a taxpayer has acquired a vessel or gear, or made mortgage payments with funds withdrawn tax free from a fishing vessel capital construction fund, the depreciable basis is reduced. See Chapter 10, Capital Construction Fund for additional information.

## **Amortization Issues**

IRC § 197 allows an amortization deduction with respect to the capitalized costs of certain intangible property acquired by a taxpayer and held by the taxpayer in connection with the conduct of a trade or business or an activity engaged in for the production of income. The amount of the deduction is determined by amortizing the adjusted basis (for purposes of determining gain) of the intangible ratably over a 15-year period that begins with the month of acquisition. No other depreciation or amortization deduction is allowed with respect to an IRC § 197 intangible acquired by a taxpayer.

The term "section 197 intangible" is defined to include "any license, permit or other right granted by a governmental unit or any agency or instrumentality thereof." Thus, for example, the capitalized cost of acquiring from any person a liquor license, a regulated airline route, or a television or radio broadcasting license is to be amortized over a 15-year period. Fishing permits generally are considered an intangible asset and amortized over a 15-year period.

## **Special Depreciation Allowances**

A special depreciation allowance, codified as IRC § 168(k), was enacted into law by the Job Creation and Worker Assistance Act of 2002, Pub. L. 107-147, 116 Stat. 21. The deduction is computed based on the date in which the property is acquired. Refer to IRC § 168(k) for the current allowance.

The allowance is an additional deduction of percentage of the property's depreciable basis. The allowance is deductible for both regular tax and AMT purposes. There is no AMT adjustment required for any depreciation computed on the remaining basis of the property. Basis is reduced by the special depreciation deduction before computation of regular depreciation, similar to the IRC §179 rules. Primarily, fisher property qualifying for the special depreciation allowance must be new property depreciable under MACRS with a recovery period of 20 years or less.

The Joint Committee on Taxation indicates that the IRC §179 expense allowance is claimed prior to the additional 30% special depreciation allowance (JCT, Technical Explanation of the "Job Creation and Worker Assistance Act of 2002", JCX-12-02, 3/6/02). Claiming the section 179 expense allowance does not preclude the deduction of the section 168(k) special depreciation allowance.

Various other special depreciation allowances have been enacted since 2004 for which fisher property qualifies in the same manner as other business property. Information regarding the special depreciation allowances is available through other resources and will not be detailed here. (See Pub. 946 for details)

## **Audit Issues**

The issue for examination is to determine the appropriate class life of vessels used in the fishing industry. In 1986, with the passage of MACRS, Congress gave the ADR class lives the weight of law. The ADR tables have one class for all vessels except those used in marine construction. In 1993, Chief Counsel issued a ruling that all vessels have a 10-year life for regular tax depreciation and an 18-year life for alternative minimum tax depreciation.

Rev. Proc. 62-21, 1962-2 C.B. 418, represents the earliest Service pronouncement establishing guidelines for composite lives. In this revenue procedure, fishing vessels were listed as non-manufacturing assets for which the useful life would have to be

determined under the facts and circumstances. Subsequent revenue procedures setting forth class lives for purposes of IRC §§ 167(m) and 168 do not include "taking or catching fish" as an activity with an asset class. Therefore, taxpayers rely on Rev. Proc. 62-21 as support for their position that all fishing vessels qualify as 7-year property.

With respect to vessels used primarily for harvesting or catching fish, Chief Counsel advises that the above rationale is correct. Because "taking or catching fish" does not appear in any of the revenue procedures available for ADR classification, all property used in that activity was ineligible for ADR and would have no class life for purposes of MACRS. See section 2.04 of Rev. Proc. 87-56, 1987-2 C.B. 674. Thus, if the primary activity of a vessel is fishing, the vessel constitutes 7-year property.

However, class lives do exist for related activities, such as processing of fish and tendering the catch to factory trawlers or shore-based processing plants. Under Rev. Proc. 87-56, the applicable activity for the processing of fish is "Manufacture of Other Food and Kindred Products", described in class 20.4; the applicable activity for the tendering of fish to water-based or shore-based processors in "Water Transportation" is described in asset class 44.0. Certain assigned items used in an applicable activity must be separately classified (see section 2.02 of Rev. Proc. 87-56), and among these are "vessels," which are separately classified in asset class 00.28. Consequently, if the primary activity of a vessel is processing fish or operating a tender, then the vessel would be classified in asset class 00.28, and would constitute 10-year property for purposes of MACRS.

## **Examination Techniques**

- Scan the taxpayer's detailed depreciation schedule for LUQ items. Often, cars and trucks are included as business assets when they are in fact used for commuting.
- Question the taxpayer as to the existence of a Capital Construction Fund (CCF). There is no adjustment to basis to the extent that qualified funds from the CCF were used to purchase or improve the fishing vessel.
- If MACRS accelerated depreciation is used, determine the extent of the taxpayer's depreciation preference for computation of the Alternative Minimum Tax (AMT).
- Determine if the taxpayer has filed Form 3115 as an application for the automatic change in accounting method provided in Rev. Proc. 98-60, 1998-2 C.B. 761. If filed, review the Form 3115 and determine if the change is appropriate, and if the 4-year spread required by Rev. Proc. 98-60 is being followed. See discussion of "reallocation" issue, below.
- Review computations of the §179 and §168 (k) deductions for correct application. Determine if any disposals of property have occurred which would trigger recapture of the §179 deduction, or §1245 recapture of the §168 (k) deduction.

## **Issue Identification**

The most common adjustment to depreciation is an adjustment to the basis of an asset.

Secondly, the MACRS life claimed may be incorrect.

## Documents to Request

- Detailed depreciation schedule
- Detail of any assets sold during the year
- Purchase/cost verification of selected assets
- A copy of the capital construction fund statement for the current tax year

## Interview Questions

- What new assets were acquired during this tax year?
- From whom were they acquired?
- Did you dispose of any assets during the tax year?
- Do you construct any of your assets such as traps, pots, dock, new vessel, etc.?
- Did you make any major repairs or overhauls of your fishing vessel this year?
- Do you have a Capital Construction Fund? Have you used it to pay for any assets reflected on the depreciation schedule?

## Supporting Law

IRC § 168 and regulations thereunder

IRC § 179 and regulations thereunder

## Resources

Publication 595, Capital Construction Fund for Commercial Fishers

Publication 946, How to Depreciate Property

## Glossary of Terms

**Trawler:** A fishing vessel that 'trawls' (drags) a funnel-shaped bag through water behind the vessel to scoop up fish or shrimp on the ocean floor or in midwater ranges. The trawl net is wide at the mouth and tapers back to a narrow "cod end" that collects the catch. When the bag is full, winches haul aboard the cod end so that the fish can be unloaded. A trawler can be identified by the "door" in the stern from which huge nets are spread to scoop up schools of fish. Trawl nets are usually used for deep-water fisheries such as pollock, cod, founder and sole. The average bottom trawl opening is 40 to 60 feet wide and 8 to 10 feet tall.

Bottom trawlers usually tow their nets at one to two knots on or above the ocean floor. Fishers tow midwater trawls faster to catch faster-swimming schooling fish. Trawlers

have a large metal trawl door that acts like a foil in the water pulling the net open when the net is deployed. The nets are usually hauled aboard on a ramp located at the stern end of the boat with the help of heavy-duty winches. Older trawlers without inclined ramps haul their nets over the sides using a haul line and a block on an overhead boom to bring in the cod end of the net. Trawlers catch a wide variety of fish and shrimp including rockfish, cod, sablefish (black cod), ocean perch, flounder and sole. Trawls can be designed to catch particular groups of fish through adaptations to the mesh size of the net.

Large trawlers work by dragging a net through the water catching schooling fish like walleye pollock. These boats can be up to 600 feet in length and can have entire fish processing facilities on board. Most trawl nets have "doors", which are large metal or wood devices that keep the net open as it moves through the water. Some have a heavy weighted bottom line with wheels to help the net move along the seafloor. The end of the net, the "cod end" is like a large pocket that holds the captured fish. Mesh size in the net and cod end determine the particular size of fish that are caught.

**Scallop dredge:** A fishing vessel equipped with special metal scallop nets whose size must comply with current catch standards (4" rings and 10" twine top for dredges in 2010. See 50 CFR 648.51).

**Gillnet:** Commonly deployed in Pacific Salmon fisheries, primarily to fish sockeye, chum and Coho. It works by setting curtain-like nets perpendicular to the direction in which the salmon are traveling. The net has a float line (cork line) on the top and a weighted line (lead line) on the bottom. The mesh is designed to be just large enough to allow the salmon to become entangled at their gills. Gillnet vessels are typically around 30 to 40 feet long. They are easily recognized by the hydraulic-powered drum onto which the net is rolled. The drum can be located on the back or the front of the vessel. Gillnets are like seine nets, except that they are set in a straight line like a curtain and are not closed like a purse.

**Longliners:** Can target either bottom fish like lingcod, halibut, pacific cod and sablefish, or pelagic fish like swordfish. In bottom longlining, a line up to a mile in length is anchored on the seafloor with buoy lines marked with flags at either end. The line can have up to a thousand baited hooks attached to leaders, called gangions, and are deployed for up to 24 hours, depending on the fishery. Pelagic longliners work the same way but with the gear suspended in the water column held up with floats. Longliners are used for harvesting halibut and black cod (sablefish) and are the most efficient type of gear for bottom fishing.

**Pot gear:** Pots are used for sablefish, crab, shrimp and other crustaceans, including sea snails. Most pots are constructed with wire-mesh netting stretched around a squat, cylindrical or rectangular frame that is open on the sides to allow the target fish or shellfish to crawl or swim inside. Bait is strung to the inside of the pot.

**Lobster trap:** A trap used to catch lobsters. They originally were made of wood but now are made out of wire for the most part.

**Ghost traps:** Lost or abandoned gear that continues to catch fish. Ghost traps can be a problem in the lobster fishery. Biodegradable escape panels or hinges are required on traps to prevent ghost fishing. NOAA Fisheries Service implemented an October 2007 [final rule](#) requiring larger escape vents in the traps.

**Seine gear:** Seine boats are about 50 feet long, snug, and have what looks like a small crane aft. Purse seine gear works on a simple principle: surround the fish with a net, trap them inside by closing the bottom of the net like a drawstring purse, and haul the fish aboard. The operation is often more complex and difficult in practice. The seine net hangs like a curtain that is weighted at the bottom. It is set in a circular pattern by a skiff. After the set is made, the purse line (a rope threaded through the bottom of the net) is closed and the fish are surrounded by the net and hauled aboard. Some seiners fish the spring herring runs before salmon season opens.

**Purse seiners:** Used to catch schooling fish like salmon, menhaden or herring by encircling them with a long net and drawing (pursing) the bottom closed to capture the fish within. Seiners can be recognized by their long, clean decks, large boom and power block, net stacked on back, and the power skiff used to help maneuver the net. The skiff is often seen riding "piggyback" aboard the vessel's stern while traveling. Larger purse seiners are used in tuna fisheries and are often at sea for several weeks at a time. Large tuna purse seiners may even have helicopters on board to transport crew and to spot large schools of fish.

**Setnet:** A small skiff is used to pull nets attached to huge buoys and anchored with several thousand pounds of sandbags to keep nets from washing away with the tides. The net is strung around a crescent area off the shoreline area for which the fisher has a permit. One permit can authorize up to three 210-foot nets and a lease of three fishing sites.

**Troll vessels:** Used to catch salmon, principally chinook, coho and pink salmon by "trolling" bait or lures. Usually this means four to six main wire lines are fished at a time, each with a 50-pound lead "cannon ball" weight and between eight to twelve nylon leaders spaced out along its length. Each nylon leader contains a lure or baited hook. Trollers come in a variety of lengths and styles, but can be largely recognized by the long mast poles that are used to relay the wire lines out into the water. Trolling vessels have tall poles from which gear is rigged. Like a large version of a sport fishing rod, troll gear consists of the pole, fishing line (average 600 to 900 pound test), a lure, bait or hoochies. When fishing, these poles are let down at a 45-degree or so angle. Trollers can fish for various salmon species at once by using different lures and changing fishing depth and trolling speed. Trolling is labor-intensive, but supplies high quality salmon because the fish are not damaged or marked by nets.

# Chapter 7 - Tax Home/Travel/Meals

The fishing industry has many crewmembers that live in one location and then travel to various ports where they obtain seasonal jobs on one or more fishing vessels. For example, a crewmember may live in Idaho, fly to Alaska during various fishing seasons and then fly back to his residence after the season is over, or until he works again. It is common for a fisher to deduct the cost of traveling from her personal residence to the port or boat as a business expense.

The location of a fisher's principal or regular post of employment (tax home) serves as the point of origin for computing allowable travel expenses as well as meals and lodging incurred while "away from home."

An individual is considered to be "away from home" if

- his duties require him to be away from the general area of his tax home (defined later) substantially longer than an ordinary day's work, and
- sleep or rest is necessary to meet the demands of work while away from home.

A taxpayer's "tax home" is the taxpayer's principal or regular post of employment during the taxable year regardless of the physical location of his or her residence.

If a taxpayer has more than one regular place of business, then his tax home is his main place of business. Factors to be considered are:

- the time spent in each location;
- the level of activity in each location; and
- whether the income from each location is significant or insignificant

If fishing is the major source of income for the taxpayer, and the fisher does not maintain a personal residence at the same location as the home port of the fishing vessel, travel expense from a fisher's personal residence to the home port of the fishing vessel are personal commuting expenses that are not deductible under IRC § 162(a)(2). The Tax Court held in [Tucker v. Commissioner, 55 T.C. 783 \(1971\)](#), that "if a taxpayer chooses for personal reasons to maintain a family then his additional traveling and living expenses are incurred as a result of that personal choice and are therefore not deductible."

Crewmembers who annually return to the same boat to fish may also be denied the travel expense deduction.

A fisher's principal or regular post of employment may be regarded as being aboard the fishing vessel or at the port where voyages are ordinarily begun and ended, depending on the volume of business activity conducted on the vessel as compared to business conducted at the port. Thus the "tax home" of a fisher may be the vessel itself or the home port of the fishing vessel.

[Rev. Rul. 55-235, 1955-1 C.B. 274](#), holds that the tax home of commercial fishers is their home port. Evidently, the crewmembers of the fishing vessel at issue in the revenue ruling made frequent trips to their home port, where a large portion of their commercial activities (that is, selling fish) took place. The business locus of these fishers was, therefore, more their home port than their vessel.

By contrast, [Rev. Rul. 67-438, 1967-2 C.B. 82](#), holds that a naval officer assigned to permanent duty aboard a ship having regular eating and living facilities has his or her permanent post of duty, and thus his or her tax home, aboard the moving vessel. The revenue ruling reasons that a ship is a naval officer's regular post of duty, much like a land base is the regular post of duty of an officer in any of the military services permanently assigned to such a base. Such a ship combines the place where a naval officer performs occupational duties with many of the attributes of a home in the ordinary sense.

If the commercial fishers perform the majority of their occupational duties away from their home port while aboard their vessel, and if the vessels have regular eating and sleeping facilities, the fact that the crewmembers do their eating and sleeping in regularly provided facilities makes their situation analogous to that of the naval officer in [Rev. Rul. 67-438](#). In contrast to the fishers described in [Rev. Rul. 55-235](#), the fishers sell most of their catch at points other than their home port, their vessels are outfitted initially at their home port, and they do not, after embarking, return frequently to their home port.

Therefore, the tax home for the commercial fishers will be the location where their major source of income is derived based on all of the facts and circumstances. Their tax home may be where their personal residence is located, it may be where their home port is, or it may be their vessel. No deduction should be allowed for meals provided for crewmembers whose tax home is their vessel because the expenses are not incurred "away from home."

In addition, whenever the vessel is the taxpayer's tax home and the vessel is at port, whether at home port or another shore point, the area in the vicinity of the vessel is considered part of the fisherman's tax home. An individual's tax home is not a particular place, but it includes the general locality in which he or she is customarily employed. See [Rev. Rul. 55-109, 1955-1 C.B. 261, 263](#), modified by [Rev. Rul. 90-23, 1990-1 C.B. 28](#), and [Kroll v. Commissioner, 49 T.C. 557, 561-562 \(1968\)](#).

Some taxpayers do not have a regular or main place of business and there is no place where they regularly live. In this case, they would be considered itinerant (transient), which would not entitle them to travel expense deductions because they are never considered to be traveling away from home.

Once the fisher's tax home has been determined, then the amount of the allowable expenses and limitations can be determined.

IRC § 162(a) provides, in part, that a deduction shall be allowed for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business.

IRC § 274(d) provides, in part, that no deduction shall be allowed under [section 162](#) for any expenditure with respect to traveling away from home unless the taxpayer substantiates the amount, time, place, and business purpose of such expenditure by: (1) adequate records; or (2) sufficient evidence corroborating his own statement.

IRC § 262 provides that no deduction shall be allowed for personal, living, or family expenses.

Traveling expenses include travel fares, meals and lodging, and expenses incident to travel.

Treas. Reg. § 1.274-5 allows the Commissioner to create an optional method of computing travel expenses, including a per diem deduction for meals and incidental expenses, which satisfy the substantiation requirements. The optional method of substantiation is provided in a revenue procedure which is generally updated annually. Taxpayers are not required to use the optional method of substantiation. A taxpayer may deduct actual allowable expenses if the taxpayer substantiates by adequate records or other sufficient evidence.

In general, most fishers are not reimbursed for meals. In computing their share of the catch for fishers, it is common that a set amount per day is deducted for meals or groceries. If the amount paid by the fisher in calculating his share of the catch is not included in income reported to and by the fisher, it must be added back to avoid a double tax benefit: an exclusion from income and a claim for per diem.

The courts have held that no deduction may be claimed for meals if no expenses were paid or incurred by the individual. An employee or self-employed individual who pays or incurs incidental expenses, but not meal expenses, may claim either the actual expenses or an amount for incidental expenses as provided in the annual revenue procedure for per diem allowances. The per diem rate for 2010 is \$5 per day.

Where a set amount has been deducted for meals, a fisher, who is away from home, is entitled to use the optional method for computing meals and incidental expenses even if the amount paid is less than the federal per diem rate. Actual receipts are required to substantiate lodging.

In general, whether a fisher substantiates his expenses by either the actual method or the optional method, only 50% of the business-related meals and entertainment expenses may be deducted. This applies to both employees and self-employed individuals. There are limited exceptions, such as amounts related to expenses that are required by Federal law

to be provided to crewmembers of a commercial vessel. The legislative history and the courts have held, however, that this exception does not apply to fishing vessels.

Detailed information on travel expenses and recordkeeping requirements are available in Publication 463, Travel, Entertainment, Gift and Car Expenses.

For a self-employed fisher, these expenses would be deductible as a business expense on Schedule C. If the fisher is an employee, then the expenses are deductible as employee business expenses reportable on Form 2106, Employee Business Expenses or on Form 2106-EZ, Unreimbursed Employee Business Expenses.

A fisher's status as self-employed or employee can change from voyage to voyage. See Chapter 3, Employment Status.

## **Examination Techniques**

- Establish the location of the taxpayer's residence.
- Establish the various locations of the taxpayer's work during the year to determine the taxpayer's "tax home."
- Determine if the taxpayer has "minor" or secondary work locations for which he may qualify for living expenses for work away from his tax home.

## **Documents to Request**

- Reconciliation of travel and expenditures to return
- Calendar and/or log book

## **Interview Questions**

- Do you have another source of income other than fishing?
- If so, please explain the source and where it was earned.
- Where is your primary residence?
- How much time do you spend there?
- Who pays the expenses for that home?
- Where do you fish?
- How much time do you spend on the vessel(s)
- How much time do you spend in port?

## **Supporting Law**

Rev. Rul. 54-497, 1954-2 C.B. 75 Taxpayer's "tax" home is the place where he conducts his trade or business (such as selling his catch); expenses incurred by a fisher for meals and lodging at his principal or regular post of duty are not deductible even though such place is located at a distance from his residence; expenses incurred between tax home and

minor or temporary place of employment may be deducted as traveling expenses while away from home.

Rev. Rul. 55-109, 1955-1 C.B. 261 A taxpayer can deduct actual transportation expenses only to the extent they do not exceed the transportation expense taxpayer would have incurred had taxpayer gone directly from one business location to the other.

Rev. Rul. 55-235, 1955-1 C.B. 274 The tax home of commercial fishers is their home port where their fishing trips ordinarily begin and end; expenditures for protective clothing, special gloves, boots may be deducted as itemized expenses subject to 2% limitation.

Rev. Rul. 55-236, 1955-1 C.B. 274 Tax home is not limited to a particular building or property but includes the entire city or general locality.

Rev. Rul. 60-189, 1960-1 C.B. 60 Taxpayer who does not return to any particular work location, but has a location near his personal residence where he makes his employment contacts (union headquarters), is deemed to have a tax home at the location of the employment contacts.

Rev. Rul. 67-438, 1967-2 C.B. 82 "Tax home" for a fisher is his boat if substantial business activity takes place aboard the boat (catch is sold from the boat in various ports or to other boats) and the boat provides regular eating and living facilities.

Rev. Rul. 72-385, 1972-2 C.B. 536 Defines whether fishers performing services on a vessel qualify as employees (later more specifically defined under IRC § 3121(b)(20)).

IRC § 162(a)(2) Traveling expenses (including amounts expended for meals and lodging - not lavish or extravagant) while away from home in pursuit of a trade or business are allowable.

Rev. Proc. 2010-39, 2010-42 I.R.B. 459, Per Diem Allowances Deemed substantiation under IRC § 274(d) and Treas. Reg. § 1.274-5. Note that the revenue procedure is updated annually.

*Tucker v. Commissioner*, 55 T.C. 783 (1971) If a taxpayer chooses for personal reasons to maintain a family residence far from his personal place of employment or "tax home", then the additional traveling and living expenses incurred as a result of that personal choice are considered personal commuting expenses and not deductible.

*Johnson v. Commissioner*, 115 T.C. 210 (2000)

*Westling v. Commissioner*, T.C. Memo. 2000-289

*Balla v. Commissioner*, T.C. Memo. 2008-18

*Zbylut v. Commissioner*, T.C. Memo. 2008-44

Merchant sailors were limited to the incidental expense portion of applicable meals and incidental expenses (M&IE) per diem rate. Because taxpayers were provided meals, they did not pay or incur the expense and were, therefore, not entitled to the full deduction.

*Kurtz v. Commissioner*, T.C. Memo. 2008-111

Taxpayer was an independent contractor on a commercial fishing vessel. \$25 per day was deducted from his pay for meals. The taxpayer used the federal per diem rate for meal and incidental expenses (M & IE) he incurred. The taxpayer argued that maritime common law and a statutory exception permitted crewmembers of a commercial vessel to deduct 100% of expense for food and beverages. The Tax Court held that these exceptions did not apply to fishing vessels. The court held that an individual working on a fishing vessel is limited to 50% of applicable M & IE rates pursuant to IRC § 274(n)(1)(A). This determination by the Tax Court was affirmed by the 11th Circuit Court of Appeals in *Kurtz v. Commissioner*, 575 F.3d 1275 (11th Cir. 2009).

## **Resources**

Publication 463, Travel, Entertainment, Gift and Car Expenses

# Chapter 8 - Business Use of Home

## Principal Place of Business

To deduct expenses related to the business use of part of his or her home, a taxpayer must meet specific requirements. The net income/loss of the business limits the deduction.

To qualify for the business use of home deduction, part of the home (or a separate structure) must be used exclusively and regularly for the taxpayer's trade or business. The business area of the taxpayer's home must also be the principal place of business. A separate structure qualifies as a business location if it is used in connection with the taxpayer's business. A fisher's principal place of business is usually located at either a boat or a port. However, a portion of a fisher's residence may qualify as the principal place of business if the area is used exclusively and regularly for the administrative or management activities of the fisher's trade or business and there is no other fixed location where substantial administrative or management activities of the trade or business takes place. In other words, if the self-employed fisher is taking care of books and records, paying bills, and making business calls from a qualified area of his home, then this location would qualify as a principal place of business. In addition to taking the deduction for business use of home, the fisher would then be entitled to take the mileage from the home business location to the boat or port as a business expense. This would be considered going from one business location to another business location.

Crewmembers who are considered self-employed under IRC § 3121(b)(20) do not qualify for the business use of home deduction because they are not in a trade or business. They qualify as self-employed for self-employment tax, retirement and pension plans, and the health insurance deduction only.

The size of the area in the home used exclusively for business purposes may be determined based on a percentage of square footage, or by using the number of rooms in the home if the rooms are approximately the same size. See Pub. 587, Business Use of Your Home, for details regarding qualifying expenses and necessary computations.

If a taxpayer is involved in more than one business, the same area may be used for each business, however, each business must qualify under the business use tests or neither business will qualify. For example: Todd is a fisher and a rope salesman. He uses the same space in his home to conduct business for both these endeavors. Although Todd's use of his home for the fishing enterprise qualifies as a business use, it does not qualify as business use of the home for the rope business because his employer for that business provides him with an office at its headquarters. Since the business area used in the house for both businesses qualifies only under one business, the space does not qualify for either business.

## Examination Techniques

- The initial interview needs to establish the use of the space which is identified as business use only.
- Is the business use of home amount material? Is there a related travel deduction which is material?
- Verify that the real estate taxes and home mortgage interest deducted as a business use expense are not duplicated on Schedule A as itemized deductions.

## Issue Identification

- The area of the home used for a business deduction needs to be separately identifiable. It does not need to have walls but must be visually segregated from the remainder of the home area. Area dividers or some kind of separators are deemed adequate.
- The business area must be used **exclusively** for business. For example, if the family computer is located in this area, then the area is not used exclusively for business if any activity is performed on the computer other than the business record keeping. Also, if personal bill paying is done in this area or if the children use the computer to do homework or play games, then the space is not exclusively used for business.
- The business area of the home must be used regularly for business purposes only. For example, a taxpayer may have two rooms he claims for business use. One room contains his business office and satisfies the exclusive and regular use qualifications. The second room is not used for personal use but is occasionally (a few times a year) used to meet with some suppliers. This meeting could be held in the home office room but the taxpayer has elected to use the second room in order to claim business use. Since the second room is not used regularly for business and is not necessary, it does not qualify as a business use of home area.
- The basic local telephone service charges on the first line in the residence are not deductible as a business expense. Additional charges for business long-distance calls, equipment purchased for use in the business operation and a phone line added for the exclusive use of the business operation would be deductible. Optional services, such as call waiting, may be deductible if added because of the business activity.
- If the taxpayer is a partnership, S corporation, or C corporation, then the business space in the home can be rented to the business entity and rental income would be reflected on the individual return.

## Documents to Request

- A copy of the computation used to determine the business use space vs. the personal space. This should include the total dimensions of the home and the dimensions of the business space.
- Copies of selected invoices to verify utilities, real estate taxes, mortgage interest, insurance, etc.

- Documents to establish the cost or other basis of the home including the value of the land, as well as the fair market value of the home at the time the business use began.

## **Interview Questions**

- Describe the area in your home that is used exclusively for your business. Size? How is it separate from the rest of the home?
- In detail, what do you do in this area of your home? Record keeping? Bill paying? Business phone calls? How often do you use this area of your home?
- What equipment and furniture is in this space? (A sofa could be used to house guests for personal use, especially a sleep sofa.)
- Where do you maintain and pay your personal bills? Where do you maintain your personal banking information?
- How large is your home - square footage or number of rooms?
- How was the business percentage determined?
- Do you have a business computer? Where is it located? What files are maintained on this computer? Do you have a family computer? Where is it located?

## **Supporting Law**

IRC § 280A Use of residence for business purposes.

IRC § 280A(c)(1) Allows business use of home if conducting majority of administrative or management activities in the qualified home space.

IRC § 262(b) First telephone line shall be considered personal.

Notice 93-12, 1993-1 C.B. 298 Implements Commissioner v. Soliman, 506 U.S. 168, 113 S.Ct. 701 (1993), which held that the taxpayer's dwelling unit must qualify as the principal place of business to claim the deduction for business use of home (codified in 1999 by IRC § 280A(c)(1)).

## **Resources**

Publication 587, Business Use of Your Home Form 8829, Expenses for Business Use of Your Home computation form

Publication 334, Tax Guide for Small Businesses

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# Chapter 9 - Health Insurance

## Issue

A deduction for accident and health insurance or qualified long-term care insurance is available for:

- Self-employed individuals with a net profit reported on Schedule C, C-EZ or F, to the extent of net profit less deductions for retirement plans (Keogh, self-employed SEP or SIMPLE plans) and the deduction for 50% of the Self-Employment tax taken on the first page of the Form 1040;
- Partners with net earnings from self-employment reported on Form 1065, Schedule K-1 to the extent of self-employment earnings from the partnership less deductions for retirement plans (Keogh, self-employed SEP or SIMPLE plans) and the deduction for 50% of the Self-employment tax taken on the first page of the Form 1040;
- S corporation employee/shareholders holding 2% or more of the corporation's stock, to the extent of W-2 wages from the S corporation. If premiums are paid by the business on behalf of the S corporation employee/shareholder, the premiums must be included in the employee/shareholder's income.

The accident and health insurance plans must be established under the business name. The deduction for self-employed accident and health insurance is taken as a reduction of total income to arrive at AGI on the first page of the Form 1040. If the taxpayer is eligible to participate in any employer-subsidized health plan (including his/her spouse's), at any time during any month, the taxpayer does not qualify for the health insurance deduction during that month. This rule is applied separately to plans that provide long-term care insurance and plans that do not provide long-term care insurance. In other words, if an individual participates in his/her spouse's employer-provided health plan which does not offer long-term care insurance, any premiums paid for long-term care insurance which is established under the business name are deductible by the individual subject to the appropriate limitations.

The deduction for accident and health insurance and qualified long-term care insurance includes premiums paid for the individual, the spouse, and dependents. Qualified long-term care insurance requires a qualified contract and must be for qualified long-term care services. The amount deductible for long-term care insurance is limited by the amount paid and the age of the person.

Self-employed fishers who have net income from their fishing activity qualify for this deduction. Crewmembers who receive a percentage of the catch are also entitled to this deduction since they qualify as self-employed for this purpose under IRC § 401(c).

IRC § 162(l) allows a deduction for health insurance costs in computing self-employment taxes for 2010 only. A self-employed individual is allowed a deduction equal to the

amount paid during the taxable year for insurance that constitutes medical care for himself/herself, his/her spouse, dependents, and, as of March 30, 2010, any child of the taxpayer who at the end of the taxable year has not attained age 27.

IRC § 45R provides a credit of up to 50% for a small employer who meets certain statutory requirements. The credit phases out gradually for firms with average wages over \$25,000 and for firms with more than 10 full-time workers.

The employer must meet three requirements:

- A qualifying employer must cover at least 50 percent of the cost of health care coverage for some of its workers based on the single rate.
- A qualifying employer must have less than the equivalent of 25 full-time workers (for example, an employer with fewer than 50 half-time workers may be eligible).
- A qualifying employer must pay average annual wages below \$50,000, to be adjusted annually beginning in 2014.

## **Examination Techniques**

- Verify that the insurance contracts were established under the business name. A crewmember who receives a percentage of the catch, but does not have a business name, may report his/her fishing proceeds on the Schedule C under his/her own name. The insurance contract may be in the individual's name. This would not disqualify the individual from taking this deduction.
- Verify that the premiums were not deducted as a business expense for a Schedule C business. If the Schedule C has employees, check the employee list for the business owner's spouse. Verify that the spouse is a bona fide employee of the business operation and qualifies as an employee participant in the health insurance plan. If the spouse is a qualified participant, premiums for any health insurance policy in the spouse's name would qualify for a full deduction as a business expense as would any other qualified employee's policy cost. If the business owner and the spouse are insured under separate policies, then the business owner's policy would be non-deductible on Schedule C, but would qualify as an adjustment to income based on the appropriate percentage and net income requirements. NOTE: Community property states may deem the spouse to be a 50% owner. As an owner, the spouse would not qualify for treatment as an employee.
- Premiums for health insurance paid by a partnership on behalf of a partner for services as a partner are treated as guaranteed payments. As guaranteed payments, the premiums are deductible by the partnership and includible in the partner's gross income. Constructive rules of ownership apply. The partner may deduct the cost of the premiums subject to applicable limitations. The partnership must report the cost of health insurance premiums on Form 1065, Schedule K-1. A partnership may account for health insurance premiums paid on behalf of a partner as a reduction in distributions to the partner. Under these circumstances, the premiums are not deductible by the partnership. The partner's distributive

share of partnership income and deduction is not affected by the payment of the premiums. A partner may deduct the cost of the premiums subject to the appropriate limitations.

- Premiums for health insurance paid by an S corporation on behalf of a more than 2% shareholder are deductible on the corporate return, and the shareholder must include the amount of the premiums in income on his/her Form 1040. Constructive rules of ownership apply. The income should be included on the shareholder's Form W-2 as taxable wages. Those wages are not subject to FICA or FUTA as are regular wages. If the amount of the premium is not included on the shareholder's Form W-2, it should be reported as Other Income on Line 21 of the shareholder's Form 1040.

The amount of premiums paid by the S corporation on behalf of each shareholder should be reflected on each shareholder's Schedule K-1, Line 23, Supplemental Information. The reason for the K-1 reporting is twofold. First, if the amount of the premium is not included in the shareholder's Form W-2, there must be a statement on the K-1, Line 23, showing the amount of the premiums to be included as other income on the shareholder's Form 1040. Second, these premiums are deductible on the shareholder's individual return, subject to the limitations mentioned above. An S corporation shareholder is considered self-employed with regard to medical insurance premiums.

If the shareholder does not work for the S corporation, the shareholder cannot have any earned income from the activity. Also, if the shareholder or the shareholder's spouse is allowed to participate in any subsidized health plan maintained by any employer of the taxpayer or the taxpayer's spouse, the shareholder is not allowed to deduct self-employed medical insurance as an adjustment to income. Any amount not allowed as an adjustment to income is allowable as an itemized deduction. See Publication 535, Business Expenses, for the Self-Employed Health Insurance Deduction Worksheet.

- A special computation is required if the taxpayer has more than one health plan established under different business names. See Publication 535 for details.
- No deduction is allowed for self-insurance reserve funds.

## **Issue Identification**

- Check the taxpayer's Form 1040 for a claimed adjustment to income for health insurance premiums.
- Verify that Schedule C, C-EZ, or F show a net profit. Verify that partnership net earnings from self-employment are reflected on Schedule K and K-1 of Form 1065, and carried over to the individual return. Verify that Form W-2 wages from the S corporation are reflected on the individual return.
- Health insurance premiums may be reflected under insurance expense, employee benefits, or some other category.
- If a taxpayer itemizes, verify that the insurance premiums deducted on line 28 of Form 1040 are not included in the itemized deductions.
- Verify that the insurance plan is established under the business name.

- Verify that the taxpayer **does not qualify** to be covered under any employer-subsidized plan or under a spouse's employer-subsidized plan.
- Verify that limitations, if applicable, have been followed.
- If the spouse works for the business operation, verify that the work done is as an employee and not as an independent contractor, using the common law factors to make the determination. If the spouse is an independent contractor, the cost of accident and health insurance may not be excluded by the spouse under IRC § 106(a).
- Check the health plan adoption agreement and the plan document to determine whether the employee-spouse has satisfied all service requirements under the plan. Verify that the spouse is the named owner of the health plan.
- If an employee-spouse qualifies to deduct the health insurance premium, check who owns the business assets. Whose name(s) are on the accounts? The spouse may be a co-owner rather than an employee.

## Documents to Request

- Copy of the business health and long-term care insurance plan.
- Copy of the health insurance policy which includes who is covered, the amount of the premium, and who is the owner of the policy.
- Detail of the insurance expense as claimed on the return which identifies the payees, related amounts, and dates paid.

## Interview Questions

- Does your business have a qualified health insurance plan?
- Does your business have a qualified long-term care insurance plan?
- Who pays for your health insurance premiums?
- Do you or your spouse qualify to be covered under an employer health insurance plan?

If the spouse works for the business:

- What are the duties of the spouse?
- How many hours per week does the spouse work in the business operation?
- How is the spouse paid for the work provided to the business operation?

## Supporting Law

IRC § 45R Provides a credit of up to 50% for a small employer who meets certain statutory requirements.

IRC § 162(l) Allows a deduction for health insurance for purposes of computing self-employment tax for 2010 only.

IRC § 106 Excludes from the gross income of an employee accident or health plan coverage provided by an employer.

IRC § 162 (l) Establishes allowable percentage deductions for health premiums; plan must be established under the business; deductions are limited to net positive earnings; premiums are not deductible if individual or spouse qualifies for employer-sponsored health coverage; individual's S corporation wages are treated as individual's earned income.

IRC § 267(e)(3) Constructive ownership in the case of partnerships.

IRC § 318 Constructive ownership of stock.

IRC § 401(c)(1) Self-employed individual is considered an employee for health plan provisions; health plan must be established under the business for this treatment.

IRC § 401(c)(6) Specifically includes fishers described under IRC § 3121(b)(20) who are crewmembers as qualifying for self-employed status.

IRC § 419 Employer deduction for qualified welfare benefit plans.

Rev. Rul. 60-275, 1960-2 C.B. 43 & Rev. Rul. 57-485, 1957-2 C.B. 117 Self-insurance amounts not immediately deductible; amounts paid for actual expenses may be deductible.

Announcement 92-16 Health insurance premiums for 2% shareholder/employees of S corporations may be excluded from FICA tax.

Rev. Rul. 91-26, 1991-1 C.B. 184 Partnership rules apply to S corporation for fringe benefit purposes.

Rev. Rul. 71-588, 1971-2 C.B. 91 Amounts expended for qualified employee health care plan of sole proprietor are fully deductible, including premiums paid for the owner's wife/family who are bona fide employees of the business operation.

## **Resources**

Publication 535, Business Expenses

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# **Chapter 10 - Capital Construction Fund**

## **Background**

The Capital Construction Fund (CCF) program was established as part of the Merchant Marine Act of 1936, at 46 USC § 1177. Qualifying U.S. citizens may enter into an agreement with either the Department of Commerce (DOC), with respect to the vessels operated in the fisheries of the United States, or the Department of Transportation (DOT), with respect to all other vessels, to establish a tax-deferred reserve fund in order to provide for the acquisition, construction or reconstruction of a qualified vessel. Amounts deposited into the fund are deductible in computing taxable income and the earnings from the fund are excluded from income if left on deposit. Qualified withdrawals made for the acquisition, construction, or reconstruction of a qualified vessel do not result in taxable income. Nonqualified withdrawals are subject to taxation at the highest rate of tax imposed under IRC § 1 (for individuals) or IRC § 11 (for corporations). The resulting tax liability is subject to interest payable from the last date prescribed for payment of tax for the taxable year for which the amount was deposited into the fund.

Fishers who own or lease a fishing vessel used in a fishing operation may contribute to an approved CCF. The National Marine Fisheries Services (NMFS) has overall responsibility for oversight of the program with respect to commercial fishers. The Internal Revenue Service is responsible for the tax administration of the program.

## **The Technical Workings of the Fund**

The Merchant Marine Act of 1936 originally authorized the establishment of the CCF as a deduction on tax returns on a limited basis. It was not until revision of the Act in 1970 that fishing vessels qualified for this treatment. The Act was again revised in 1976, loosening the documentation requirements for vessels.

## **How the Program Works**

Any vessel owner or lessee has the opportunity to set aside part of his or her current taxable income for capital improvements on a vessel, toward the building of another vessel or acquisition of a used vessel. By setting aside these earnings, the vessel owner may deduct certain contributions made to the fund, depending on the source of earnings, or may defer the gain on certain sales of qualifying assets. Funds withdrawn in accordance with the agreement are tax-free. However, the basis of the asset must be reduced by the amount of the CCF funds used.

## **Example 1**

Joe Fleming has \$150,000 of earnings from the operations of F/V (fishing vessel) Wendy in 2010. In agreement with the NMFS, Joe decides to set aside \$100,000 of this money for the purchase of a larger vessel in three years. Joe's taxable income is reduced by \$100,000 for the taxable year 2010, provided the money is deposited into a designated account by the due date of the tax return, with extensions. When Joe eventually replaces his boat and uses the \$100,000 in the purchase, his basis in the vessel will be the purchase price less the \$100,000 of CCF money. Reducing the basis avoids a double deduction which would have resulted because he effectively expensed the \$100,000 earlier by deducting this amount on his 2010 tax return.

## **Eligibility Requirements**

- The taxpayer must be a U.S. citizen (individual), a corporation, a partnership or a Limited Liability Company. If other than an individual, the applicant must be 75-percent owned by U.S. citizens, and the president and majority of the board must also be U.S. citizens.
- The taxpayer must own or lease an eligible vessel.
- The vessel must be built in the United States and, if rebuilt, must be reconstructed in the United States.
- The vessel must be used commercially in U.S. Fisheries or in U.S. foreign trade, non-contiguous domestic trade (for example, Alaska to Seattle) or on the Great Lakes.
- Fishing vessels that are not under 2 net tons and not over 4 net tons require no Coast Guard certification to participate in the CCF program, but their home port must be in the United States. Those vessels which are five net tons or greater (approximately a 25-foot vessel) require Coast Guard certification and documentation for "Fishery."

## **Establishing a CCF Account**

To establish a CCF account, the taxpayer must enter into an agreement with the NMFS as to agreement vessels, planned use of withdrawals, and the CCF depository.

The contract, drawn up between the taxpayer and the NMFS, designates at least one vessel as the income-producing vessel (the "Schedule A vessel") and at least one vessel which is to benefit from the CCF funds (the "Schedule B vessel"). The Schedule A vessel is the vessel producing the income to be deferred. The Schedule B vessel is the vessel that will be constructed, reconstructed or acquired with funds from the CCF account.

If there is more than one person operating the agreement vessel, it is important to understand the share of the income for applying limitations.

The definition of an agreement vessel is found in 26 CFR § 3.2(f):

For purposes of this section, the term agreement vessel includes any shares in an agreement vessel. Solely for purposes of this section, a party is considered to have a "share" in an agreement vessel if he has a right to use the vessel to generate income from its use, whether or not the party would be considered as having a proprietary interest in the vessel for purposes of state or federal law. Thus, a partner may enter into an agreement with respect to his share of the vessel owned by the partnership and he may make deposits of his distributive share of the sum of the four subceilings [eligible tax ceilings]. Notwithstanding the provisions of the Code (relating to the taxation of partners and partnerships), the Internal Revenue Service will recognize, solely for the purpose of applying this part, an agreement by an owner of a share in an agreement vessel even though the "share" arrangement is a partnership for purposes of the Code.

### **Example 2**

Both a partnership and a partner may contribute to a CCF fund. The partnership must contribute before computation of partnership ordinary income. A partner must contribute based on his or her distributive share of income from the qualifying fishing operation.

### **Example 3**

Party "A" owns a fishing permit and party "B" owns a fishing vessel. Together, they have the means to fish (permit + vessel), but separately they cannot. Their agreement to combine and fish establishes that the two parties together have the "right to use the vessel to generate income from [the vessel's] use" thereby fulfilling the "share" requirement above.

### **Example 4**

In the case of a closely held corporation, if the shareholder receives remuneration from the corporation and contributes this amount into a CCF fund, it is NOT considered an allowable contribution. The shareholder/employee is paid as an employee of the owner of the vessel (that is, the corporation) and as such does not have a share interest in the vessel income.

### **Example 5**

A partner who maintains an individual CCF fund with respect to the partnership's eligible vessel, and uses the funds to purchase a new qualified vessel, cannot transfer the vessel to the partnership and avoid recognition of gain based on FMV.

## Fund Deposits

The funds must be deposited and retained in an approved financial institution in a separate account established solely for that purpose. The funds cannot be commingled with any other business or personal account. The deposits must be from sources which qualify for a tax deduction. It is possible to have more than one CCF depository account.

Deposits to a CCF fund and withdrawals from the fund should always be considered as two separate transactions, even if they are made on the same day at the same hour.

In some cases, a fisher takes a deduction on his or her income tax return for CCF contributions or excludes from income certain contributions to specific CCF accounts. The qualified sources of funds for contributions to the CCF come from three types of bookkeeping accounts: the ordinary income account, the capital account, and the capital gain account. The total CCF deposits and earnings are limited to the amount attributed to these three accounts for any year.

The ordinary income account consists of deposits attributable to

1. Any earnings (without regard to the carryback of any net operating or net capital loss) from the commercial operation of agreement vessels in the fisheries of the United States or in the foreign or domestic commerce of the United States. This contribution is tax deductible.
2. Any capital gain from the following sources reduced by any capital losses from assets held in the CCF account for six months or less:
  - a. The sale or other disposition of agreement vessels held for six months or less. Taxable amount is not included in income. No tax deduction is allowed for this contribution but gain is deferred.
  - b. Insurance or indemnity proceeds attributable to agreement vessels held for six months or less. Taxable amount is not included in income. No tax deduction is allowed for this contribution but gain is deferred.
  - c. Any capital gain from assets held in the CCF account for six months or less. Taxable amount is not included in income. No tax deduction is allowed for this contribution but gain is deferred.
3. Any ordinary income, such as depreciation recapture, from either
  - a. The sale or other disposition of agreement vessels. The recapture amount is not reflected as income. No tax deduction is allowed for this contribution; or
  - b. Insurance or indemnity proceeds attributable to agreement vessels. Taxable amount is not included in income. No tax deduction is allowed for this contribution.
4. Any interest (not including tax-exempt interest from state and local bonds), most dividends, and other ordinary income earned on the assets in the taxpayer's CCF account. Amount included in income. Deduction is allowable.

The **capital gain account** consists of the amounts attributable to the following items reduced by any capital losses from assets held in the CCF account for more than six months:

1. Any capital gain from either
  - a. The sale or other disposition of agreement vessels held for more than six months. No deduction but the gain is deferred; or
  - b. Insurance or indemnity proceeds attributable to agreement vessels held for more than six months. No deduction but gain is deferred.
2. Any capital gain from assets held in your CCF account for more than six months. No deduction but gain is deferred.

The **capital account** consists primarily of amounts attributable to

1. Allowable depreciation deductions for agreement vessels. This is an amount equal to the amount of depreciation claimed on the tax return for the qualifying Schedule A vessel. No tax deduction is allowed for this contribution.
2. Any nontaxable return of capital from either (a) or (b), below.
  - a. The sale or other disposition of agreement vessels. No tax deduction for this contribution.
  - b. Insurance or indemnity proceeds attributable to agreement vessels. No tax deduction for this contribution.
3. Any tax-exempt interest earned on state or local bonds in your CCF account. No tax deduction for this contribution.

## **Maximum Deposits (Sub-Ceilings)**

A deposit may be made in an amount which is the sum of the following sub-ceilings:

1. Lower of (a) taxable income, or (b) taxable income attributable to the operation of the Schedule A vessel,  
Plus
2. Depreciation of the Schedule A vessel (an amount equal to the depreciation claimed on the tax return for the Schedule A vessel),  
Plus
3. Net proceeds from the sale or other disposition of the Schedule A vessel,  
Plus
4. The earnings from investment of CCF money.

The sum of items 1 through 4 is eligible for deposit into the CCF account. The ceiling for a tax deduction is limited to the amount in item 1.

## **Definition of Taxable Income Attributable to Operations of a Schedule A Vessel**

- Normally, the only source of income for a fisher is from his or her Schedule A vessel.
- General rules of allocation of expenses prevail; regulations refer to principles established by Treas. Reg. § 1.861-8.
- For related parties, arm's-length pricing shall be used (or as adjusted under IRC § 482).
- Taxable income is computed under the taxpayer's method of accounting.
- Taxable income is computed without consideration of an NOL carryback or capital loss.

## **Minimum Deposits**

The Secretary of Commerce has the right to determine the minimum annual deposit. NMFS requires annual deposits of the lesser of: (a) 2 percent of the total anticipated cost of all Schedule B objectives; or (b) 50 percent of taxable income. Further rules allow a 3-year averaging of deposits to meet these criteria.

## **Timing of Deposits**

Constructive deposits and withdrawals are only available in the first taxable year of the CCF Agreement up until the effective date of the CCF Agreement. Once an Agreement with NMFS is established, in order for the deposits to qualify, they must be physically deposited by the due date of the tax return plus any extensions.

The Internal Revenue Code specifies requirements for maintaining an ordinary income account, a capital "gains" account, and a capital account for the fund. Details of these three accounts are reflected under Fund Deposits earlier in this chapter. For additional information on the maintenance of accounts, see joint regulations found at 50 CFR § 259 and IRC § 7518.

## **Investments of the Fund**

The earnings on investments in the fund are tax deferred as long as the ultimate use is for a fund objective.

The investments must be maintained in a specific depository or account, kept segregated, and used exclusively for CCF objectives. NOAA/NMFS, Financial Services Division provides a CCF Program Investment Guide which details the types of allowable and non-allowable investments.

The allowable types of investments are only the most conservative, such as interest-bearing notes, usually government securities. The Merchant Marine Act specifies that no more than 60 percent of the assets of a CCF fund may be invested in the stock of domestic corporations which are listed and registered on an exchange registered with the Securities and Exchange Commission as a national securities exchange. 46 USC § 1177(c).

The regulations do allow certain "non-cash" contributions to the fund. It does not allow a fund holder to buy a recreational boat from contribution funds and then "redeposit" the asset as a noncash deposit, nor does it allow the fund to invest in such assets.

## Qualified Withdrawals

Qualified withdrawals must be used to acquire, construct, or reconstruct a new or used vessel or skiff, including but not limited to payments in direct acquisition or payments for a lease with a minimum of a five-year duration. When a taxpayer makes a qualified withdrawal, the amount is treated as being withdrawn first from the capital account, then from the capital gain account and finally, from the ordinary income account. The following are examples of qualified withdrawals:

- All capital costs, including travel, deductible portion of meals, and lodging, if the taxpayer is self-constructing his/her vessel, the project is away from the taxpayer's tax home and the capital expenses are incurred in connection with the inspection of vessel construction or reconstruction. Wages and other expenses deemed attributable to construction or reconstruction activities are also eligible.
- The overhaul of vessel machinery, including but not limited to rebuilding engines and generator sets, hydraulics and steering systems, if considered an integral part of the vessel.
- Upgrading or acquiring equipment, including but not limited to booms, blocks, reels and drums, if considered an integral part of the vessel.
- Trawl nets: a cone or funnel-shaped net, continuously attached to the fishing vessel, which is towed or drawn through the water by a fishing vessel and includes any gear appurtenant to the net.
- Upgrade of the vessel hull, including but not limited to reconstructing or expanding top house and lengthening the vessel.
- Upgrading or acquiring vessel electronics.
- Installation of safety equipment, including but not limited to life rafts, alarms, electronic navigation, communication equipment, electronic emergency beacon (EPIRB), fire control equipment and special non-skid coatings to vessel surface.
- Mortgage payments on a vessel mortgage (principal portion only).
- A qualified withdrawal also includes the earnings on investments (investment income). However, if earnings are withdrawn in the year earned they shall be considered as taxable, unless specifically excludable.

In order to qualify as an eligible CCF withdrawal, the expenditure must be an otherwise capitalized cost. Some components of nets or gear, for example, components of troll

gear, may be expense items. CCF withdrawals cannot be used to pay for any expense items. NOAA/NMFS will not authorize withdrawals for any nets that are not continuously attached to the vessel. NOAA/NMFS has specifically identified the following gear as not allowable - seine nets, gill set-nets, gill drift-nets, pots, traps and longline.

## **Basis Reduction**

The basis of assets acquired with CCF money funds must be reduced by the amounts of qualified withdrawals from the CCF.

### **Example 6**

A taxpayer acquires a fishing vessel for \$1,000,000 and uses \$250,000 of CCF money for the purchase. The basis of the vessel for depreciable purposes will be \$750,000.

## **Mortgage Payments**

The CCF program allows a taxpayer to use CCF money to make principal payments on the debt of Schedule B vessels up to the lesser of mortgage balance or depreciable basis at the beginning of the tax year. Frequently, these funds are deposited into the CCF account and are immediately withdrawn to make payments on the vessel mortgage. Only the amount of the principal is allowable as a qualified withdrawal. The basis reduction in this case may be taken as the funds are paid or, at the election of the taxpayer, the basis may be adjusted by all payments in the first six months of a taxable year to be effective on the first day of the year. Payments made in the second half of the year will be effective in reducing basis on the first day of the succeeding year. See 26 CFR § 3.6(d).

NMFS administration allows a CCF deposit to be made in a subsequent year, before the due date of the tax return, and then withdrawn to reimburse the general fund of the fisher for the principal payments on a vessel. The basis adjustment is still governed by the date the principal payments are made, not the date of the CCF deposit. This may be an audit issue because NMFS has no legislative authority for this policy determination.

46 CFR § 390.9(c) limits withdrawals for reimbursements to a party's general funds for a period not exceeding 120 days after the eligible expenditures.

### **Two Special Cases on Mortgages**

**Case One:** A taxpayer applies CCF funds toward a mortgaged vessel where the tax basis of the vessel, through depreciation and prior CCF contributions, has been reduced to zero (\$0). The excess may be applied to reduce the basis of another vessel. For example:

Cost of the vessel	\$600,000	
Prior CCF basis reduction	\$(250,000)	
Accumulated depreciation	\$(200,000)	
Beginning balance tax basis	\$150,000	
Current year principal mortgage	\$(250,000)	Payments from CCF funds
Payment in excess of basis	\$(100,000)	

Per joint regulations, 26 CFR § 3.6(c)(3), the payment will be applied in the following order:

1. to reduce the basis of other schedule B vessels owned by the taxpayer (26 CFR § 3.6(c)(3)(i));
2. any other Schedule A vessel which is not a Schedule B vessel (26 CFR § 3.6(c)(3)(ii));
3. against any other vessel owned by the taxpayer (26 CFR § 3.6(c)(3)(iii));
4. nonqualifying withdrawals, as taxable income at the maximum tax rate. No interest is assessed on this type of nonqualified withdrawal (26 CFR § 3.7(e)(3)).

**Case Two:** A taxpayer refinances a Schedule B vessel for an amount in excess of his tax basis. For example:

Original cost of the vessel	\$750,000
Prior CCF basis reduction	\$(350,000)
Accumulated depreciation	\$(200,000)
Tax basis before refinance	\$200,000
Original mortgage balance	\$50,000
Refinance proceeds	\$250,000
Total loan amounts	\$300,000
Less tax basis before refinance	\$(200,000)
Receipt in excess of basis	\$100,000

Should these circumstances exist, there is additional taxable income of \$100,000 subject to the tax rate for nonqualified withdrawals. This is the amount by which the total loans exceed the tax basis. "It may be appropriate, for example, under some circumstances, to treat the mortgaging of the vessel as in effect the sale of the vessel." (S. Rep. No. 91-

1080, 91st Cong., 2d Sess. 49, 52; H.R. Rep. No. 91-1073, 91st Cong., 2d Sess. 47 (1970).)

If the proceeds are (1) channeled through a CCF fund and (2) used for the prescribed purpose of the fund, then no taxable income is triggered. If, for example, the new proceeds are used to put a new power plant in the vessel, no additional income is triggered, as shown in the following example.

### **Example 7**

Using the facts in Case Two. The taxpayer purchases a new \$150,000 power plant for use in his vessel. His basis in the power plant would be:

Cost of new power plant	\$150,000
Less receipts in excess of basis	\$(100,000)
Basis of new power plant	\$50,000

CCF funds cannot be pledged as collateral for other loans or assets without prior written consent from the Secretary of Commerce. To do so could trigger the termination of the fund. The amount pledged will be considered as having been distributed in a nonqualifying withdrawal.

## **Nonqualifying Withdrawals**

The general rule is that anything that is not a qualified withdrawal is a nonqualified withdrawal. The following examples fall under the category as nonqualified withdrawals:

- Payment of expenses that qualify for tax deductions in the current year (operating expenses), including but not limited to expenses for labor, materials, supplies, fuel, bait, auto expenses, legal and professional fees, supplies, and machinery and equipment that are not considered an integral part of the vessel.
- Fishing permits and licenses.
- Fishing rights, including but not limited to set-net sites and vessel moratorium rights.
- Shore-based capital assets, including but not limited to docks, real property, machinery, and vehicles.
- Other capital assets, including but not limited to set-net site survey and moorings.
- Payments for repairs.
- Payments of interest expense.
- Acquisition or reconstruction of fishing gear, including pots, traps, longline, and for any nets not continuously attached to the vessel, including seine nets, gill set-nets, and gill drift-nets.
- Payments relating to personal living expenses.

- Amounts remaining in the fund after voluntary or involuntary termination of the fund.
- Amounts withdrawn to pay vessel mortgage indebtedness that is in excess of vessel tax basis. No interest is assessed on this type of nonqualified withdrawal.
- Amounts not withdrawn after 25 years.
- Amounts in accumulation determined by the Internal Revenue Service that exceed the plan objectives.
- Annual over-deposit in the fund, not cured by either withdrawal or carry-over provisions.

A nonqualifying deposit is taxable in the year of withdrawal. The order of the withdrawal is from the **ordinary income account** first, followed by the **capital gain account**, and then the **capital account**. Withdrawal from individual accounts will be considered as having occurred on a FIFO basis. Exceptions to this last rule are provided in the case of withdrawals for research and development, mortgage principal payments, and payments in excess of basis.

In determining the tax consequences of a nonqualified withdrawal, a withdrawal from the ordinary income account is treated as ordinary income and a withdrawal from the capital gain account is treated as long-term capital gain. The tax in both cases is determined in the year of withdrawal. Such amounts are to be added to other taxable income, gains, and losses for that year of the entity involved in computing income tax. A withdrawal that comes out of the capital account does not result in any tax since there has been no previous tax benefit from funds deposited into this account.

The tax on a nonqualifying withdrawal is at the maximum tax rate in the year of withdrawal. Check the maximum tax rates in effect for the year under audit. Nonqualified withdrawals treated as made from the capital gain account are taxed at a rate that cannot exceed 15% for individuals and 34% for corporations. Interest is charged from the last date for payment of tax for the tax year in which the amount was deposited into the fund to the last date for payment of tax for the tax year in which the withdrawal is made. Both dates are determined without regard to extensions of time for payment. The interest will be simple interest and, in the usual case, will be determined by multiplying the applicable interest rate by the number of years which include the year of deposit through (and including) the year of withdrawal.

The interest on the additional tax is computed by reference to the interest determined for the year of withdrawal and will not reflect variations in the interest rate during the years between deposit and withdrawal. Interest computed in the manner described here will be in lieu of interest and additions to tax that might otherwise have been payable if the withdrawal had been treated as in fact relating back to the year of deposit.

In 1997, the Department of the Treasury delegated to the Bureau of the Public Debt the responsibility of providing interest rate certification to various agencies. The current rate is available on their website.

The interest rates for recent years are as follows:

2006 5.16%

2007 4.82%

2008 3.04%

2009 2.39%

Nonqualifying withdrawals are taxed regardless of the taxable position of the taxpayer. A taxpayer may not utilize a loss year to cover the withdrawal of CCF money.

Payments of interest under this provision will be deductible for tax purposes because the interest is considered business interest. The interest determined under this provision is, however, treated as tax due for purposes of collection, and also in determining any interest or additions to tax for the year in which the withdrawal is made, as well as later years.

Amounts in a CCF that are not withdrawn after a 25-year period are treated in the following manner as nonqualified withdrawals:

- in the 26th year the fisherman is treated as having withdrawn 20 percent;
- in the 27th year, 40 percent;
- in the 28th year, 60 percent;
- in the 29th year, 80 percent; and
- in the 30th year, 100 percent

IRC § 7518(g)(5) and 46 USC § 1177(h)(5).

This rule applies to all deposits made to the **ordinary income account** and the **capital gain account**. The capital account deposits are excluded because they were previously taxed and the taxpayer has not received any additional tax benefits from them. Earnings from the capital account funds are deemed deposited into the ordinary income account or the capital gain account, depending on the source transaction. The 25-year period begins to run on the later of the date of deposit or January 1, 1987. Earnings (other than net gains) of any fund are treated as amounts deposited for the tax year in which they were earned.

Taxable nonqualified partnership withdrawals are separately stated on Schedule K, Form 1065 and allocated to the partners on Schedule K-1, Form 1065. Taxable nonqualified withdrawals by an S corporation are separately stated on Schedule K, Form 1120S, and allocated to the shareholders on Schedule K-1, Form 1120S. See the instructions for the forms for the appropriate line to report the income and the related code

## Withdrawal Examples

The following withdrawal facts are used in Examples 8, 9, and 10.

Captain Fisher opened a CCF account on 12/15/2000 and deposited earnings from the F/V Seaworthy in the amount of \$5,000. Additional deposits were made to Fisher's CCF account from Seaworthy earnings as follows:

YEAR	AMOUNT
12/31/2000	\$5,000
12/31/2001	\$100,000
12/31/2002	\$20,467
12/31/2003	\$19,211
12/31/2004	\$2,384
12/31/2005	\$3,505
12/31/2006	\$20,000

The following withdrawals were made:

DATE	AMOUNT	PURPOSE
12/31/2000	\$5,000	safety equipment
04/05/2001	\$60,000	engine purchase
04/20/2001	\$10,000	electronics
08/01/2001	\$20,000	mortgage principal payment on Seaworthy
05/05/2002	\$5,000	safety equipment

### Example 8

Captain Fisher withdrew CCF monies in 2000, 2001, and 2002 for assets that were qualified withdrawals. The basis in these assets is as follows:

Year	Item	Cost	CCF Used	Depreciable Basis
2000	safety equipment	\$5,000	\$5,000	\$0
2001	Engine	\$60,000	\$60,000	\$0

2001	Electronics	\$10,000	\$10,000	\$0
2001	mortgage principal payment	\$20,000	\$20,000	\$0
2002	safety equipment	\$5,000	\$5,000	\$0

### Example 9

After Captain Fisher withdrew monies from his CCF account in 2000, 2001, and 2002, the balance in his account is as follows:

Year	Beginning Balance	Deposits	Withdrawals	Ending Balance
2000	\$-	\$5,000	\$5,000	\$-
2001	\$-	\$100,000	\$90,000	\$10,000
2002	\$10,000	\$20,467	\$5,000	\$25,467
2003	\$25,467	\$19,211	\$-	\$44,678
2004	\$44,678	\$2,384	\$-	\$47,062
2005	\$47,062	\$3,505	\$-	\$50,567
2006	\$50,567	\$20,000	\$-	\$70,567

### Example 10

Captain Fisher withdrew \$56,525 from his CCF account in 2009. The withdrawal (WD) has been determined to be nonqualified. Captain Fisher did not deposit or withdraw CCF money in 2007 or 2008. Fisher operates his business as a sole proprietorship. The maximum tax rate for an individual in tax year 2009 is 35%. The interest rate on the amount of tax due is 2.39%. Fisher has deposits remaining in his account starting with tax year 2001. The 2002 safety equipment withdrawal was out of the 2001 deposit; the remaining 2001 original deposit is \$5,000. The tax due on the nonqualified withdrawal is \$19,783. Interest is due in the amount of \$2,864. The above amounts are computed as follows:

Date of Original Deposit	Original Deposit Remaining	Tax Rate on W/D 35.00%	Interest From	Interest To	Number of Days	Interest Due
12/31/2001	\$5,000	\$1,750	04/15/2002	04/15/2010	2,922	\$335
12/31/2002	\$20,467	\$7,163	04/15/2003	04/15/2010	2,557	\$1199
12/31/2003	\$19,211	\$6,724	04/15/2004	04/15/2010	2,191	\$964

12/31/2004	\$2,384	\$834	04/15/2005	04/15/2010	1,826	\$100
12/31/2005	\$3,505	\$1,227	04/17/2006	04/15/2010	1,459	\$117
12/31/2006	\$5,958	\$2,085	04/16/2007	04/15/2010	1,095	\$149
Total NQWD	\$56,525	\$19,783	< Total Tax on NQWD		Total Interest on tax>	\$2,864
2.39% interest rate used to compute interest due						

The interest in the example is computed by multiplying the nonqualified withdrawal amount by the maximum tax rate applicable to the year of withdrawal, then multiplying that figure by the interest rate applicable to the year of withdrawal by the total number of days from due date of the original deposit divided by 365. The 2001 computation is  $\$5,000 \times 35\% = \$1,750 \times 2.39 \times (2922/365) = \$335$ .

**Examples 11 and 12** involve a fisher who has been commercial fishing for 35 years. In 1980, he set up a CCF account with NOAA. Over the years, he deposited and withdrew money from his account. All his withdrawals were for qualified purposes. All deposits to the CCF account were made from vessel earnings. His CCF account was held at a brokerage firm, with CCF money invested in a cash savings account and a bond mutual fund. The interest and dividends earned on the brokerage account were left in the account and no income tax was paid over the years. The bond fund fluctuated in value over the years.

Captain Jones retired from fishing in 2009. According to his 2009 NOAA statements, he had \$10,500 remaining in his ordinary income CCF account. The funds were invested in a bond mutual fund with \$5,000 in bonds and \$5,500 in cash. On December 15, 2009, Captain Jones withdrew all the funds from his CCF account and deposited them into his personal bank account. Since the funds were not used for a qualified purpose, the withdrawal is a nonqualified withdrawal (NQWD) and is taxed at the maximum income tax rate.

The 2009 brokerage account statements reflect that the bond fund was sold, investment earnings were received and a check was issued to close the account.

Captain Jones elected to withdraw the current year investment earnings, interest and dividends in the amount of \$625, and report those earnings on his 2009 tax return on Schedule B, thereby paying income tax on that part of the withdrawal.

### **Example 11**

The brokerage statement showed two bond fund sales. The first sale occurred in November and was a return of principal due to the bonds maturing. The second sale occurred in December, shortly before the brokerage account was closed. This sale resulted in the remaining money in the fund being sold at a loss.

The following is the calculation of the nonqualified withdrawal and the current year earnings:

The first sale in the mutual bond fund account was for \$2,000. The basis was \$2,000 which is equal to the sale amount as the bonds had matured, resulting in no gain or loss. The \$2000 was distributed to Captain Jones. Because there is no tax basis in the investment as Captain Jones received a deduction when he deposited the money into the CCF account, the full amount of the distribution is a non-qualified withdrawal.

The second sale in the bond fund account was for \$2,387. The face amount of the shares was \$3,000 resulting in a loss of \$613. \$2,387 was distributed to Captain Jones. The \$613 loss is a non-deductible loss and the \$2,387 distribution is a non-qualified withdrawal because there is no tax basis in the investment as he, Captain Jones, received a deduction when he deposited the money into the CCF account.

The beginning balance in the cash management account was \$5,500 which represents prior deposits and previously untaxed earnings. The \$5,500 was distributed to Captain Jones. Because there is no tax basis in the investment as Captain Jones had received a deduction when he deposited the money into the CCF account and the prior earnings were not previously taxed, the full amount of the distribution is a non-qualified withdrawal.

During 2009, Captain Jones earned \$250 of dividends in the cash management account and \$375 from the government securities bond fund. The total \$625 of current year investment earnings was distributed to Captain Jones who elected to report this as a current-year withdrawal (reported on Schedule B).

Based on the above, Captain Jones received a check of \$10,612 as a withdrawal from the CCF account. \$10,375 (\$2,000+ \$2,387 + \$5,500) is a nonqualified withdrawal and \$625 is treated as a withdrawal in the current year. Tax on the NQWD is \$3,460 (\$ 9,887 x 35% = \$3,460.45). Tax on the current investment earnings is \$194 (\$625 x 31% = \$193.75 {single filing status, taxable income \$56,000}). Interest on the nonqualified withdrawal is required in this example but has not been computed.

The following table represents the same information in a workpaper format.

Captain Jones' CCF Account						
Date	Government Securities Bond Fund Account	Cost Basis	Sale Price	Gain or Loss	Current Year Earnings	CCF Nonqualified Withdrawal
11/17/09	Principal Payment	\$2,000	\$2,000	\$0	\$0	\$2,000
12/13/09	Sold Fund 10,000 shares	\$3,000	\$2,387	\$(613)	*	\$0
						\$2,387

		\$5,000	\$4,387	Balance 12/14/09	\$4,387
* no loss to be reported on tax return - \$0 tax basis					
Cash Management Account			2009 Opening Balance		\$5,500
2009	Investment Earnings deposited to Cash Account during 2009				
	Dividends from CMA Fund (Cash Account)		\$250		
	Interest from Govt Securities Bond Fund		\$375		
	Total current year investment earnings		\$625		
12/31/09	Total Nonqualified Withdrawal (\$4,387 + \$5,988)				\$9,887
12/15/09	check #600 (Account Closing Balance)		\$10,612		

### Example 12

Same facts as *Example 11* except Captain Jones sold the bond fund for \$4,000. He elected to report the gain as current year earning.

The current year gain is \$1,000 based on the sales price of \$4,000 minus the face value of \$3,000. The \$1,000 will be included as current earning. Captains Jones has no basis in the \$3,000. The full amount is includible as a non-qualified distribution.

Based on the above, Captain Jones received a check of \$12,125 from the CCF account. \$10,500 (\$2,000+\$3000+\$5,500) is a nonqualified withdrawal and \$1,625 is treated as a current year withdrawal. Tax on the nonqualified withdrawal is \$3,675 ( $\$10,500 \times 35\% = \$3,675$ ) and the tax on the current earning on the interest and dividends would remain \$194 ( $\$625 \times 31\% = \$193.75$  {single filing status, taxable income \$56,000}). If the \$1,000 gain on the sale of the bond does not represent interest, it would be reportable on schedule D. See Publication 550, Investment Interest and Expenses for additional information on bonds. Interest on the withdrawal is required in this example but has not been computed.

The following table represents the calculation of the nonqualified withdrawal and current earnings in a worksheet format:

Captain Jones' CCF Account						
Date	Government Securities Bond Fund	Cost Basis	Sale Price	Gain or Loss	Current Year Earnings	CCF Nonqualified Withdrawal
11/17/09	Principal Payment	\$2,000	\$2,000	\$0	\$-	\$2,000
12/13/09	Sold Fund 10,000 shares	\$3,000	\$4,000>	\$1,000	\$1,000	\$3,000
		\$5,000	\$6,000			\$5,000
Cash Management Account		2009 Opening Balance			\$5,500	
2009	Investment Earnings deposited to Cash Account during 2002					
	Dividends from CMA Fund (Cash Account)				\$250	
	Interest from Govt Securities Bond Fund				\$375	
Total Current Year Earnings (includes \$1,000 from bond fund above)					\$1,625	
12/31/09	Total Nonqualified Withdrawal (\$5,000 + \$5,375)					\$10,500
12/15/09	check #600 (Account Closing Balance)		\$12,125	(\$1,625 + \$10,500)		

## Alternative Minimum Tax - Corporations

The CCF deduction is an adjustment under IRC § 56(c)(2) on Form 4626 for Alternative Minimum Tax purposes. In the subsequent year, the corporations could be eligible for a credit of the minimum tax.

Some closely held corporations have disbursed funds to the sole shareholder who personally contributes to a CCF fund. The fund is then contributed to the corporation to purchase assets, thereby avoiding the alternative minimum tax preference item on the corporate return. Although this should generally be viewed as an unallowable, tax-motivated transaction, there may be circumstances where it is allowed.

## **Alternative Minimum Tax: Individuals**

The computation of alternative minimum taxable income under IRC § 55 is taxable income modified by exemptions and certain itemized deductions specified in IRC § 56. The Code does not provide any modification for the CCF contribution. As a result, both taxable income and alternative taxable income are reduced by the amount of the CCF contribution.

If any adjustment is made to taxable income as a result of redetermining the deduction, a corresponding adjustment must be made to the alternative minimum taxable income.

There is no line item to reflect the subtraction in arriving at taxable income for a contribution to a CCF. As a result, the Service has made computational adjustments to fishers' taxable income and/or the alternative taxable income during processing and sent out balance due notices. This processing error should be corrected.

## **Self-Employment Taxes**

Some taxpayers who have CCF deductions are using the net profit figure from the fishing Schedule C, AFTER deduction of the CCF, to compute self-employment tax. CCF contributions are not deductible in determining self-employment income upon which self-employment tax is based. The CCF deduction must be added back to net profit to compute net self-employment income. *Eades v. Commissioner*, 79 T.C. 985 (1982); Rev. Rul. 79-413, 1979-2 C.B. 309; *Lytle v. Commissioner*, T.C. Memo. 1992-461 Taxpayers are required to take the CCF deduction on the Other Income line of Form 1040 and not on Schedule C.

## **Deficiency Deposit Procedures**

If, as the result of adjustments made due to an income tax examination, it is determined that a taxpayer may make additional deposits into his CCF account, in the absence of penalties pursuant to IRC § 6653, the taxpayer may choose to make a "deficiency deposit" on the determined audit adjustment that increased the lower of: (a) the taxable income; or (b) the taxable income attributable to the operation of the Schedule A vessel. This deposit can be up to the amount of the qualifying adjustment to income and is treated as if it were a deduction against the audit adjustment amount. This action simulates a net operating loss (without inter-period adjustments) and will generate "restricted interest" from the date of the deficiency (April 15, 20xx) to the date of the eventual deposit. In other words, the taxpayer can reduce the tax due amount, but interest is still due on the deficiency amount without regard to the deficiency deposit made by the taxpayer.

A deficiency deposit must be made on, or within 90 days after the audit determination and prior to the filing of a claim for deduction for deficiency deposits.

Form 4549, Income Tax Examination Changes, will NOT be considered a determination as required by Proposed Reg. § 3.2(a)(4)(ii). It is not an "agreement signed by the area director or the director of the service center with which the party files its annual return, or by such other official to whom authority to sign the agreement is delegated." Unless there is a final court decision, the parties will need to enter into a closing agreement for the determination.

A Form 866 should be executed after the Form 4549 is signed.. Consult with your local Counsel for language to be included. A Form 906 is not used unless required by other audit issues.

The claim for refund based on a deficiency deposit must be filed within 120 days after the audit determination. After Form 4549 (RAR), and Form 866 or 906 are executed, the taxpayer makes the deficiency deposit by filing a Form 1040X or 1120X. As an alternative, if the taxpayer makes an immediate deficiency deposit and files an immediate claim with the examiner, the examiner will prepare a revised RAR. The revised RAR should be an abatement RAR. In other words, the deficiency Form 4549 that the taxpayer previously signed should be **processed** as a partial agreement. The starting figures for the revised "abatement" RAR would be the Form 4549 that the taxpayer signed previously and that was assessed as a partial agreement.

**Important Note:** Make sure to properly note on Form 3198 of the case file how interest and penalties are affected by the deficiency deposit. Proposed Reg. § 3.2(a)(3)(iii) discusses how interest is computed and how penalties are affected when a deficiency deposit is made. The deficiency on the first RAR will accrue interest from the due date until paid. An amount of tax equal to the abatement resulting from the deficiency deposit RAR is considered "paid" on the date the deficiency deposit is made. In other words, if there is a \$10,000 deficiency from audit adjustments on the first RAR and a deficiency deposit abatement of \$6,000 is reflected on the second RAR, \$6,000 of the \$10,000 deficiency is considered paid on the date the deficiency deposit was made for interest purposes. No penalties, with the exception of the failure to pay penalty, can be reduced as a result of the deficiency deposit. Based on the above example, the failure to pay penalty amount on the \$6,000 abatement will stop accruing on the date the deficiency deposit is made.

If the taxpayer does not make an immediate deficiency deposit and file an immediate claim, the case can be closed upon execution of the agreement forms. If the taxpayer states that he will be making the deposit within the next month, it is up to the examiner and the examiner's manager to determine whether to process the case for closing or hold it in group suspense pending the deposit payment and the related claim. It is recommended that the case not be closed but held in suspense instead. While waiting for the deficiency deposit and the filing of the related claim, the Form 4549 should be processed under partial agreement procedures. If not, and the claim is filed with the service center, the case will most likely be processed with a regular tax abatement and restricted interest will not be applied nor will the penalties be computed properly. For the same reason, if an examiner decides to close the case, it is suggested that she ask the

taxpayer to file the claim with her. An examiner can then prepare a Form 3870 to process the abatement resulting from the deficiency deposit and ensure that the interest and penalties are properly computed.

A taxpayer does not have to pay the deficiency, interest, and penalty in order to file a claim. Under IRC § 6404, the Service has the authority to make an abatement of an unpaid amount that is excessive. The deficiency deposit abatement can be processed under IRC § 6404, in which case the tax, penalties, and interest do not have to be paid first.

Proposed Reg. § 3.2(a)(4)(iii) requires that the claim for refund be made in duplicate, dated and signed under penalties of perjury, and include the following information:

- The name and address of the party.
- The amount of the deficiency determined with respect to the party's income tax and the taxable year(s) involved.
- The amount of the unpaid deficiency or, if the deficiency has been paid in whole or in part, the date of payment and the amount thereof.
- A statement as to how the deficiency was established, if unpaid; or if paid in whole or in part, how it was established that any portion of the amount paid was a deficiency at the time when paid.
- The nature of the determination - closing agreement, agreement, final court decision. Certain documentation is required to be attached and/or explained regarding the agreement. The type of documentation or explanation depends upon the type of agreement.
- The amount and date of the deposit with respect to which the claim for the deduction or exclusion for the deficiency deposit is filed, and a copy of the deposit receipt for such deposit. If the examiner has kept the case in group suspense, the deposit receipt should be sufficient corroboration if the case file workpapers contain the name of the financial institution and the CCF account number.
- The amount claimed as a deduction or exclusion for deficiency deposit.
- Such other information as may be required by the Commissioner or his delegate.

If all of the above information is attached to the claim as required, it should be sufficient verification, provided the examiner already knows the CCF account number to confirm that the deposit was actually made into the CCF account.

If all is in order and the claim is possible and valid, a Form 4549 is used to compute the revised liability. It should be clearly noted that the claim can only offset income tax. Other taxes, SE tax, interest, and penalties are not abatable.

Forms 3363 and 2297 are only applicable if an examiner is disallowing some of the claim. If the examiner is allowing the claim in full, she need only complete Form 4549. The key is clear and specific instructions on the Form 3198, covering in detail how interest and penalties are to be computed as a result of the abatement/deficiency deposit.

## Examination Techniques

- Fishers must apply to initiate a CCF, identify the specific income-producing vessel and the plan for using the CCF deposits, and sign an agreement with the Department of Commerce. The first two numbers of the account indicate the year the CCF was initiated; for example, CCF-S-75042 indicates that 1975 was the first year the taxpayer entered the Agreement. Due to the complexity of the laws governing CCFs, an examiner with a CCF issue should carefully study the applicable regulations.
- Verify that the CCF deduction is taken on the correct line on the return. Remember, the deduction is taken against taxable income on the Form 1040 and not as a deduction on Schedule C. On Form 1120S and Form 1065 (pass-through entities) the deduction must be separately stated on Schedule K and allocated on Schedule K-1, not deducted in "other deductions" on the front of the return.
- Verify that the taxpayer owns or leases a qualified fishing vessel and uses it in a commercial fishing operation.
- If there is a tax deduction for the CCF, verify that the taxpayer has a qualifying source for the deposit.
- Verify that the taxpayer has a CCF contract with NMFS. Review the contract and determine which vessel is the Schedule A vessel and what is the Schedule B objective.
- Verify that the CCF deposit was actually made by the due date of the tax return plus extensions. The deposit will be made to a bank or brokerage account expressly for the CCF. Verify that the deposited amount does not exceed the statutory limit or the Schedule B objective.
- Verify the sources of the CCF deposits and make sure they are qualifying sources.
- With respect to withdrawals, ask whether the taxpayer had any withdrawals from the CCF account? If so, what was the money used for?
- Verify that the basis of the vessel was properly reduced for each CCF withdrawal.
- Are the withdrawals qualified or nonqualified? Generally, acquisition, construction or reconstruction of a vessel is qualified, and general repairs, pots, or certain types of nets is nonqualified.
- Verify that it is a qualified withdrawal approved by NOAA. Also verify the date of the withdrawal and the purpose of the withdrawal. If NOAA did not approve the withdrawal, the tax deferral associated with the withdrawal may be in jeopardy.
- If the withdrawal is not qualified, verify that the taxpayer paid the appropriate tax and interest on his tax return (total tax line) in the year of withdrawal. Nonqualified withdrawals are subject to the highest marginal rate of tax. As part of the audit report, a worksheet must be prepared reflecting the tax and interest due on the nonqualified withdrawal amount. The total of this will then be reported on Form 4549, below the computation of the SE TAX.

## **Issue Identification**

Where CCF deduction is claimed --

### **Individuals**

The taxpayer should write in the margin to the left of the taxable income line "CCF" and the total amount of the qualifying tax-deductible deposit. The taxpayer must then subtract the qualifying CCF deduction from the amount that would normally be entered on the taxable income line. The taxpayer should not claim the deduction for CCF deposits on Schedule C, nor should the CCF contribution be subtracted from the net self-employment income when computing the self-employment tax.

The CCF deduction does not affect Form 6251, Alternative Minimum Tax - Individuals, or Schedule D worksheets, Capital Gains and Losses. If using one of these forms, the taxpayer will have to do an additional computation when the form instructs him to use an amount from the line which reflects the total AGI less itemized deductions/standard deduction. The taxpayer must use the amount computed by adding the taxable income line (after deducting the CCF amount for the year) and the amount on the exemptions line.

### **Partnerships and S Corporations**

The qualified CCF deduction for partnerships that is deposited into a qualified CCF account is separately stated on Form 1065, Schedule K, and allocated to the partners from Form 1065, Schedule K-1, Partner's Shares of Income, Credits, Deductions, Etc.

The qualified CCF deduction for S corporations that is deposited into a qualified CCF account is separately stated on Form 1120S, Schedule K, and allocated to the shareholders from Form 1120S, Schedule K-1, Shareholder's Share of Income, Credits, Deduction, Etc.

### **Corporations**

The CCF deposit reduces taxable income on the Corporation's return. But the earnings and profits of a corporation maintaining a fund are to be determined without regard to the Merchant Marine Act and IRC § 7518 provisions. As a result, the earnings and profits of a corporation are not to be reduced by the amount of taxable income deposited into the fund, even though that deposit reduces the income tax of a corporation maintaining a fund. In other words, a distribution by the corporation to its shareholders may be taxable as a dividend to the shareholders even though the corporation deposited all of its taxable income into the fund.

Amounts held in the CCF fund are not to be taken into account for purposes of the accumulated earnings tax under IRC § 531 while they are held in the fund.

Reporting of investment earnings --

The taxpayer does not have to pay income tax on the investment earnings from the assets in a CCF account when the earnings are redeposited or left in the CCF account. If a taxpayer chooses to withdraw the CCF investment earnings in the year earned, he must generally pay income tax at the standard rate of tax for the taxpayer for that tax year.

## **Capital Gains**

Capital gains from the sale of capital assets held in a CCF account, including capital gains distributions reported on Form 1099-DIV, are not required to be reported on the tax return. The taxpayers should, however, attach a statement to her tax return listing the payors and the amounts and identifying the capital gains as "CCF account earnings."

## **Interest and Dividends**

A taxpayer is not required to report any ordinary income (such as interest and dividends) she earned on the assets in their CCF accounts. The taxpayer should, nevertheless, attach a statement to her return listing the payors and the related amounts, and identifying them as "CCF account earnings." If the taxpayer is required to file Form 1040, Schedule B, she can add these earnings to the list of payors and amounts on line 1, identify them as "CCF earnings", and then subtract these amounts from the list and identify them as "CCF deposits."

## **Tax-Exempt Interest**

Tax-exempt interest from state or local bonds held in CCF accounts is not reported on a federal tax return.

Treatment of Qualified CCF Withdrawal --

A qualified withdrawal from a CCF account is one that is approved by NMFS for acquiring, building, or rebuilding qualified fishing vessels, or making principal payments on the mortgage for a qualified fishing vessel. The taxpayer must reduce the tax basis of the assets acquired or improvements made to the agreement vessel by the amount of qualified withdrawals. For example, the taxpayer would reduce the depreciable basis of a qualified fishing vessel by the amount of qualified CCF funds withdrawn and used to acquire, build, or rebuild that fishing vessel.

Treatment of Nonqualified Withdrawal --

A nonqualified withdrawal from a CCF account is any withdrawal that is not qualified.

The taxpayer must report the additional tax and interest on nonqualified withdrawals. A statement should be attached to the taxpayer's income tax return showing the computation of both tax and interest on a nonqualified withdrawal. The tax and interest on the nonqualified withdrawal will be included on the total tax line of the Form 1040 with a "CCF" notation to the left of the total tax line.

## **Documents to Request**

- CCF account application and agreement letter (NOAA Form 88-14), including schedules showing CCF objectives (A & B Forms). If there is a sale of a vessel, obtain the "net proceeds worksheet" given to NOAA.
- Documents showing an amendment, if any, to the agreement.
- Final Deposit and Withdrawal Report (NOAA Form 34-82) to the National Marine Fisheries Service CCF Program, CCF bank statements, or periodic statements from financial institutions showing fund activity for the year under audit.
- Request a copy of the withdrawal approval letter for each objective where CCF funds were withdrawn.

## **Interview Questions**

- Do you have a capital construction fund?
- When was the fund opened?
- Have you filed all appropriate NOAA forms?
- What are your Schedule A and B objectives?
- Did you make withdrawals or deposits during the year under audit? The prior year? The subsequent year?
- If withdrawals were made, did NOAA approve them? How were the withdrawn funds used?

## **Supporting Law**

46 U.S.C. 1177 Section 607 of the Merchant Marine Act of 1936

IRC § 7518 Tax Incentives relating to Merchant Marine capital construction funds.

50 CFR § 259

26 CFR § 3

Rev. Rul. 79-413, 1979-2 CB 309 Earnings deposited in the CCF do not reduce net earnings from self-employment under IRC § 1402(a).

Rev. Rul. 94-26, 1994-1 CB 310 CCF deposits reduce taxable income, not adjusted gross income.

*Eades v. Commissioner*, 79 T.C. 985 (1982) Net profit of a self-employed fisher that was deposited into a CCF pursuant to the Merchant Marine Act did not reduce the amount of income on which self-employment tax was due. Although the Act was intended to provide for the deferral of taxable income by reducing taxable income by the amount deposited into the fund, Congress did not intend for net earnings to be reduced in the determination of self-employment tax.

Similarly, *Lytle v. Commissioner*, T.C. Memo. 1992-461.

## **Resources**

Publication 595, Capital Construction Fund for Commercial Fishermen

[National Marine Fisheries Service Capital Construction Fund Program Website](#)

[Bureau of Public Debt Website](#)

[National Marine Fisheries Service for Documented Vessels by Name or United States Coast Guard Official Number](#)

# Chapter 11 - Income Averaging for Fishers

## Background

The American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat 1418, amended IRC § 1301 to permit fishers to average their income over three years, similar to the treatment allowed taxpayers involved in a farming trade or business. Making this election may give a taxpayer a lower tax liability for the current year if his fishing income is high in the current year and his taxable income was low in one or more of the three prior years. This provision allows a taxpayer to treat elected fishing income as if one-third of it was earned in each of the three prior years and taxed at the rate in effect for those periods.

A fishing business is the trade or business of fishing in which the fish harvested, either in whole or in part, are intended to enter commerce or enter commerce through sale, barter or trade, including

- The catching, taking, or harvesting of fish;
- The attempted catching, taking, or harvesting of fish;
- Any other activity which can reasonably be expected to result in the catching, taking, or harvesting of fish;
- Any operations at sea in support of, or in preparation for, any activity described above;
- Leasing a fishing vessel, but only if the lease payments are (a) based on a share of the catch (or a share of the proceeds from the sale of the catch) from the lessee's use of the vessel in a fishing business (not a fixed payment), and (b) determined under a written lease entered into before the lessee begins any significant fishing activities resulting in the catch; or
- Compensation as a crewmember on a vessel engaged in a fishing business, but only if the compensation is based on a share of the catch (or a share of proceeds from the sale of the catch).

The word "fish" means finfish, mollusks, crustaceans, and all other forms of marine animal and plant life other than marine mammals and birds.

A fishing business does not include any scientific research activity which is conducted by a scientific research vessel.

## Making the Election

A fisher uses Schedule J, Income Averaging for Farmers and Fishers, to elect to average all or part of her taxable fishing income over the previous three years. If the election year

is 2010, then the base years are 2009, 2008, and 2007. The election may be made on an original or amended return.

**Example 1.** T is a fisher who uses the calendar taxable year. In each of the years 2007, 2008, and 2009, T's taxable income is \$20,000, none of which is electable farm income. In 2010, T has taxable income of \$30,000 (prior to any farm income averaging election), \$10,000 of which is electable farm income. T makes a farm income averaging election with respect to \$9,000 of the electable farm income for 2010. \$3,000 of elected farm income is allocated to each of the base years 2007, 2008, and 2009. T's 2010 income tax liability, without regard to self-employment tax liability, is the sum of the following amounts:

The income tax on \$21,000, which is T's taxable income of \$30,000 minus elected farm income of \$9,000; plus

For each of the base years 2007, 2008, and 2009, the amount by which the income tax would be increased if one-third of elected farm income were allocated to each year. The amount for each year is the income tax on \$23,000 (T's taxable income of \$20,000, plus \$3,000, which is one-third of elected farm income for the 2010 election year), minus the income tax on \$20,000.

Income averaging only applies to income tax, not to employment tax. In the example above, if the \$10,000 electable farm income was subject to self-employment tax, the full \$10,000 will remain subject to self-employment tax even though T elected to income average \$9,000 of the \$10,000. No additional self-employment tax would be due based on the addition of the electable income to the base years.

A fisher does not need to be in the business of fishing during any of the base years. If the taxpayer filed a Schedule J for the previous year, then the taxpayer enters amounts from the previous year's Schedule J on his or her current year Schedule J. If the taxpayer did not file a Schedule J for the previous year, then the taxpayer enters income amounts on its current year Schedule J from the appropriate line of the prior years' income tax returns. If deductions exceed gross income for any year that is a base year, the taxpayer may have negative taxable income for that base year. Any amount that may provide a benefit in another taxable year is added back to determine the base year taxable income. See the worksheet in the instructions for Schedule J.

If a fisher did not file a return for any of the three previous years, the amount entered on Schedule J for any such year is the amount that would have been reported had the taxpayer filed a return.

Taxable income for a base period year may be zero. If the deductions exceed income, the starting point for the base period year will be the negative taxable income prior to adding back the elected fishing income.

Wages attributable to a fishing business are eligible for income averaging for an S corporation employee.

A fisher's regular tax liability for purposes of computing alternative minimum tax (AMT) is determined without reduction for income averaging. These taxpayers receive the full benefit of income averaging because it reduces the regular tax while the AMT, if any, remains unchanged.

A change in filing status will prevent an otherwise eligible individual from electing income averaging.

Minor children who had unearned income and were taxed based on their parents' rates during the base years do not recompute their tax liability when a parent makes an election to average income in a later year. If minor children have unearned income and are taxed based on their parents' rates, the applicable tax rate for the election year is the rate determined after the parent makes an income averaging election.

## Taxable Income From Fishing

Taxable income from fishing includes all of the items listed below that are attributable to any fishing business:

- Income
- Gains
- Losses
- Deductions
- Compensation received by a shareholder from an S Corporation engaged in a fishing business. Income from services as an employee is not considered fishing income.

Elected farm income (EFI) is the amount of taxable income attributable to a farming and/or fishing business that the taxpayer elects to treat as elected farm income. The EFI may not exceed taxable income, and any capital gain cannot be more than total net capital gain.

**Example 2.** D has ordinary income from a fishing business of \$200,000 and ordinary loss of \$50,000 that is not from a farming or fishing business. D's taxable income is \$150,000 (\$200,000 - \$50,000). Because electable farm income may not exceed taxable income, D may elect to treat up to \$150,000 as EFI, all of which is ordinary income.

If an individual conducts both farming and fishing businesses, all income, gains, losses, and deductions attributable to farming and fishing must be combined for purposes of determining the EFI and applying the limitations.

**Example 3.** C has ordinary income of \$200,000 from a fishing business and ordinary loss of \$60,000 from a farming business. C's taxable income is \$140,000 (\$200,000 - \$60,000). C must deduct the farming loss from the fishing income to determine C's electable farm income. C's electable farm income is \$140,000 (\$200,000 - \$60,000), all of which is ordinary income.

Based on the facts and circumstances, gains or losses from the disposition of property used regularly and for a substantial period in a farming or fishing business can be designated as EFI. If the business has been liquidated, property disposed of within one year after the liquidation can be designated as EFI. Beyond the one-year period, it is a facts and circumstance determination.

If a fisherman reduces taxable income by an amount deposited into a Merchant Marine Capital Construction Fund (CCF), the reduction must also be taken into account in figuring taxable income for income averaging purposes. Also, the CCF reduction is generally treated as a deduction attributable to the fishing business in computing elected farm income.

**Example 4.** T is a fisher who uses the calendar taxable year. In each of the years 2007, 2008, and 2009, T's taxable income, before taking any CCF reduction into account, is \$20,000. For taxable year 2008, all of T's income is attributable to T's fishing business. T makes a \$5,000 deposit into a CCF for taxable year 2008. In 2010, T has total taxable income of \$30,000, before taking the CCF reduction into account, \$10,000 of which is electable farm income for 2010 attributable to T's fishing business. For taxable year 2010, T makes a \$4,000 deposit into a CCF.

The amount of the 2010 CCF deposit reduces taxable income. Accordingly, T's taxable income for 2010 is \$26,000 (\$30,000 - \$4,000). In addition, the entire amount of the CCF reduction is treated as an item of deduction attributable to T's fishing business. T's electable farm income for 2010 is \$6,000 (\$10,000 - \$4,000). Similarly, the amount of the 2008 CCF deposit reduces T's taxable income for 2008. T's taxable income for 2008 is \$15,000 (\$20,000 - \$5,000).

T makes an income averaging election with respect to all \$6,000 of the electable farm income for 2010. Under IRC § 1301, \$2,000 of elected farm income is allocated to each of the base years 2007, 2008, and 2009. Under IRC § 1301, T's 2010 tax liability is the sum of the following amounts:

The income tax on \$20,000, which is T's taxable income of \$26,000 (\$30,000 reduced by the \$4,000 CCF deposit), minus elected farm income of \$6,000; **plus**

For each of the base years 2007, 2008, and 2009, the amount by which income tax would be increased if one-third of elected farm income were

allocated to each year. The amount for base years 2007 and 2009 is the income tax on \$22,000 (T's taxable income of \$20,000, plus \$2,000, which is one-third of elected farm income for the election year), minus the income tax on \$20,000. The amount for base year 2008 is the income tax on \$17,000, which is T's taxable income of \$15,000 (\$20,000 reduced by the \$5,000 CCF deposit), plus \$2,000 (one-third of elected farm income for the election year), minus the income tax on \$15,000.

If any taxable income (without regard to the carryback of any net operating or net capital loss) from the operation of agreement vessels in the fisheries of the United States or in the foreign or domestic commerce of the United States is not attributable to a fishing business, that amount does not reduce elected farm income.

More examples of computing income subject to income averaging and applying the limitations are contained in Treas. Reg. § 1.1301-1 and the instructions for Schedule J.

## **Oil Spill Legislation**

### **Exxon Valdez Litigation**

If a fisher received qualified settlement income made up of interest and punitive damages in connection with the civil action in *In re Exxon Valdez*, No. 89-095-CV (HRH) (Consolidated) (D. Alaska), he may treat this settlement payment as income from a fishing business for the purpose of income averaging. This provision applies to plaintiffs in the civil action, or to the beneficiary of the estate of the plaintiff who acquired the right to receive qualified settlement income and was a spouse or immediate relative to the plaintiff.

### **Deepwater Horizon Oil Spill Payments**

As of August 2010, no provision had been enacted with respect to payments from British Petroleum (BP) for lost income from the Deepwater Horizon Oil Spill. Payments for lost income to the fisher will be characterized in the same manner as the income it replaced. If the income replaces lost fishing income, it will be eligible for income averaging. Legislation would be required to treat payments received for other purposes as income from farming, or to extend the eligibility of beneficiaries to make an election. Income received with respect to work performed in the oil cleanup is not income from fishing and is not eligible for income averaging.

## **Documents to Request**

- Computation of elected farm income for taxable year under exam.
- Copies of returns for base period years.
- Copies of all computations for the Schedules J filed, including any worksheet completed from the Schedule J instructions.

## **Audit Techniques**

- Review election year and base periods for reasonableness of income and tax reported.
- Interview the taxpayers and discuss any questionable items
- Recompute all years (including barred years) to reflect correct base year income

## **Supporting Law**

Magnuson-Stevens Fishery Conservation and Management Reauthorization Act of 2006, 16 U.S.C. §§ 1801-1884 (2011)("Sustainable Fisheries Act") Defines "commercial fishing."

IRC § 1301

Treas. Reg. § 1.1301-1 Averaging of farm and fishing income

## **Resources**

Form 1040, Schedule J and the related instructions

Publication 225, Farmer's Tax Guide

IRM 21.6.4.4.9.1 Taxable Income from Farming or Fishing and Elected Farm Income

# Chapter 12 - Fuel Tax Credit

## Background

A boat owner/operator may be eligible to claim a credit or refund of excise tax on gasoline or diesel fuel used in a boat engaged in commercial fishing. Boats engaged in commercial fishing include only watercraft used in taking, catching, processing, or transporting fish, shellfish, or other aquatic life for commercial purposes, such as selling or processing the catch, on a specified trip. This definition includes boats used in both fresh and salt water fishing, but does not include boats used for both sport fishing and commercial fishing on the same trip. The credit can only be taken on fuel used in the boat, not in road vehicles or aircraft used in fishing.

## Examination Techniques

### Issue Identification

If a taxpayer claims a Fuel Excise Tax Credit or refund, the amount of the credit claimed must be included in gross income. The year the amount is includible in gross income depends on whether the taxpayer uses a cash or accrual method of accounting. The inclusion is limited to the extent the tax paid or incurred was deducted as a business expense and actually resulted in a reduction of the taxpayer's income tax.

A claim for credit is made on Form 4136 and attached to the annually-filed income tax return. Alternatively, a refund claim for the excise tax paid may be filed quarterly using Form 8849. The taxpayer cannot claim a credit for any amount for which he has filed a refund claim, nor may he file a refund claim for any amount for which the credit has been paid.

Fuel purchased that is exempt from the excise tax is not eligible for either the credit or a refund. This is often the case with commercial fishers using diesel fuel. All states, except Alaska, use diesel fuel with a red dye added to indicate that it is being sold without payment of the fuel excise tax. Invoices often reflect that the fuel purchased is dyed fuel. If the invoice does not indicate taxed or untaxed fuel or dyed fuel, then additional information may be needed from the fuel supplier regarding the type of fuel sold to the taxpayer.

### Documents to Request

- Invoices for the fuel expense.
- Copies of Form 8849 if filed.
- Copies of prior year return(s).

## Interview Questions

- What types of fuel do you use on your boat - gas, diesel, compressed natural gas, special motor fuels?
- Do you use this same fuel in other motors/vehicles?
- What fuel do you use to heat your home?
- Who are your suppliers for the fuel used in your boat?
- Do you pay an excise tax on this fuel?
- Do you file Form 4136 with your return to claim a fuel tax credit? How do you report the refund of the credit on your return?
- Do you file Form 8849 to claim a refund of the excise tax paid on the fuel used on your boat? How do you reflect the refund on your tax return?
- Did you include the amount received in the 20XX year for prior periods as income for the 20XX year?

## Supporting Law

IRC § 34(a)(3) Credit against the tax is allowed for the taxable year in an amount equal to the sum of the amounts payable to the taxpayer under IRC § 6427 with respect to fuels used for nontaxable purposes during the taxable year.

IRC § 61 Credit refund is included in income, based on the taxpayer's method of accounting, to the extent the fuel cost was deducted as a business expense.

IRC § 4041(g) No tax shall be imposed on fuel used in a "vessel employed in the fisheries or in the whaling business."

IRC § 4041(g)(1) Exempts the sale of diesel fuel used in commercial fishing boats from taxation.

IRC § 4221(a) and (d) Defines certain tax-free sales regarding supplies for vessels or aircraft used by vessels employed in the fisheries or whaling business.

IRC § 6421(c) The amount of the credit will be the number of gallons purchased by the taxpayer multiplied by the rate of tax imposed by IRC § 4081.

IRC § 6427(a) Fuels not used for taxable purposes; taxpayer is allowed a refund of the amount of tax imposed on the sale of fuel to him if he uses the fuel for a nontaxable purpose.

IRC § 6427(l) Nontaxable uses of diesel fuel including fuel used for supplies for vessels.

Rev. Rul. 78-312, 1978-2 C.B. 266 Vessel employed in the fisheries includes only watercraft used in taking, catching, processing or transporting fish, shellfish or other aquatic life for commercial purposes. The term does not include watercraft used on a

specific trip for both sport fishing and commercial fishing. The term also does not include aircraft even though used to locate fish.

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# Chapter 13 - Indian Fishing Rights

## Background

Generally, income derived by a member of an Indian tribe (either as a self-employed individual or as an employee working for a qualified Indian entity) or by a "qualified Indian entity" from a fishing rights-related activity of that member's or entity's tribe is exempt from federal and state taxation (income tax, income tax withholding, FICA, unemployment tax, and self-employment tax). IRC § 7873.

There will be no employment tax imposed on remuneration paid for services performed in a fishing rights-related activity of an Indian tribe by a member of such tribe for another member of such tribe or for a qualified Indian entity. This includes administrative, judicial, and enforcement activities. Wages are not exempt if paid by an employer who is not a member of the same tribe or is not a qualified Indian entity. Wages are also not exempt if paid to an employee who is not a member of the tribe whose fishing rights are exercised. Tribal members must fish in their own waters to be exempt.

Any distribution with respect to an equity interest in a qualified Indian entity (e.g. a partnership or S corporation) to a member of the tribe is exempt from these taxes to the extent the distribution is attributable to income derived by the entity from a fishing rights-related activity of the tribe. Income earned by a corporation or other business entity from a fishing rights-related activity of a tribe is also exempt from federal income tax if the entity constitutes a qualified Indian entity.

In general, a business entity is a qualified Indian entity if it is:

- Engaged in a fishing rights-related activity of the tribe,
- 100% owned by one or more qualified Indian tribes, their members, or the spouses of members, \* and
- Substantially all of the management functions of the entity are performed by members of qualified Indian tribes.

**\*Note:** A qualified Indian entity may be jointly owned by more than one tribe, or members of more than one tribe, provided that the entity is engaged in fishing rights-related activities of each of the tribes.

If an entity is engaged in substantial processing or transporting of fish, it generally is not considered a qualified Indian entity unless 90 percent or more of annual gross receipts are derived from fishing rights-related activities of one or more qualified Indian tribes, each of which owns at least a 10 percent equity interest in the entity. For this purpose, ownership by members of a tribe and their spouses is treated as ownership by that tribe.

If a processor or transporter fails to meet the 90% rule, all income from that year is taxable, as well as all wages paid to employees during the year.

In this context, transporting means the shipment of fish for profit as a separate commercial activity, and not the mere carrying of fish from waters where they are harvested to the point of sale or processing.

This rule applies only to the processing and transporting of fish. If an entity, that is 100 percent owned and managed by tribal members, engages solely in harvesting and selling fish, then the entity is a qualified Indian entity, regardless of the 90% gross receipts rule. However, income must be allocated between exempt and non-exempt income.

A fishing rights-related activity is any activity by a tribe or members of that tribe directly related to harvesting (including aquaculture), processing, or transporting fish harvested in the exercise of a recognized fishing right of such tribe, or to selling such fish, if substantially all the harvesting was performed by members of such tribe.

Recognized fishing rights of an Indian tribe are fishing rights that are secured as of March 17, 1988, by treaty, an executive order, or an Act of Congress. Although the fishing right must have been in existence as of March 17, 1988, it need not have been formally adjudicated or recognized as of that date.

## **Contacting Indian Tribes**

The Indian Tribal Governments office (ITG) in the Tax Exempt and Government Entities Operating Division (TE/GE) serves as the central point for all Service contacts with federally recognized Indian tribes. In order to mitigate potential problems and to ensure that the Service is in compliance with existing legal requirements, all SB/SE employees are required to contact the local area ITG specialist before making initial contact with Indian tribal government entities.

Indian tribal governmental entities can be identified on IDRS by business operating division (BOD) code TE and client code I. Entities established prior to January 1, 2002, may not be coded and are difficult to identify. On all coded and encoded (once the entity type has been identified) ITG cases, SB/SE employees must contact the local ITG specialist.

Self-employed individuals, employees of qualified Indian entities, and qualified Indian entities owned by tribal members or spouses (not by an Indian tribe) are not strictly ITG taxpayers. Contact an ITG specialist for additional information on any treaty-related fishing issue. As a matter of protocol, the IRS employee should notify the recognized tribal leader(s) whenever entering tribal lands for the purpose of conducting an examination of an individual tribal member or business. At no time should the IRS employee disclose the name or identity of the taxpayer under examination.

For a list of tribes with secured treaty fishing rights, see Exhibit 1. If a tribe is not listed and is claiming to be a qualified tribe, or if further information is needed about a tribal entity, the examining agent should contact her local Indian Tribal Governments Office.

## Examination Process

IF	REQUEST THIS INFORMATION	TAX ISSUE
<p>Excluding wages earned as an employee</p>	<ul style="list-style-type: none"> <li>• Proof of tribal membership verified by the tribe. This can be verified with a statement from the tribe or a tribal membership enrollment card. This card includes the enrollment number, the signature of the authorizing official, as well as the official seal.</li> <li>• A statement from the employer verifying that it is either an arm of the tribe or that it meets each of the following requirements for qualified Indian entities per IRC 7873:               <ul style="list-style-type: none"> <li>○ Engaged in treaty fishing rights-related activities of the employee’s tribe</li> <li>○ Owned 100% by one or more qualified Indian tribes or members of such tribes (or their spouses).</li> <li>○ Substantially all of the management functions are performed by members of qualified Indian tribes.</li> <li>○ If its business is the processing or transporting of fish, at least 90% of its annual gross receipts is derived from fishing rights-related activities of one or more qualified Indian tribes, each of which owns at least 10% of the entity.</li> <li>○ The document states that the employer maintains records to support these requirements.</li> </ul> </li> <li>• Verification of the time allocated to</li> </ul>	<ul style="list-style-type: none"> <li>• Reasonable allocation of exempt vs. non-exempt wages.</li> <li>• Wages paid to a tribal member who is an employee of a qualified Indian entity that is jointly owned by members of more than one tribe would be exempt only to the extent the income was derived from the exercise of fishing rights of that employee’s tribe.</li> <li>• Income derived from the exercise of fishing rights guaranteed to another tribe would not be exempt when paid as wages.</li> <li>• Unless the entity is a qualified Indian entity (100 percent owned and managed by tribal members engaged solely in harvesting and selling fish) wages are taxable if the 90% gross receipts test is not</li> </ul>

	<p>fishing versus non-fishing activity. For example, consider a game warden who is responsible for protecting other wildlife and has other duties, as well as patrolling the treaty waters of his tribe. His employer should verify the percentage of time he engages in fishing rights-related activities of his tribe. The employer should also indicate that the employer maintains records to support the allocation.</p>	<p>met for employees of processors or transporters. This computation is made on an annual basis.</p>
<p>Excluding income from self-employment</p>	<ul style="list-style-type: none"> <li>• Proof of tribal membership verified by the tribe. This can be verified with a statement from the tribe or a tribal membership enrollment card. This card includes the enrollment number, the signature of the authorizing official, as well as the official seal. For fishers, a tribal fishing license is also necessary.</li> <li>• Evidence that income is from treaty fishing rights-related activities of that individual's tribe.</li> <li>• For fishers, this could be copies of fishing logs, fish tickets or other documentation indicating that the activity was conducted in that tribe's protected waters.</li> <li>• For transporters, copies of cargo logs/tickets would be acceptable, so long as such records clearly indicate that the transported fish were harvested in the exercise of a recognized fishing right of the tribe.</li> <li>• For sellers, copies of purchase logs and receipts that clearly indicate the sold fish were harvested to a substantial extent by members of the seller's tribe.</li> <li>• Request information regarding sales of boats, nets, or other assets during the year</li> </ul>	<ul style="list-style-type: none"> <li>• Make sure the fishing income and expenses are matched for fishing in tribal waters and non-tribal waters. Fishing activities in non-tribal waters are taxable.</li> <li>• The taxpayer may have included all fishing expenses on a Schedule C while only reporting the non-tribal fishing income. Expenses that can be specifically identified for non-tribal fishing would be 100% deductible provided the expense is allowable by the code.</li> <li>• For common expenses, a reasonable allocation should be made to the non-treaty fishing activity.</li> </ul>

		<ul style="list-style-type: none"> <li>• All income is taxable if the 90% gross receipts test is not met for processors or transporters.</li> <li>• Sales of assets are taxable.</li> </ul>
<p>Excluding income as a qualified Indian entity, tribally owned business, or from distributions of a qualified Indian entity</p>	<ul style="list-style-type: none"> <li>• Verify the entity is a qualified Indian entity. Determine ownership and verify that the requirements of a qualified Indian entity are met. These requirements are: <ul style="list-style-type: none"> <li>○ Engaged in treaty fishing rights-related activities of a qualified Indian tribe</li> <li>○ Owned 100% by one or more qualified Indian tribes or members of such tribes (or their spouses).</li> <li>○ Substantially all of the management functions are performed by members of qualified Indian tribes.</li> <li>○ If its business is the processing or transporting of fish, at least 90% of its annual gross receipts is derived from fishing rights-related activities of one or more qualified Indian tribes, each of which owns at least 10% of the entity.</li> </ul> </li> </ul> <p>2) Request information regarding sales of boats, nets, or other assets during the year</p>	<ul style="list-style-type: none"> <li>• Make sure the fishing income and expenses are matched for fishing in tribal waters and non-tribal waters. Fishing activities in non-tribal waters are taxable.</li> <li>• The taxpayer may have deducted all fishing expenses while only reporting the non-tribal fishing income.</li> <li>• Expenses that can be specifically identified for non-tribal fishing would be 100% deductible provided the expense is allowable by the code.</li> <li>• For common expenses, a reasonable allocation should be made to the non-treaty fishing activity.</li> <li>• All income is taxable if the 90% gross receipts test is not met for</li> </ul>

		<p>processors or transporters.</p> <ul style="list-style-type: none"> <li>• Sales of assets are taxable</li> </ul>
<p>Excluding wages for employment tax purposes</p>	<ul style="list-style-type: none"> <li>• Verify the employer’s status as a qualified Indian entity. Determine ownership and verify that the requirements of a qualified Indian entity are met. These requirements are: <ul style="list-style-type: none"> <li>○ Engaged in treaty fishing rights-related activities of the employee’s tribe</li> <li>○ Owned 100% by one or more qualified Indian tribes or members of such tribes (or their spouses).</li> <li>○ Substantially all of the management functions are performed by members of qualified Indian tribes.</li> <li>○ If its business is the processing or transporting of fish, at least 90% of its annual gross receipts is derived from fishing rights-related activities of one or more qualified Indian tribes, each of which owns at least 10% of the entity</li> </ul> </li> <li>• Verify each employee’s proof of tribal membership. This can be verified with a statement from the tribe and with the tribal membership enrollment card. This card includes the enrollment number, the signature of the authorizing official, as well as the official seal.</li> </ul> <p>Verify time allocated to fishing versus non-fishing activity. This could be done with time cards, contracts, job descriptions or executive board resolutions. A letter stating the amount and tax-exempt nature of an</p>	<ul style="list-style-type: none"> <li>• Reasonable allocation of exempt vs. non-exempt wages.</li> <li>• Wages paid to a tribal member who is an employee of a qualified Indian entity that is jointly-owned by members of more than one tribe would be exempt only to the extent the income was derived from the exercise of fishing rights of that employee’s tribe.</li> <li>• Income derived from the exercise of fishing rights guaranteed to another tribe would not be exempt when paid as wages.</li> <li>• Wages are taxable if the 90% gross receipts test is not met for employees of processors or transporters. This computation is made on an annual basis.</li> </ul>

	employee's wages may be issued to the employee to be used for various non-tax purposes, such as bank loans. Exempt wages are not included on Form 941, Form 940, or Form W-2.	
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## Supporting Law

IRC § 7873 Provides an exemption from the imposition of tax for income derived by a tribal member (directly or through a qualified Indian entity) or a qualified Indian entity, from a fishing rights-related activity of the tribe.

IRC § 7873(b)(1) Defines fishing rights-related activity.

IRC § 7873(b)(2) Defines recognized fishing rights.

IRC § 7873(b)(3)(A) Defines qualified Indian entity.

Notice 89-34, 1989-1 C.B. 674 Provides guidance on IRC § 7873, which exempts from federal income and employment taxes certain income derived by Indians from the exercise of their recognized tribal fishing rights.

Rev. Rul. 67-284, 1967-2 C.B. 55, 58 (modified on another issue by Rev. Rul. 74-13, 1974-1 C.B. 14) Holds that Indian tribes are not taxable entities. The revenue ruling further holds that tribal income not otherwise exempt from federal income tax is includible in the gross income of the Indian tribal member when distributed to, or constructively received by, the tribal member.

*Earl v. Commissioner*, 78 T.C. 1014 (1982) Cash shares received by a Puyallup Indian, while acting as a crewman on a non-Indian vessel, were not exempt from taxation under the Treaty of Medicine Creek of 1854, 10 Stat. 1132. The 1854 treaty did not contain express exempting language and the General Allotment Act of 1887, ch. 119, 24 Stat. 388, did not provide an exception to the general rule requiring express exempting language because the income in question was not derived from operations conducted on the taxpayer's own allocated land.

*Warbus v. Commissioner*, 110 T.C. 279 (1998) A member of the Lummi Nation, a federally recognized American Indian tribe, realized taxable income in the year when the Bureau of Indian Affairs (BIA) discharged him of liability for repaying a loan that it had guaranteed and on which he had defaulted. Although the taxpayer had used the loan proceeds to operate a fishing business related to Lummi treaty fishing rights, the debt discharge income was not exempt as fishing rights income. The income was attributable to the freeing of the taxpayer's assets from repayment obligations, rather than to any activity directly related to the exercise of tribal fishing rights. Also, it arose indirectly from the BIA, which is not a qualified Indian entity under IRC § 7873.

*Hall v. Commissioner*, T.C. Memo. 1998-336, 1998 RIA TC Memo 98,336

Part of the premature distribution from an individual retirement account made to a member of an American Indian Tribe was nontaxable because the distributed amount consisted of nondeductible employee contributions. The contributions were made by the taxpayer's employer, a tribal fish hatchery, and were excludable from his gross income as income derived from an Indian fishing-rights-related activity.

*Allen v. Commissioner*, T.C. Memo. 2006-11, 91 T.C.M. (CCH) 673. Compensation received from an American Indian tribe was taxable. The income received was compensation for services as an elected tribal council member. The income was not shown to be attributable to any fishing-rights related activity nor received from an entity that satisfied the ownership, gross receipts, and management test to meet the definition of a qualified Indian entity.

IRM 4.86.1.1.3 and Exhibit 4.86.1-1

IRM 4.88.1.9 and Exhibit 4.88.1-8

## Resources

[IRS Indian Tribal Governments Office](#)

## Glossary of Terms

**Tribal members:** Individuals in a recognized tribe. To claim tribal membership, the individual must provide proof of his/her membership. This may be done with a tribal membership card. The tribe can also verify that the individual is an enrolled member.

**Treaty/tribal waters:** Waters designated by treaties between a qualified tribe and the federal government.

## Exhibit 1 - Qualified Tribal Entities

Note: If a tribe is not listed and is claiming to be a qualified tribe or if you need further information about a tribal entity, contact your local Indian Tribal Governments Office.

TRIBE	UMBRELLA ORGANIZATION
The Hoh Tribe in Western Washington	Not Applicable
Nez Perce Tribe	4 Columbia River Tribes
Confederated Tribes of the Umatilla Indian Reservation	4 Columbia River Tribes

Confederated Tribes of the Warm Springs Reservation of Oregon	4 Columbia River Tribes
Confederated Tribes & Bands of the Yakama Nation	4 Columbia River Tribes
Confederated Tribes of the Colville Reservation	Not Applicable
Jamestown S'Klallam Tribe	Northwest Indian Fisheries Commission
Lower Elwha Klallam Tribe	Northwest Indian Fisheries Commission
Lummi Indian Tribe	Northwest Indian Fisheries Commission
Makah Indian Tribe	Northwest Indian Fisheries Commission
Muckleshoot Tribe	Northwest Indian Fisheries Commission
Nisqually Indian Tribe	Northwest Indian Fisheries Commission
Nooksack Indian Tribe	Northwest Indian Fisheries Commission
Port Gamble S'Klallam	Northwest Indian Fisheries Commission
Puyallup Tribe	Northwest Indian Fisheries Commission
Quileute Indian Tribe	Northwest Indian Fisheries Commission
Quinault Nation	Northwest Indian Fisheries Commission
Sauk-Suiattle Tribe	Northwest Indian Fisheries Commission
Skokomish Tribe	Northwest Indian Fisheries Commission
Squaxin Island Tribe	Northwest Indian Fisheries Commission
Stillaguamish Tribe	Northwest Indian Fisheries Commission

Suquamish Tribe	Northwest Indian Fisheries Commission
Swinomish Tribe	Northwest Indian Fisheries Commission
Tulalip Tribe	Northwest Indian Fisheries Commission
Upper Skagit Tribe	Northwest Indian Fisheries Commission
Hoopa Valley Tribe (by Executive Order)	Not Applicable
Shoshone-Bannock Tribe	Not Applicable
Bay Mills Community	Great Lakes Indian Fish & Wildlife Commission
Keweenaw Bay Community	Great Lakes Indian Fish & Wildlife Commission
Lac Vieux Desert Band	Great Lakes Indian Fish & Wildlife Commission
Bad River Band	Great Lakes Indian Fish & Wildlife Commission
Lac Courte Oreilles Band	Great Lakes Indian Fish & Wildlife Commission
Lac du Flambeau Band	Great Lakes Indian Fish & Wildlife Commission
Red Cliff Band	Great Lakes Indian Fish & Wildlife Commission
St. Croix Chippewa	Great Lakes Indian Fish & Wildlife Commission
Sokaogon Chippewa	Great Lakes Indian Fish & Wildlife Commission
Fond du Lac Band	Great Lakes Indian Fish & Wildlife Commission
Mille Lacs Band	Great Lakes Indian Fish & Wildlife Commission
Bay Mills Indian Community	Chippewa Ottawa Resource Authority
Grand Traverse Band of Ottawa & Chippewa	Chippewa Ottawa Resource Authority

Indians	
Little River Band of Ottawa Indians	Chippewa Ottawa Resource Authority
Sault Ste Marie Tribe of Chippewa Indians	Chippewa Ottawa Resource Authority
Little Traverse Bay Bands	Chippewa Ottawa Resource Authority
The Grand Portage Tribe of Minnesota	Not Applicable
The Bois Forte Tribes of Minnesota	Not Applicable
The Metlakatla Tribe of Alaska	Not Applicable

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# Chapter 14 - Miscellaneous Provisions

## Estimated Tax Payments

Many commercial fishers are not aware that there are special rules relating to the payment of estimated taxes and the timely filing of their tax returns to avoid an estimated tax penalty. If at least two-thirds of the gross income is from fishing, they have two options:

1. Pay all of the estimated tax by January 15, and file the Form 1040 by April 15, or
2. File the Form 1040 by March 1 and pay all the tax due.

If a fisher exercises one of these options, no estimated tax penalties apply. Form 2210-F, Underpayment of Estimated Tax by Farmers and Fishers, is used to compute any penalty due.

Gross income includes all income received in the form of money, goods, property, and services that is not exempt from tax. To determine whether two-thirds of gross income is from fishing, use as gross income the total amount of income (not loss). On a joint return, both spouse's gross income is included to determine if at least two-thirds of total gross income is from fishing.

Gross income from fishing includes income from catching, taking, harvesting, cultivating, or farming any kind of fish, shellfish (for example, clams and mussels), crustaceans (for example, lobsters, crabs, and shrimp), sponges, seaweeds, or other aquatic forms of animal and vegetable life. Gross income from fishing includes the following amounts.

1. Schedule C (Form 1040), Profit or Loss From Business, line 7.
2. Income for services as an officer or crewmember of a vessel while the vessel is engaged in fishing.
3. Taxpayer's share of the gross fishing income from a partnership, S corporation, estate or trust, from: Schedule K-1 (Form 1065), Box 14, code B; Schedule K-1 (Form 1120S), Box 17, code U; or Schedule K-1 (Form 1041), Box 14, code F.
4. Certain taxable interest and punitive damage awards received in connection with the Exxon Valdez litigation.
5. Income for services normally performed in connection with fishing.
6. Shore service as an officer or crewmember of a vessel engaged in fishing, and
7. Services that are necessary for the immediate preservation of the catch, such as cleaning, icing, and packing the catch.

## **Charitable Contribution for Whaling**

IRC § 170(n) provides that an individual recognized by the Alaska Eskimo Whaling Commission (AEWC) as a whaling captain, who is responsible for maintaining and carrying out sanctioned whaling activities and who engages in these activities during the taxable year, may claim a charitable contribution deduction not exceeding \$10,000 per taxable year for the reasonable and necessary whaling expenses paid in carrying out sanctioned whaling activities.

Under § 170(n)(2)(B), "whaling expenses" include amounts paid for (1) the acquisition and maintenance of whaling boats, weapons, and gear used in sanctioned whaling activities, (2) the supplying of food for the crew and other provisions for carrying out sanctioned whaling activities, and (3) the storage and distribution of the catch from sanctioned whaling activities.

Sanctioned whaling activities are defined as subsistence bowhead whale hunting activities conducted pursuant to the management plan of the AEWC.

Any deduction under this provision may only be claimed as an itemized deduction. A taxpayer claiming a deduction under this provision must have timely adequate records as set forth in Rev. Proc. 2006-47, 2006-2 C.B. 869.

Expenses relating to a whaling boat that is used for sanctioned whaling activities and other activities in a taxable year must be allocated between the sanctioned whaling activities and other activities by comparing the total number of days the whaling boat is used for sanctioned whaling activities to the total number of days in the taxable year.

## **Supporting Law**

IRC § 6654(i) Estimated tax payment installment requirements for farmers and fishers.

IRC § 170(n) Charitable contributions for expenses paid by certain whaling captains.

Rev. Proc. 2006-47, 2006-2 C.B. 869 Provides procedures to substantiate a charitable deduction for whaling expenses of an individual recognized by the Alaska Eskimo Whaling Commission (AEWC) as a whaling captain charged with the responsibility of maintaining and carrying out sanctioned whaling activities.