

Fishing Information Newsletter

News You Can Use from the Internal Revenue Service

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Message from the Editor

The FIN publishing schedule for the remainder of the summer will be July, followed by a joint August/September newsletter published in mid-September. Our feature article for this month, beginning at the top of page 2, is the result of a suggestion from a FIN subscriber. We would like to thank the subscriber for this suggestion.

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Please send us your topic ideas and questions....

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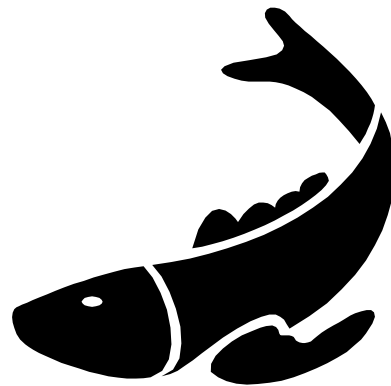
Publication 595 Clarification – Page 11, Line 22, Galley Supplies

We have had several inquiries regarding Line 22, galley supplies, in the example on page 11 of the 2000 Publication 595. Some fishermen and return preparers believe they may deduct 100% of food/meals because of this example. However, in this example “galley supplies” means non-food kitchen items, such as dishes, utensils, pots, pans, and paper supplies. Galley supplies *does not* mean food or meals. See page 3 of Publication 595 for a brief discussion, and the upcoming July 2001 newsletter for a more detailed discussion, of whether food and meals are deductible as trade or business expenses.

Question Regarding April/May 2001 Article – “Cash” Payments for Fish Purchases - Form 1099-MISC Requirements

Q: Can a taxpayer avoid the 1099-MISC requirements by issuing the fisherman checks and then cashing them directly on the spot? The fisherman would endorse the check and the company representative would cash it. The checks would never be processed by any bank. Would this qualify as a non-cash payment and truly avoid the Form 1099-MISC requirement outlined in the April/May 2001 newsletter?

A: This check would not qualify as a non-cash payment. We look to the substance of the transaction and not the form. In form, the fish purchaser is using their personal or business account to pay for the fish. However, in substance, the fish purchaser is actually making a cash payment. The only purpose of the check is an attempt to avoid the reporting requirements. Consequently, the check should be disregarded when determining the reporting requirements for purchasers of fish. Since in substance cash was paid for the fish, a Form 1099-MISC is required to be filed by the fish purchaser.



Reasonable Compensation of S Corporation Shareholders

A question was received from a FIN subscriber that we thought deserved its own article. The question deals with the common occurrence of taxpayers setting up Subchapter S corporations (hereinafter "S Corps") in an attempt to reduce their self-employment taxes.

Example: A taxpayer whose Schedule C would have shown \$100,000 of net profit in the 2000 tax year would have paid \$12,127 in self-employment taxes. The taxpayer, desiring to reduce his 2000 tax year self-employment taxes, sets up an S Corp on January 1, 2000, in which he is the sole shareholder. Assuming the same \$100,000 of net fishing income (before the shareholder's compensation), the shareholder sets his officer's salary at \$12,000. The shareholder takes the remaining S Corp profit as a cash or property distribution, leaving little to no profit in the corporation. The combined employer/employee FICA/Medicare taxes payable on this \$12,000 is \$1,836. The self-employment taxes have effectively been reduced by \$10,291.

The key issue in this situation is whether the \$12,000 salary is considered to be reasonable compensation. This type of scenario has long been a concern to the IRS since it is well established that one of the reasons some fishers incorporate is to reduce their self-employment taxes by paying themselves inadequate compensation. Generally in situations when inadequate compensation is paid, the shareholder withdraws additional funds from their corporation in the form of nontaxable distributions of the S corp's profits. There is a heavy burden on the taxpayer to prove these payments are properly characterized as nontaxable distributions rather than compensation, as salary arrangements between closely held corporations and its shareholders receive close scrutiny by both the IRS and the courts.

There are several court cases that clearly establish the IRS's authority to reclassify payments made to a shareholder as wage expense. See the following cases: *Joly v. Comm.*, 2000-1 USTC 50315 (6th Cir., 2000); *Radtke v. Comm.*, 90-1 USTC 50113 (7th Cir., 1990); *Spicer Accounting, Inc. v. Comm.*, 91-1 USTC 50103 (9th Cir., 1990); *Esser v. Comm.*, 750 F Supp. 421 (DC Ariz. 1990); and *Ulrich, Ltd. v. Comm.*, 88-

1 USTC 9318 (DC Minn. 1988). Also, Revenue Ruling 1974-44, 1974-1 CB 287, concludes that a shareholder of an S corp cannot arrange to receive dividends rather than compensation so that the corporation may avoid paying employment taxes.

The Internal Revenue Service approaches this issue by determining the reasonable compensation for the services performed by the shareholder. It must be remembered that when an S corp engages in fishing, the shareholder generally receives two or more forms of compensation for the two or more types of "services" provided to the corporation.

First, the shareholder should receive wages for the services he provides the corporation in his capacity as a corporate officer. **Second**, if the corporation meets the Internal Revenue Code (IRC) section 3121(b)(20) exception to the definition of wages for fishers, the shareholder should receive skipper/crew shares, which are subject to self-employment tax. The primary thrust of IRC section 3121(b)(20) is to treat the compensation paid to crew members as self-employment income, as opposed to wage income, if the operating crew of the boat is normally made up of fewer than 10 individuals (and certain other requirements are met). If the IRC section 3121(b)(20) exception isn't met, the wages paid to the shareholder should be increased to include the compensation for the shareholder's service as a skipper/crew member. **Third**, when some individuals incorporate, they retain the fishing boat as an individual asset and rent it to their S corp. The shareholder receives rental income for the boat and/or gear which is reported on a Schedule C, subject to self-employment tax.

When evaluating **1)** the amount of wage income paid for the shareholder's services as a corporate officer, **2)** the amount of compensation for services as a skipper/crew member, and **3)** the amount of boat rental income, if any, **the IRS makes a determination of the reasonableness of each type of compensation based on the taxpayer's particular facts and circumstances.**

Since this is a related-party transaction, one of the primary factors we consider in determining the reasonableness of the compensation is what the corporation would have to pay an unrelated party for the same services the shareholder provides and what

the corporation would have to pay an unrelated party to rent the same type of boat for the same duration. The IRS expects the shareholder to be compensated for the full value for each type of service and rental provided to the corporation in lieu of classifying some of the reasonable compensation as dividends.

For example, if an unrelated party acting as a skipper would be paid 35% of the catch, so should the shareholder if he acts in that capacity. If an unrelated party would be paid 25% of the catch for the rental of an equivalent type of boat for the same duration, so should the shareholder if he/she rents a boat to the S corp. As long as the corporation properly determines the reasonableness of each type of compensation, the corporation is free to make additional payments to the shareholder in the form of cash or property dividends. If it is determined that the compensation paid to the shareholder is less than adequate, additional employment taxes and/or self-employment will be due.

Did You Know...

... that the IRS Web site, the *Digital Daily*, contains a wealth of important tax information, just a computer keystroke away? If you have access to an Internet connection, the IRS is a great site to visit, especially for business owners and tax professionals.



To access the Digital Daily, type in www.irs.gov on the address line of your Internet browser. Once at the IRS "home page," move down to the bottom of the first page and click on **Tax Info for Business** section. The **Tax Corners for Business Segments** heading will appear. From here, you can choose many different options, such as the new **Small Business and Self Employed Community** link or the **Tax Professionals' Corner**. Under **IRS Subscription Services** you can add your name to the Digital Dispatch mailing list, the email service of the IRS Digital Daily. You can also add your name to the mailing list for Local IRS News Net, which provides email messages regarding local policies, special events, new practices, and new contact numbers for your area.

Tax practitioners can access **Internal Revenue Bulletins** directly from the web site, while the **Tax Regs in English** area offers IRS regulations in an easy to understand format. The **Business Library**

has a listing of the most frequently requested business oriented publications and business oriented tax forms available on the site. And if you need tax forms or publications — current year or prior years — the Digital Daily has them all!

The IRS has developed various industry guides, including one for the fishing industry, which are available through the Web site at (www.irs.gov/bus_info/mssp/index.html). You can read about the proper treatment of certain issues for your industry. Check it out!



2001 Advance Payments

This isn't fishing related, but we thought the FIN subscribers might appreciate a little information about the 2001 advance payments. The Economic Growth and Tax Relief Reconciliation Act of 2001 directs the Treasury to send checks to most taxpayers this year, giving them an advance payment of a 2001 tax credit. Highlights of this check mailout are:

- The Internal Revenue Service will automatically process these advance payments after the taxpayers have filed their returns for Tax Year 2000. Taxpayers will not have to complete applications, file any extra forms or call the IRS to request their payments.
- The 2001 amount is a maximum of \$300 for a single taxpayer, \$500 for a head of household, and \$600 for a married couple filing a joint return.
- By mid-July, the IRS will send taxpayers a letter, describing the amount of the advance payment check, the week it will be sent, and the possibility of an offset for an outstanding government debt. Recipients should keep the letter for reference when completing their 2001 returns. The IRS will also send a letter of explanation to taxpayers who are not eligible for the advance payment.
- Taxpayers who have moved since filing their last tax return should receive the IRS letter and the

advance payment check if they have filed a change of address with the U.S. Postal Service.

- The advance payment may be reduced for taxpayers with an outstanding government debt, such as back taxes, or a student loan, or with certain past-due child support obligations. In such a case, the IRS will send the person an explanation of the offset. If the advance payment amount is larger than the debt, the taxpayer will get a check for the difference. If the full advance payment amount is applied to the debt, the taxpayer will not receive any check.
- Generally, the last two digits of the taxpayer's Social Security number will determine when the advance payments are mailed, so a person may get a check at a different time than a neighbor or even other family members. For married taxpayers who filed a joint return, the first Social Security number on the return will determine the mailing date for the advance payment.

If the last two digits of your Social Security number are:

00 – 09
10 – 19
20 – 29
30 – 39
40 – 49
50 – 59
60 – 69
70 – 79
80 – 89
90 – 99

You should receive your check the week of:

July 23
July 30
August 6
August 13
August 20
August 27
September 3
September 10
September 17
September 24

- Because the bank account information provided by the taxpayer when filing the tax return may no longer be applicable, the Treasury will not send the payments by direct deposit.
- Those who have not yet filed a tax return for 2000 will not get an advance payment check until the IRS processes that return. The sooner they file their returns, the sooner they will receive any advance payment due.
- By the end of June, the IRS TeleTax system – at 1-800-829-4477 – will have recorded information

on the mailout schedule and the steps for figuring the advance payment amount.

Tax Assistance Hotline, Forms Hotline, Internet Access

Taxpayer Assistance

Phone Numbers:

(800) 829-1040

(800) 829-4059 TTY/TDD (Hearing Impaired)

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The IRS Web Home Page allows convenient access to tax information 24 hours a day. The Web Site provides tax forms with instructions, publications, the latest tax law changes, and much more information for individuals and businesses.

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