DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224
March 11, 2003

OFFICE OF
CHIEF COUNSEL
Number: **200321018**
Release Date: 5/23/2003
UILC: 1402.02-00

CC:TEGE:EOEG:ET1
SPR-121533-01

MEMORANDUM FOR WILLIAM J. HEALEY
S:C:CP:RC:ES C9-467 TEAM MANAGER, MARKET SEGMENT
SPECIALIZATION PROGRAM

FROM: John Richards
Senior Counsel
CC:TEGE:EOEG:ET2

SUBJECT: Self Employment Tax Issues - Commercial Fishing

This completes our response to your request of June 13, 2000, for our review and comments as to your conclusions regarding the application of the Self Employment Contributions Act ("SECA") tax to seven scenarios involving the rental of personal property in connection with commercial fishing. In our May 5, 2001, memorandum, we address five of the scenarios (Scenarios #1 through #4 and Scenario #7). This memorandum responds to Scenarios #5 and #6. We apologize for the delay in responding.

A. Scenario #5

Scenario #5 involves instances in which the holder of the permit is unable to continue fishing, either for health reasons or due to death.

i. Scenario #5a.

In scenario #5a, the fisher becomes ill and unable to fish for a period of time. The fisher applies for and receives an emergency transfer, and therefore is able to lease the fishing permit.

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 crew members in settlement of certain claims were included in net earnings from self-employment. Under the facts of the ruling, X corporation compensated certain commercial fishing boat owners and operators and crew members for losses suffered during the year because of X's alleged negligence.

Prior to X's alleged negligence, which substantially reduced or completely eliminated the commercial fishing operations in the area, the fishers were self-employed and engaged in the trade or business of fishing. Most of the fishers did not fish during the taxable year subsequent to X's alleged negligence, although some engaged in fishing in unaffected waters during the year.

In Rev. Rul. 91-19, to avoid protracted litigation, X established a claims office and instituted a settlement procedure. X required proof that the fishers had received a certain amount of income from fishing in prior years and that each was ready, willing, and able to fish during the taxable year. Based on these representations, X compensated the fishers for estimated losses.

Rev. Rul. 91-19 concludes that the amounts received by the fishers from X are included 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 section 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. (This formulation of the nexus requirement has not been adopted by courts and was specifically rejected in Jackson v. Commissioner, 108 T.C. 130 (1997), discussed below.)

Rev. Rul. 91-19 also stated the Service's nonacquiescence in Newberry v. Commissioner, 76 T.C. 441 (1981). In Newberry, the taxpayer owned and operated a grocery store that was destroyed by fire, and as a result of which he was unable to operate the business for approximately seven months. During that time, he received insurance payments for lost earnings measured by his historical profits. The Tax Court concluded that the payments were not includible in computing net earnings from self-employment because they were not derived from a trade or business that was actually carried on. In Newberry, the court set forth the "nexus" requirement as follows:

> There must be a nexus between the income received and a trade or business that is, or was, actually carried on. Put another way, the construction of the statute can be gleaned by reading the relevant language all in one breath: the income must be derived from a trade or business carried on.

Applying Rev. Rul. 91-19 to the facts in Scenario #5a, payments received under the fishing permit lease were arguably derived from the fishing activity. Even though temporarily unable to fish, the fishers 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. See Alaska Stat. 16.53.150(g)(1) (2000).

However, the Ninth Circuit (which includes Alaska) provided standards contrary to those provided by Rev. Rul. 91-19. Milligan v. Commissioner, 38 F.3d 1094 (9th Cir. 1994), considered whether termination payments paid to former insurance agents were derived from a trade or business. Milligan was an insurance agent and independent contractor with the State Farm Insurance Companies. Milligan entered into a series of contracts to perform services for State Farm. The contracts provided that, in the event of termination of his services, an agent with two or more years of service would receive "Termination Payments" for a period of five years. The amount of these payments was based upon the amount of the agent's compensation during his last twelve months as an agent. As a condition to receipt of these payments, an agent was required to refrain from selling insurance to former State Farm customers for a period of one year.

In Milligan, the Ninth Circuit held that the Termination Payments were not subject to self-employment tax. The court held that the payments in question did not derive from Milligan's trade or business because they were not "tied to the quantity or quality of the taxpayer's prior labor." It also reasoned that the payments did not represent deferred compensation because Milligan "had no vested right to payment of an identifiable money amount." The court concluded that Milligan had been fully compensated for his services and interpreted the payments as being for a covenant not to compete. In Gump v. United States, 86 F.3d 1126 (Fed. Cir. 1996), and Jackson v. Commissioner, 108 T.C. 130 (1997), the courts followed the holding in Milligan.

Under the Milligan standard, the payments under the fishing permit lease described in Scenario #5a were not derived from the fishing activity. These lease payments were not directly “tied to the quantity or quality of the taxpayer's prior labor" in carrying on the fishing activity. Although Milligan reached a result contrary to the principles articulated in Rev. Rul. 91-19, the Service is required to follow Milligan in the Ninth Circuit.[1] Based upon the law of the Ninth Circuit, the lease payments should not be considered to be derived from the fishing trade or business.

ii. 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).

---

[1]The Ninth Circuit includes Alaska, California, Washington, Oregon, Idaho, Nevada and Arizona.

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.

iii. Scenario #5b

In this scenario, 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.

iv. Scenario #5c

We agree with your conclusion that SECA tax applies to the leasing activity.

B. Scenario #6

Scenarios #6 involves individuals who rent crab pots and/or fishing nets to fishermen, but do not conduct commercial fishing activities themselves.

i. Scenario #6a

In this scenario, 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. The rental activity has been in place for several years and is expected to continue indefinitely.

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, it may with the leasing of the crab pots constitute one activity which would constitute a trade or business. To constitute one business activity, the two activities must be sufficiently related. For example, if the individual generally leased both types of items to the same individuals at the same time, advertised and marketed the products together, and provided package deals, the activity generally would constitute one activity. See Regulations § 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.

We agree with your conclusion that the activities described in Scenario #6a constitute a trade or business for purposes of SECA tax.

ii. Scenario #6b

In Scenario #6b, the individual leases crab pots and nets on a speculative basis, depending upon the needs of the fishers. The leasing activity has been in place for several years and is expected to continue indefinitely.

Again, the facts strongly suggest that these activities constitute a single trade or business. Similar facts and circumstances to those discussed for Scenario #6a would be relevant in further developing a particular case.

We agree with your conclusion that the activities described in Scenario #6b constitute a trade or business for purposes of SECA tax.

We appreciate having had the opportunity to comment on Commercial Fishing MSSP Audit Technique guide. Please contact us if we can be of further assistance.

_____

JOHN RICHARDS