

Fishing Information Newsletter

News You Can Use from the Internal Revenue Service

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Message from the Coordinator

For those readers who are planning to attend the FISH EXPO which will be held from October 12 – 14, 2000 at the Rhode Island Convention Center in Providence, RI, please stop by the Internal Revenue Service booth found in Hall C, booth number 1040. There will be customer service representatives on hand to answer your tax related questions and we will have several forms and publications available that you should find most helpful.

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

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Fish Processing Equipment – Depreciation Issues

What is the depreciable life of fish processing equipment?

Taxpayers who operate fish processing facilities are often faced with this question. Typically, these facilities sort and process fish, and packages, freezes and prepares the fish products for shipment. The processing lines operate under a complex combination of computer and manual controls and continuously function under severe conditions such as extreme temperatures and corrosive salt water. Fish processing equipment includes items such as belts and screws, conveyors, bins, holding tanks, washes,

climate control devices, screens, separators, automatic deheaders and filleters, waste product recovery systems, refiners, plate freezers, packaging equipment, and a large number of standard motors and power transmission systems.

It has been the long standing position of the Internal Revenue Service that fish processing equipment falls under the Asset Class 20.4 as food production and manufacturing equipment and should be depreciated over 7 years. Some taxpayers are erroneously treating these assets as “special handling devices”, as described in Asset Class 20.5, and are depreciating them over 3 years.

The Office of Chief Counsel stated in Letter Ruling 9415003 that a taxpayer’s reliance on the economic life of the assets corresponding to the 3-year recovery period is unsupported since recovery periods are statutorily defined by class lives and do not correspond to economic lives. They also noted that the fact that a taxpayer’s fish processing equipment is species specific does not justify a shorter recovery period.

Special handling devices such as returnable pallets, palletized containers, boxes, baskets, carts and flaking trays used in a taxpayer’s fish processing facility may be classified under Asset Class 20.5 and be depreciated over 3 years.

Retroactive Bonus Payments

*By Katie Jarvis
Revenue Agent
Anchorage, Alaska*

It is common for fish processors to pay a retroactive bonus to fishermen (based on the ultimate sales price of the fish) in order to entice the fishermen to sell to the processor in the upcoming fishing season.

Many fish processors struggle with the accounting mechanics of when to properly deduct these bonuses.

If a fish processor is using an accrual method of accounting and a calendar year, the bonus expense is deductible in the year it is paid, and not in the previous year the fish were sold to the processor.

An accrual basis taxpayer, unlike a cash basis taxpayer, is not governed by the time of payment in deducting expenses. Generally, expenses are deductible by accrual-method taxpayers if the “all-events test” is satisfied. The answer to this question will be made clearer, if one first understands what is meant by meeting the all-events test.

The all-events test states that a liability is incurred and is deductible, for income tax purposes, in the taxable year in which:

- (1) all of the events have occurred which fix the fact of the liability,
- (2) the amount can be determined with reasonable accuracy, and
- (3) economic performance has occurred.

With respect to the first requirement, no accrual can be made where the liability has not actually been incurred, is contingent upon an uncertain future event, or is contested and not paid.

With respect to the second requirement, although no liability can be taken in to account before economic performance and all of the events that fix the liability have occurred, the fact that the exact amount of liability cannot be determined and the date of payment has not been fixed does not prevent a taxpayer from taking into account that portion of the amount of the liability which can be computed with reasonable accuracy within the taxable year.

With respect to the third requirement, the all-events test is not treated as met before the time that economic performance occurs regarding the item. If a taxpayer’s liability arises out of the provision of service or property to the taxpayer by another person, economic performance occurs as the services or property is provided.

The commercial fishing industry can be quite volatile. Depending on the profitability of a particular fishing season, the retroactive bonus may or may not be paid. Some seasons have seen a total absence of bonuses in some fisheries. The amounts paid per pound and per species vary from season to season and from fishery to fishery.

In the commercial fishing industry, “economic performance” between a seafood processor and commercial fisher occurs simultaneous with the purchase of the raw seafood from the fisher. The retroactive bonus is not necessarily fixed and determinable prior to the end of the calendar year. All events which fix the fact of liability have not occurred. With respect to retroactive bonuses, the fact of liability is not fixed until each seafood processor unilaterally decides to pay a bonus. The processor has no legal obligation to pay the bonus until the check is actually cut. Furthermore, the amount of the bonus may not be determinable with reasonable accuracy until certain events have occurred.

Generally fishers do not enter contracts with seafood processors guaranteeing the fishers will receive a bonus if the processors earns a certain level of profit during the year. Although wholesale buyers will occasionally guarantee a base price per pound and a profit percentage to certain processors in writing, written price guarantees to fishers by processors are largely unheard of. The only event which occurs with respect to a bonus which fixes the liability is payment.

In summary, a retroactive bonus paid to a fisherman should be deducted in the year it is paid. When a fish processor is using the accrual method of accounting, the all-events test is difficult to meet. The first test is generally not met by most processors because industry practice does not “fix” the liability or incur a legal obligation on the part of the processor. The second test of the all-events test is generally not met because of the uncertainty associated with the wholesale seafood market - the amount of the bonus may not be determinable until the next calendar year.

Fishing Nets – Depreciation, Section 179 Deduction, Repairs, Capital Construction Fund Issues:

By Joan Olmstead,
Associate Technical Coordinator
Anchorage, Alaska

Fishing nets used in a fishing business are expected to last more than one year. Since their useful life extends beyond the tax year they are placed in service, fishing nets are capital assets and require depreciation treatment. When an asset is depreciated, the cost of the asset is recovered through depreciation deductions over the “life” of the asset. This is different than the treatment of assets having a useful life of less than one year, which may be deducted entirely in the year of acquisition.

The “life” over which depreciation deductions must be taken is the asset’s class life. All personal property assets with no designated class life are assigned a 7-year class life under the General Depreciation System. Since fishing nets have no designated class life, they are depreciated over 7 years using the appropriate convention and method. See Publication 946, *How to Depreciate Property*, for further details and depreciation tables. *Note* – If a taxpayer elects to use the Alternative Depreciation System, the class life for fishing nets is 12 years.

As an alternative, it may be possible to elect a Section 179 deduction for a portion, or all, of the cost of fishing nets. The maximum cost of Section 179 property that you can elect to deduct for tax year 1999 is \$19,000. The limit is \$20,000 for tax year 2000, \$24,000 for tax years 2001 and 2002, and \$25,000 for tax years after 2002. This maximum dollar limit applies to each taxpayer, not to each business. You do not have to claim the full maximum dollar limit. You can decide how much of the business cost of your qualifying property you want to deduct under Section 179. Also, if you acquire and place in service more than one item of qualifying property during the year, you can divide the deduction among the items in any way, as long as the total deduction is not more than the maximum dollar limit for the year. You can depreciate the cost of nets and other qualifying property that you do not deduct un-

der Section 179. For example, if you purchase a net that costs \$25,000 and place it in service in the 2000 tax year, a Section 179 deduction can be elected from \$1 to \$20,000. Assuming a \$20,000 election, the remaining \$5,000 cost of the net is depreciated over 7 years (12 years if the Alternative Depreciation System is elected).

The total cost that you can deduct each year for Section 179 purposes is limited to the taxable income from the active conduct of all trade or businesses for the tax year. You can carry over the cost of any Section 179 property you elected to expense but were unable to because of the taxable income limit. You use the amount you carry over to determine your Section 179 deduction in the next year. There are also situations in which part of the section 179 deduction must be recaptured (i.e. added back to income). See Publication 946 for further information on both of these issues.

The election to claim the Section 179 deduction is made by taking the deduction on Form 4562, *Depreciation and Amortization*. This form is attached to, (1) your original tax return filed for the year the nets were placed in service (whether or not you file it timely) or (2), an amended return filed by the due date (including extensions) for your return for the year the property was placed in service. In other words (except as explained in the next sentence), you cannot make an election for the Section 179 deduction on an amended return filed after the due date (including extensions). However, if you timely filed your return for the year without making the election, you can still make the election by filing an amended return within six months of the due date of the return (excluding extensions). Attach the election to the amended return and write “Filed pursuant to section 301.9100-2” on the election statement. File the amended return at the same address you filed the original return.

Once you elect a Section 179 expense deduction, you cannot change your election or revoke your election without IRS approval. The IRS will grant approval only in extraordinary circumstances.

Frequently Asked Questions

Q: *If I don't claim section 179 deduction and instead depreciate my nets over 7 years, what do I do when the nets are discarded after only 5 years due to wear and tear?*

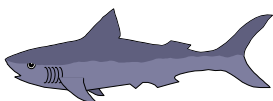
A: In the year of disposition, you may claim the remaining cost (the portion of the total cost that hasn't already been deducted as depreciation in the current and prior years) on Form 4797, *Sales of Business Property*.



Q: *If I claimed the section 179 deduction for the entire cost of my nets in the year I placed the nets in service (Year 1), what do I do when the nets are discarded after only a few years due to wear and tear?*

A: Nothing – You have already received a tax deduction for the entire cost of the nets in Year 1.

Q: *Throughout the fishing season I make repairs to nets. Must these be depreciated also?*



A: Ordinary repairs to fishing nets made during the fishing season are deductible when they do not increase the value of property, make it more useful, or lengthen its life. If the repair or replacement does increase the value of your property, makes it more useful, or lengthens its life, the repair or replacement must be capitalized and depreciated.

Q: *Can I withdraw funds from my Capital Construction Fund (CCF) for the purchase of fishing nets?*

A: The purchase of nets is not considered to be the acquisition, construction, or reconstruction of a qualified vessel for CCF withdrawal purposes. Consequently, a CCF withdrawal for the acquisition or repair of nets will be a non-qualified withdrawal from your CCF account.

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