MSSP

Market Segment Specialization Program

Alaskan Commercial Fishing: Processors and Brokers - Part II

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Department of the Treasury
Internal Revenue Service

Training 3149-121 (7-95
TPDS 83963Q

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FOREWORD

The Market Segment Specialization Program (MSSP) presents this Audit Technique Guide as an aid to compliance and enforcement strategies involving the Alaska commercial fishing industry. Although, the guide is specifically structured around the Alaska commercial fishing industry and processor and brokers, it may be used as a broad outline for commercial fishing MSSP efforts in any region.

Catcher vessels are addressed in Part One.

Alaskan Commercial Fishing Part Two - Processors and Brokers was written by the Examination Division, Pacific Northwest District.

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INTRODUCTION

The intent of this guide is to provide additional information for those auditing the fishing industry. This additional information is tailored for use during audits of fish processing plants; larger, vertically integrated organizations; and fish brokers.

This guide concentrates on specific audit issues which are evident within these types of organizations. These fall mainly into the treatment of capital assets and transactions and foreign-related party transactions. This guide is separated into these two major categories.

Chapter 1, Capital Assets and Transactions, includes the issue of the appropriate depreciable life for factory trawlers, processing equipment, and other vessels. Working with Capital Construction Funds is an additional topic in this chapter. Within the discussion of tender vessels, the issue of employment taxes is examined.

Chapter 2, Foreign Business Considerations, was developed due to the enormous amount of influence exerted by offshore (foreign) interests in fishing. For land-based processing plants, estimates of foreign ownership run as high as 90 percent, conservative estimates run 50 percent. Foreign interests not only contribute equity capital, but also contribute substantial sums in the form of loans to land-based and sea-based processors alike.

The section on foreign related parties covers some of the myriad of possible audit issues. First covered are topics of withholding on partnership income, dividends, and interest payments to nonresident aliens. Earnings stripping and transfer pricing are covered next. Special provisions of the Code under IRC sections 982 and 6038A will help examiners secure needed information from foreign individuals and corporations. The issue of the appropriate treatment of nonresident aliens in terms of withholding on compensation payments and filing requirements is covered last.

This guide is intended to provide additional information for those who will audit the fish processors or companies with foreign ownership or capital. For overview of the Northwest fishing marketplace, refer to the MSSP guide, Alaskan Commercial Fishing: Catcher Vessels.

The ex-vessel price of fish from Alaskan waters is a $5 billion industry. The processing and brokerage of these fish constitute another $5 to $7 billion. The price of fish sold to the processor has remained stagnant over the last 5 to 10 years. The price of fish from processor to wholesaler, and ultimately to the consumer, has doubled over the same period.

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Chapter 1

CAPITAL ASSETS AND TRANSACTIONS

VESSELS: DESCRIPTIONS AND DEPRECIABLE LIVES

There are five basic categories of fishing vessels used in the North Pacific fishing industry. Additionally, there may be hybrids of these categories.

The descriptions of these vessels are as follows:

1. Smaller fishing vessels like those which harvest salmon are usually under 50 feet long and have an average cost basis of $200,000. These are purely catching/harvesting vessels with no processing capabilities.

2. Larger catcher/harvester vessels average 150 feet in length and have 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 by the Coast Guard or Department of Commerce regulations. This size and capital requirement also describes some crab boats.

3. Factory trawlers have a capacity for harvesting and processing. These vessels range between 250 feet and 400 feet in length and have an average cost basis between $25 million and $80 million, depending on size and processing capability. These vessels may have as many as 100 processing employees on board to operate the plant. These vessels may also, because of short seasons of ground fish or operational difficulties, process fish from other catcher vessels.

4. There are other processing vessels with no catching capacity which 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.

5. Other vessels used to transport fish are called "tenders." These vessels do not run nets or longline, but may operate fish pumps to take another vessel's catch from the water. The tender's primary function is transporting fish to a shore-based processor or to a floating processor. The size of these vessels varies; the crew size is fewer than 10 persons. No processing is involved.

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. Then, in 1993, National Office 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 sections 167(m) and 168 do not include "taking or catching fish" as an activity with an asset class. Taxpayers rely on this as support for their position that all fishing vessels have no class life, and, therefore, constitute 7-year property.

With respect to vessels used primarily for harvesting or catching fish, the National Office 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. 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 vessels would be classified in asset class 00.28, and would constitute 10-year property for purposes of MACRS.

TENDER VESSELS AND EMPLOYMENT TAX ISSUES

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 fishermen. Tenders, in the North Pacific, are essential to the salmon and herring fisheries where the highly migratory nature of the fish require the fishermen to stay at sea. Tenders are not used in the pollack, whiting, black cod, Pacific cod, or any of the crab fisheries.

A tender may use a "fish pump" to extract the fish from the fisherman'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 fisherman and the tender, and ultimately, the processor, in disputes over poundage and species.

A tender will generally have fewer than six crew members, including the skipper. The contractual arrangement between the tender and the processor has 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.

Generally, when the owner of the vessel contracts with the captain, who staffs and provisions the vessel and manages its day-to-day operation, both captain and crew are employees of the owner. This issue is well settled after United States v. Webb, Inc., 397 U.S. 179 (1970), in which the Supreme Court held that the employment status of captain and crew is determined under the standards of maritime law, which is the common law of seafaring enterprises. The Supreme Court stated: "* * * except where there is nearly total relinquishment of control through a bare boat, or demise, charter, the owner may nevertheless be considered, under maritime law, to have sufficient control to be charged with the duties of an employer." See also Cape Shore Fish Co. v. United States, 330 F.2d 961 (Ct. Cl. 1964); S.S.T. 387, 1940 C.B. 192.

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 examiner should consider whether the captain is an independent contractor under the standard set forth in Webb. In this situation, the crew members are probably employees of the captain. However, if the crew members are paid by the processor, IRC section 3401(d)(1) may operate to make the processor the employer for employment tax purposes.

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 crew member.

The accounting for a tender is frequently provided by the processor in its final settlement. The processor will provide advances to the crew and skipper, cover costs associated with the operations of the vessel, and take possession of the fish for processing. The largest costs not born 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.

NOTE: 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). See sections on international issues in this guide.

See IRC sections 3121(b)(20), 3401(a)(17), and 3306(c)(18), and Publication 595, Tax Guide for Commercial Fishermen, for further information.

CAPITAL CONSTRUCTION FUNDS (CCF)

The capital construction fund program is a program of the Department of Commerce and is administered by the National Marine Fisheries Services. The program provides incentives for the domestic production and improvement of all vessels. The underlying objective is stated as national security and competitiveness through promoting a strong domestic shipbuilding industry and an up-to-date and well-equipped merchant marine.

How The Program Works

Any ship owner (or lessee) has the opportunity to set aside part of his or her current taxable income for capital improvement on a vessel or toward the building of another vessel. By setting aside these earnings, the vessel owner then may "expense" the amount reserved.

The regulations require that the "set aside" earnings must be from the operations of a designated Schedule A vessel. The expense must be on a designated Schedule B vessel. They may be the same vessel.

Example 1

Joe Fleming has $150,000 of earnings from the operations of F/V Wendy in 1990. He, in agreement with the National Marine Fisheries, decides to set $100,000 of this money aside for the purchase of a larger vessel in 3 years. Joe's taxable income is reduced by $100,000 for the taxable year 1990, as long as 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 of the vessel will be the purchase price less the $100,000 CCF fund monies. This is because he effectively expended these costs earlier in the deduction on his 1990 return.

Problems for Sole-Proprietors

There are two common problems in the use of CCF funds for the sole-proprietor fisherman reporting fishing income on a Schedule C.

1. A Capital Construction Fund contribution is not a deduction for self-employment tax purposes. To compute self-employment tax, you must add back the CCF fund monies to the Schedule C earnings before computing the tax. Additionally, you cannot recompute depreciation without the reduction in basis that the original CCF contribution caused.

2. CCF contributions are defined as reductions in taxable income and NOL adjusted gross income. See Rev. Rul. 94-26, 1994-15 I.R.B. 13.

There are specific deposit and withdrawal rules which are also sources of considerable errors resulting in additional tax. Similarly, the associated basis adjustments have complicated rules which also influence the timing of deductions.

BE AWARE: In the absence of penalties on a case, a taxpayer may choose to make a "deficiency deposit" on an audit adjustment. This deposit can be up to the amount of the adjustment to income and is treated as though the deposit is a deduction against the audit amount. The actual action simulates a net operating loss (without inter-period adjustments) and, therefore, will generate "restricted interest" from the date of the deficiency (April 15, 19xx) to the date of the eventual deposit.

National Office is currently considering whether "deficiency deposits" should be continued. The relief clause is part of a 30-year old proposed regulation. Call the National Office for the current status on this issue before allowing the deduction.

Other possible transactions for consideration are those involving non-qualifying withdrawals from the fund. A non-qualifying withdrawal occurs when an expenditure is made on something other than the vessel. The rule of thumb is: An expenditure made for an item that is bolted onto the vessel qualifies; an expenditure made for any other item, for example, those items thrown over the side such as fishing gear, does not qualify.

For corporations, the CCF contribution is an alternative minimum tax preference item. It has been found that 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 may be allowed.

The Technical Workings of the Fund

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

Currently, fishing vessels that are not under 2 tons and not over 5 tons require no Coast Guard certification to participate. Those vessels over 5 tons (approximately a 25 ft. vessel) do require Coast Guard certification. The Commerce regulations for Capital Construction Funds appear in Title 46, Chapter 27, Section 607, of the U.S. Code.

Eligibility Requirements

1. The taxpayer must be a U.S. citizen (individual), a corporation, or a partnership 75-percent owned by U.S. citizens; the president and majority of the board must also be U.S. citizens.

2. The taxpayer must own or lease a vessel.

3. The vessel must be built in the United States.

4. The vessel must operate in the U.S. Fisheries or in U.S. foreign trade, non-contiguous domestic trade (for example, Alaska to Seattle) or the Great Lakes.

Definition of Agreement Vessel

A contract, drawn up between the taxpayer and the National Marine Fisheries Service (NMFS), designates one vessel as the income-producing vessel (the "Schedule A vessel") and a second vessel which is to benefit from the CCF funds (the "Schedule B vessel").

26 CFR, Part 3.2(f), Definition of an agreement vessel:

> "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 {eligible tax ceilings}. Not withstanding 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 the 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.

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 its (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 to be 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 his or her individual CCF fund in 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

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

Maximum Deposits

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

   Plus

3. Net proceeds from the sale or other disposition of Schedule A vessels

Plus

4. The earnings from investment of CCF monies.

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

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

1. Normally, the only source of income for a fisherman is from his or her Schedule A vessel.

2. General rules of allocation of expenses prevail -- regulations refer to principles established by Treas. Reg. section 1.861-8.

3. For related parties, arm's-length pricing shall be used (or adjusted for under IRC section 482).

4. Taxable income is computed under the taxpayer's method of accounting.

5. Taxable income is computed without consideration of a carry back of an NOL or capital loss.

Minimum Deposits

The Secretary of Commerce has the right to determine the minimum annual deposit. NMFS requires deposit of the lesser of 2 percent of the objective's cost or 50 percent of taxable income. Further rules allow a 3-year averaging of deposits to meet this criteria.

Timing of Deposits

Deposits must be made by the due date of the return plus any extensions.

The Code specifies requirements for maintaining ordinary income, capital "gains," and other capital accounts for the fund. For additional information on the maintenance of accounts, see joint regulation or IRC section 7518.

Investments of the Fund

The earnings on the investments in the fund are tax free 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 the CCF funds.

The allowable types of investments are only the most conservative types such as interest-bearing notes, usually government securities. Not more than 60 percent of the assets may be in domestic, public-traded equities. The regulations do allow certain "non-cash" contributions to the fund. It does not allow a fund holder to buy a "Bayliner" from contribution funds and then "redeposit" the asset as a noncash deposit, nor does it allow the fund to invest in such assets.

Basis Reduction

The basis of assets acquired with Capital Construction Funds must be reduced by the amounts of withdrawals from the fund.

Example 6

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

Mortgage Payments

The CCF program allows a taxpayer to use CCF funds to make principal payments on the debt of Schedule B vessels. Frequently, these monies 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 6 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, then withdrawn to reimburse the general fund of the fisherman 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.

Regulations under Title 46 (46 CFR 390.9(c)(3)) limit withdrawals for reimbursements to a partys' general funds for a period not exceeding four months after the eligible expenditures.

<u>Two Special Cases on Mortgages</u>

<u>Case One:</u> 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. An 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 mortgage payments from CCF funds	($250,000)

Payment in excess of basis	($100,000)
	========

Per joint regulations, the payment will be applied in the following order to reduce:

a. The basis of other schedule B vessels owned by the taxpayer;

b. Any other Schedule A vessel which is not a Schedule B vessel;

c. Against any other vessel owned by the taxpayer;

d. Non-qualifying withdrawals, as taxable income at the maximum tax rate.

<u>Case Two</u>: A taxpayer refinances a Schedule B vessel for an amount in excess of his tax basis. An example:

Cost of the vessel	$750,000
Prior CCF basis reduction	($350,000)
Accumulated depreciation	($200,000)

Tax basis before refinance	$100,000
Original mortgage balance	$ 50,000
Refinance proceeds	$250,000

	$300,000 - $100,000 = $200,000
Receipt in excess of basis	$200,000

Should this circumstance exist, there is additional taxable income of $200,000. 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." (Committee Reports: 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.

CCF funds cannot be pledged as collateral for other loans or assets. To do so could trigger the termination of the fund. The amount pledged will be considered as having been distributed in a non-qualifying withdrawal.

Non-Qualifying Withdrawals

A non-qualifying 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.

The tax on a non-qualifying withdrawal is at the maximum rate in the year of withdrawal, with interest on the tax from the date the money was placed into the fund.

Non-qualifying 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 monies.

Investment Tax Credit

Should we see it again, the taxpayer may be allowed half the credit which would otherwise be allowable, if not for the CCF contribution. The tax basis of the asset acquired is still reduced by the entire amount of CCF funds used.

Chapter 2

FOREIGN BUSINESS CONSIDERATIONS

OVERVIEW OF THE MARKET -- HOW AND WHY FOREIGN INTERESTS PLAY SUCH IMPORTANT ROLES

The fishing industry in the Northwest and nationally is greatly influenced by international forces. The primary force in action is the marketplace for fish products. Foreign markets absorb 50 to 90 percent of the U.S. domestic production, depending on the product. For example, some runs of Alaskan Salmon are sold 100 percent to Japan. The domestic price frequently follows the international price of products, even where there are considerable cost advantages because of lower freight and storage costs. U.S. domestic demand is price elastic only over a small range and it is perceived that if dramatic supply increases or price reductions occurred in the domestic market, it would not increase the demand (sales volume) significantly.

A large change in the nature of foreign involvement in the U.S. fishing industry occurred in response to the passage of the Magnuson Act and the Anti-Reflagging Act. These two acts established a 200-mile U.S. economic zone and required that vessels fishing in this zone be U.S. owned and manufactured. It should be noted that this occurred with a phase-out period which by 1990, was fully implemented. Certain foreign interests may still operate under what is alternatively called the "Savings Clause" or "Grandfathering provisions" under the Anti-Reflagging Act.

For the Northwest, this change has resulted inconsiderable economic change as well as precipitated ongoing political and legal battles over the allocation of the resources. These skirmishes involve domestic enterprises positioning to fill market niches which historically had been the dominion of both foreign mother ships performing at-sea processing, and foreign fishing fleets harvesting previously ignored bottom fish.

International interests have been forced to resort to alternative avenues to assure a supply of products to their existing processing and marketing organizations. In the Northwest, these interests are primarily from Japan, Norway, and Korea, but may also include Taiwan and Mainland China.

Because of the restrictions of the Anti-Reflagging Act, foreign interests who want to influence fish harvesting have chosen to become partners or equity-holders with U.S. domestic taxpayers. These relationships run from a relatively benign passive investment to a foreign investor who may own 49 percent of an enterprise and also provide loans amounting to 80 percent of the total capitalization. The latter begs the question of who is in fact the controlling interest.

Foreign investors have purchased 80 to 90 percent of the shore based processing capacity in the Pacific Northwest.

Foreign brokers account for considerable operational cash flow to the independent fisherman. This capital, in the form of advances, is provided to fishermen to gear up prior to fish openings, with the proviso that the right of first refusal of the catch be to given the foreign entity. Interest on the debt which is frequently repaid through price adjustments on the sales of fish and is often omitted from Form 1042.

TREATMENT OF ALIEN PARTNER'S DISTRIBUTIVE SHARES

Ownership of fishing operations maybe very complicated, multi-tiered arrangements reminiscent of the most complex tax shelter. These arrangements are generally not born from the desire to confuse the flows of cash or capital, nor to help manipulate tax benefits or avoid payment of dividends, but to spread risk. Fishing for any one species is highly volatile. Tremendous gains in one year are frequently followed by great losses in the following year. Risk can be decreased by fishing in various locations, harvesting multiple species, or investing in a number of vessels.

This desire to diversify will create partnership structures where individuals, partnerships, and corporations own minor interests -- 1/32 or 1/64 in many operating organizations.

The partners are nonresident foreign individuals or entities:

If a partnership has effectively connected income which is allocable to a foreign partner, then there is a requirement for that partnership to withhold tax on the foreign partner's allocable share of that income and to file Forms 8804 and 8805, whether or not a distribution has been made to the partner during the partnership's tax year.

The requirement to file Forms 8804 and 8805 applies only if the partnership interest is held directly by a foreign partner and not tiered through an intervening entity created or organized in the United States.

The partnership or designated agent is responsible for withholding on the foreign partner's allocable percentage of effectively connected taxable income. The partnership is also required to file yearly Forms 8804 and 8805 which are analogous to Forms 941 and W-2, and to make quarterly deposits of withholding with Form 8813. See IRC section 1446.

Note: Fixed or determinable annual or periodical income subject to tax under IRC section 871(a) or section 881(a) is not included in the partnership's effectively connected income. These items of income are separately treated under IRC sections 1441 and 1442. Generally, the Code sections require 30 percent (or 14 percent) withholding by the withholding agent on payments made to the foreign person (unless an applicable tax treaty provision provides an exemption from U.S. tax or a lower withholding rate). Additionally, Forms 1042 and 1042S (rather than Form 8804) must be filed. The withholding agent is required to make deposits of the amounts withheld using Form 8109.

Guaranteed payments present a special problem and each case must be looked at individually. The payment may be compensatory, and, therefore, part of the effectively connected income. Alternatively, it may be fixed and determinable income and, therefore, subject to withholding under IRC section 1441 or section 1442 and filing Form 1042.

A partnership may have to file both Forms 8804 and 1042 for the same partner in any one year. It may also have to submit withholding payments with one form and not with the other.

TREATMENT OF FIXED AND DETERMINABLE PAYMENTS TO FOREIGN INDIVIDUALS

Payments which are fixed and determinable, and are paid to a foreign payee, should be scrutinized as to whether withholding is appropriate and whether Form 1042 should be filed. This income includes interest, dividends, rents, royalties, certain compensation, and, in some cases, franchise payments.

Management fees and commission expenses are frequently a means of moving money across borders while creating an argument for sourcing the income in another country. Auditors should be alert to these disguised forms of fixed and determinable income. These arguments can be attacked under IRC sections 482 or 162 as a reallocation of income problem, or as being excessive and, therefore, not ordinary and necessary.

Example 1

A corporate entity paid each of three shareholders $125,000 in a profitable year. Two of the shareholders are not employees of the firm while the third is the CEO. The corporation treated two of the shareholders as independent contractors and paid them commissions. These individuals reside outside the United States. No withholding was made on their commissions. The taxpayer's argument was that the non-employee shareholders assured certain business relationships which constituted a large portion of the business and, therefore, the monies were deemed to be commissions on the sales to these companies. The examiner could not find that any services were performed and proposed that the whole disbursement was a dividend.

Example 2

A corporation received a loan from its 49 percent shareholder who is also a nonresident alien. The loan provided 80 percent of the capital of the firm and paid for three fishing vessels. The 49-percent shareholder acted as the corporation's broker in Japan where 100 percent of the fish were sold. The firm paid the shareholder market interest denominated in yen. The 49-percent shareholder dictated to the firm a commission contract stating that the commission rate on sale of fish is 5 percent of the proceeds of sale, but while the debt owed by this firm to the broker is greater than $2 million the commission rate will be increased to 9 percent.

Additional interest at 4 percent of sales revenue was paid to the 49-percent owner. This firm may be in violation of the Anti-Reflagging Act. Forms 1042 should include both the stated interest paid and also the interest paid which is disguised as commission expense.

EARNINGS STRIPPING -- IRC SECTION 163(j)

IRC section 163(j) applies to interest paid or accrued for taxable years beginning after July 10, 1989. It was enacted to prevent foreign corporations from stripping earnings from a U.S. subsidiary (it also addresses partnerships) in the form of deductible interest expense where the parent pays no or little U.S. tax on the interest because of the treaty rates. This section will limit the interest expense of any domestic enterprise which has a debt to equity ratio larger than 1.5:1.

If the interest expense of a domestic enterprise is greater than 50 percent of the adjusted taxable income for the year, then that excess will not be allowed as a deduction if the debt to equity ratio is greater than 1.5:1.

Of course, this is just the beginning of a relatively complicated Code section which not only allows for carryforward of the disallowed deduction, but also allows for carryforward for computing unused allowable deductions for interest. The computation which is needed to arrive at adjusted taxable income reads like a detailed statement of cash flows. Taxable income based on cash flow or cash basis without depreciation, depletion, and various other adjustments for current transactions is adjusted taxable income.

As of January 1, 1994, IRC section 163(j) also applies to loans from unrelated lenders which are guaranteed by related persons.

TRANSFER PRICE ISSUES UNDER IRC SECTION 482 -- SALES OF TANGIBLE PROPERTY; AND PAYMENTS TO RELATED ENTITIES FOR MANAGEMENT FEES, COMMISSIONS, ETC., AT OTHER THAN ARM'S-LENGTH

Transfer pricing is not unique to the fishing industry. In the Northwest, the issue is evident in companies where significant foreign ownership is present. This ownership may take the form of direct stock or capital interest, or it may take the form of loans to the fishing operations. A significant proportion of fish processing plants in Alaska have foreign owners. Transfer pricing may involve numerous entities which have foreign owners in vertical integration. The catching vessels may have foreign investors or have secured operating loans from foreigners in exchange for"right of first refusal" marketing arrangements. The processing plants may be wholly foreign owned. Separate marketers or brokers which also are foreign owned may be involved on the United States side.

The sales which involve transfer to offshore entities also involve related parties. The offshore market may involve more processing and transfers before the ultimate consumption of the products. The foreign "owners" may also ascribe trade names to the products or add guarantees of product quality which also"muddies" the determination of the appropriate transfer price. The Federal reporting requirements may disclose foreign ownership within the intervening tiers of this vertical integration, but the foreign sale will not be evident in any entity except the last marketer or broker organization.

Until now, the use of tax haven countries by domestic corporations to reduce taxable income has not been a significant issue in audits of Northwest companies. The examiner should be aware that tax havens may be used to avoid the tax of foreign countries as well as to avoid U.S. taxation. Because Korean domestic policy restricts the export of capital, Korean companies have motivations to realize income in countries other than Korea. A company in Korea which realizes income from domestic sales may have difficulty making foreign investments with this same money.

Although the transfer price issue in the Northwest fishing industry generally involves foreign-controlled corporations, this may not be true elsewhere. Examiners should be aware of pricing issues to controlled foreign entities, particularly in the Gulf States and the Atlantic Coast.

IRC Section 482: Transfer Pricing

Regulations issued in 1968 for issues relating to transfer pricing and allocations of income, deductions and credits are effective for years until beginning before April 22, 1993. Temporary regulations were in effect from April 23, 1993, to July 1, 1994, when the new regulation became effective. Although this writer is unaware of the exact reasoning behind the issuance of new regulations it is apparent in tax literature and in practice that the old regulations frequently served more as a cookbook for planning tax avoidance than as an administrative tool. The strict ordering of the application of transfer pricing methods served to focus auditors and courts on the methods rather than the economic realities. The new regulations attempt to provide the Service with more flexibility in approach and require taxpayers to maintain contemporaneous records to support their related party transactions. BE AWARE THAT THE CURRENT TEMPORARY REGULATIONS AND THE NEW REGULATIONS DO HAVE MINOR VARIATIONS.

Overview of Pre-1993 Temporary Regulations

The following section applies to years where the 1968 regulations apply:

Treas. Reg. section 1.482-1(b) Scope and Purpose: The purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer by determining, according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer. "The district director shall intervene, and by making such distributions, apportionments, or allocations as he may deem necessary *** The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer."

Burden of Proof: (From Tax Management Portfolio 230-3rd, page 86.) In virtually every decision involving section 482, there is a statement to the effect that the Commissioner's determination is not only entitled to the usual presumption of correctness, but can be successfully challenged only by a showing that it is "arbitrary, capricious or unreasonable," or that the Commissioner has "abused his discretion" granted under the statute. The burden of proof that the tax determination under IRC section 482 is in error is on the taxpayer.

Note: the burden of proof may shift to the Commissioner where the taxpayer has not had the opportunity to present evidence in the course of the examination or in response to the 30-day letter. Care should be taken not to have the burden shift to the Commissioner.

Methods and problems: Sales of tangible property(normal sales): With one exception, all of the methods prescribed within the Code and Regulations start from the vantage point of the controlled taxpayer. Data from the controlled taxpayer's records used to arrive at an arm's-length price, either through adjusting the original transfer price, or by referring the price to an uncontrolled taxpayer. There is an ordering preference to the methods which an auditor may use to arrive at the "true" price. Many fish products are sold on a commodity market for which there are published prices. Commodity market pricing is allowed only when the use of other methods do not result in a reasonably ascertainable price.

In order of priority, the pricing methods are as follows ((pre-1993) Treas. Reg. section 1.482(e)):

1. The comparable uncontrolled price method (CUP): The CUP method allocates revenue by determining that the sales price of a goods sold to a controlling, or controlled, party is equal to an arm's-length price of the same or similar goods sold by the taxpayer to an unrelated (uncontrolled) third party. The regulations provide that adjustments may be made to comparable prices for minor modifications in product and differences in sales terms, payment of freight, and transit insurance.

2. Resale price method: Where one member of a group of controlled entities sells property to another member who, in turn, resells the property in an uncontrolled sale. The arm's-length price of the controlled sale is determined by the gross profit of the second sale. Wherever possible, markup percentages in the first sale should be derived from the uncontrolled purchases and resales by the buyer involved in the controlled sale.

3. Cost Plus Method: The arm's-length price of a controlled sale of property is computed by adding to the cost of producing such property, an amount which is equal to such cost multiplied by the appropriate gross profit percentage. The appropriate gross profit percentage is equal to the gross profit percentage earned by the seller or another party on the uncontrolled sale or sales of property most similar to the controlled sale in question.

4. Any Other Appropriate Method: This term means any method which correctly reflects the arm's-length price of goods between uncontrolled parties. According to a GAO study, this is the method most often used for sustained deficiencies at 47 percent of the total proposed, or 86 percent of the total dollars.

In defending their positions, taxpayers have two alternative courses of action. They may show that their transfer price is correct by using the highest priority method. They may otherwise provide a rationale as to why the IRS method, not the price, is unreasonable. The second defense generally follows the express language of the regulations. From the taxpayer's perspective, none of the first three methods provide a reasonable approach.

Example 3

A foreign corporation owns brother/sister corporations in the United States. The brother corporation purchases pollack (fish) which is processed to make surimi. The surimi is sold at 1 percent over cost to the sister corporation, which operates as the broker/exporter, selling to both unrelated third parties and to the foreign parent. All sales are FOB Dutch Harbor, AK.

The examiner established one uncontrolled price utilizing prices FOB Alaska. The taxpayer argues that: (1) their markets are significantly different, therefore, the prices should be different; (2) in the case of the uncontrolled transaction, an additional risk is present which should reflect a higher sales price; and, (3) the uncontrolled market cannot absorb sufficient output of the U.S. company. The taxpayer further argues that (1) there are differences in the tariffs charged by the controlled and uncontrolled taxpayers; (2) that varied terms of payment cause additional administrative expenses and additional processing charges from the bank; (3) the controlled sale is ultimately made at market with the addition of the controlling companies' trade names and guarantees; and,(4) the U.S. company is ultimately introducing an unproven product to the foreign market which should call for price concessions.

Because of these "unique" characteristics, use of the CUP method would not lead to a fair transfer price.

Other methods meet similar arguments. Many of the assertions cannot be proven nor can a positive or negative value be ascribed. The taxpayer's argument is not to show that the price is wrong but simply that the method used is not absolutely accurate.

Temporary Regulations Effective for Returns After April 21, 1993

The new proposed and temporary regulations reflect three basis concepts. Comparability means that the prices paid by taxpayers to related parties should compare favorably to prices paid by unrelated parties in similar transactions. Flexibility means that the uncertainty inherent in this highly factual area needs to be accommodated by using a transfer pricing method most likely to achieve accurate results in a taxpayer's particular situation. Documentation means that the taxpayer must establish the justification for its transfer prices at the time the transactions occur (not years later when the IRS auditor arrives.) The temporary regulations add two additional methods to those mentioned in the prior regulations, the Uncontrolled Transaction method and the Comparable Profits method. The proposed regulations include yet one more method, the Profit Split method. The methodology employed by the new regulations employs the following logic:

1. Determine the "Best Method" with which to calculate the transfer price. The best method is the one which provides the most accurate measure of an arm's length result under the facts and circumstances of the transaction under review. Factors to be considered in selecting a method include the completeness and accuracy of the data used to apply each method, the degree of comparability between controlled and uncontrolled transactions, and the number, magnitude and accuracy of the adjustments required to apply each method.
   Treas. Reg. 1.482-1(T)(b)(2)(iii)

2. Perform functional analysis. The determination of whether the controlled and uncontrolled taxpayer are comparable requires a comparison of the functions performed by both. Factors considered for functional analysis will parallel the business organizational structure. The product engineering, production, R&D, fabrication, extraction, assembly, purchasing and materials management, inventory management, warehousing, transportation, legal, accounting, credit and collection, etc.

3. Perform risk analysis. For purposes of comparison between controlled and uncontrolled taxpayers determine first whether the controlled taxpayer bears the risks associated with the transaction, which includes a consideration of whether the income earned by that controlled taxpayer is over a reasonable period of time and is commensurate with the risk assumed. Then determine whether the risks borne by the uncontrolled taxpayer are comparable to those borne by the controlled taxpayer. The risks ordinarily considered include market risks, including fluctuations in cost, demand, pricing, and inventory levels; risks associated with the success or failure of research and development activities; financial risks including fluctuations in foreign currency rates of exchange and interest rates; credit and collection risks; product liability risks; and general business risks related to the ownership of property plant and equipment.

Other analysis should be made of the contractual terms, economic conditions, and the degree of similarity between the property or services transferred and how this could affect prices charged or paid, or the profit that would be earned in the two transactions.

The relative importance of any one of these analysis will change depending on the pricing method employed.

Conclusions: The regulations and tax services have much more detailed and insightful analysis of the treatment of IRC section 482. The Northwest Fishing Industry has transactions for which proper development will demand use of most if not all of the methods described in the regulations.

SPECIAL AUDIT TOOLS: FORMAL DOCUMENT REQUEST UNDER IRC SECTION 982 AND DESIGNATION OF AGENT FOR A DOMESTIC CONTROLLED BUSINESS TO SECURE INFORMATION FROM A FOREIGN RELATED PARTY UNDER SECTION 6038A

IRC Section 982

IRC section 982 is effective in situations where a taxpayer has transactions with a foreign entity over which it has control. The Code provides that in a situation where records are unavailable but under the control of a foreign controlled entity a formal document request may be used to demand submission of the records. If the records are not produced, Appeals or a court may prohibit the introduction by the taxpayer of any foreign-based document covered by the request. A copy of a formal document request is provided as Exhibit 2-1.

IRC Section 6038A

IRC section 6038A requires a 25-percent foreign domestic corporation to file annually an information reporting form (Form 5472) and to maintain records and to cause foreign related parties to maintain records relevant to transaction between the domestic corporation and the foreign related parties. Additionally, a foreign related party that engages in transactions with a domestic corporation must authorize that domestic corporation to act as its agent for IRS summonses purposes when requested to do so by the Service. Refer to IRM Exhibit 42(10)-17 for flowcharts and pattern letters for IRC section 6038A.

A $10,000 monetary penalty may be assessed when a domestic corporation fails to file Form 5472 or when it fails to maintain or cause a foreign related party to maintain records relevant to related party transaction.

The noncompliance penalty adjustment must be applied when a foreign related party fails to authorize a domestic reporting corporation as its agent and may be applied when insubstantial compliance occurs with an IRC section 6038A summons. The noncompliance penalty adjustment permits the Service to adjust (in its sole discretion) the price of goods sold or deductions of the reporting corporation.

For additional information, see IRM 42(10)6.1

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FOREIGN CREW: EMPLOYEES AND INDEPENDENT CONTRACTORS

References: Publication 519, U.S. Tax Guide for Aliens; IRC sections 1402(b), 1441, 3401(a)(6),3121(b), 3121(b)(19), 3306(c), 3306(c)(19); and Treas. Reg. section 31.3401 (a)(6)-1(b). See also IRC section 863(d)

Foreign individuals who work aboard fishing and processing vessels may or may not be subject to U.S. income and social security 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.

An overview of the treatment of foreign workers is illustrated in the following table:

Elements of Control	Resident Alien (green card)	v. Non-resident (H-1 Visa)
Employee Relationship	Treat as any U.S. citizen. All taxes apply.	If operated within the United States - all taxes. If operated outside the United States, but touches U.S. port - FICA and FUTA. If all operations are outside the United States - no taxes
Non-Employee Relationship	Issue 1099-misc. Individual is responsible for income and self-employment tax.	Withholding of 30% or lower treaty rate. Independent contractor must file 1040NR and claim treaty exemptions - possible penalty - see below- IRC section 1441.

The following discussion focuses on the nonresident alien working in the fishing industry. The most often encountered circumstances are as follows:

1. A nonresident alien is employed on a vessel which is engaged in the catching and harvesting of fish and aquatic life. The vessel normally has fewer than 10 crew members, including the skipper, cook, and engineer. IRC section 3121(b)(20) applies. All crew are paid a share with no other compensation for service on board the vessel.

2. Nonresident aliens are employed on a fishing or processing vessel having greater than 10 crew members on all voyages. All crew members are employees of either

the captain or the owner of the vessel, depending on the circumstances. One of two situations occur. In salmon, crab, black cod, and most ground or bottom fishing (including pollack and halibut), the vessel operates within the territorial waters of the United States. In the second situation (occurring with tuna and possibly squid fishing), the vessel operates outside the territorial United States.

3. Nonresident aliens work as "technicians" on U.S. owned processing vessels in U.S. territorial waters. Most frequently, these workers have special training in the processing of fish roe (eggs). Some workers have special knowledge in the operations of a surimi processing lines and equipment. In some circumstances, these technicians are not being treated as employees of the vessel/processing companies. They are employees of foreign companies and are supplied as provided for in contracts between the processor and the offshore entity. These contracts call for a daily wage and benefits as the basis for the payment. The service to be provided by the "roe technician" is hands-on processing of the roe from the extraction from the fish, through salting and freezing of the product. Additional duties involve the training of domestic employees to perform the same tasks. The duties of the surimi plant technicians are to oversee the operations of the plant and coordinate quality improvement and control.

The rules for treatment of nonresidents as they pertain to employment are the same as for residents. The second consideration is whether services are "effectively connected" to a U.S. trade or business.

There are three conditions on personal services that, if all are met, the activity is not considered effectively connected:

1. Personal services are performed as an employee of, or under contract with, a nonresident alien or foreign entity

2. Not present in the United States during the tax year for greater than 90 days.

3. Not greater than $3,000 (net) is received

Most frequently, the third criterion is not met. This income is subject to the normal graduated income taxes and necessitates the filing of Form 1040NR. Tax treaties may affect the amount of income subject to tax for personal services.

If there is no employee-employer relationship, then the total compensation is subject to 30 percent withholding (or lower treaty rate). This amount is to be reported on Forms 1040 and 1042. The nonresident alien/independent contractor may enter into a withholding agreement with the IRS in order to lower the withholding rate. To have the "withholding agent" withhold at the treaty rate, the independent contractor must submit a statement to the payor stating why the treaty rate is appropriate.

Special note: If the "independent contractor" is the skipper/captain of a fishing vessel, payment to this individual may be illegal under the Anti-Reflagging Act which states that the operation of a fishing vessel in U.S. waters must, at all times, be under the control of a U.S. citizen. The tax effect is to disallow the deduction for the compensation paid under IRC section 162(c).

A nonresident alien is subject to income but not self-employment tax. In reference to the second situation, where a nonresident alien works as a crew member aboard a vessel with more than 10 total crew members, the Code does not provide that the crew member/alien may be treated as anything but an employee. There are numerous cases which establish that even under the situation where the crew is paid on a share basis, the crew is still under the dominion and control of the captain and owner of the vessel. (See *Webb* and *Cape Shore Co.*)

If the vessel is operated in U.S. waters (the service is performed within the United States), then the nonresident alien is treated as a resident and there is withholding at source for income tax and social security taxes, and payment is made toward FUTA.

Services performed by a foreign crew, whose contract of service is not entered into within the United States, and during the performance of which and while the employee is employed on the vessel it does not touch a U.S. port, are not "employment." No income, social security, or FUTA is due on these individuals. This is true regardless whether these individuals are working the same duties as persons who are subject to tax. Under the same circumstances, should the vessel touch a U.S. port, the alien crew would be subject to both FICA and FUTA.

For taxable years beginning after December 31, 1986, the source of any taxable income derived from an "ocean activity" is sourced outside the United States if derived by a person other than a U.S. person; within the United States if it is derived by U.S. person. The term "ocean activity includes "any activity conducted on or under water not within the jurisdiction (as recognized by the United States) of a foreign country, possession of the United States, or the United States." See IRC section 863(d).

The activities of the corporation operating the fishing vessel as well as the activities of those individuals working aboard a fishing vessel would fall into this category when the vessel is operating outside of both U.S. territorial waters and the jurisdiction of another country. In addition, the activities of the foreign crew on board the fishing vessels (as well as the activities of the fishing vessel operator) would fall within this definition when the vessels operate outside U.S. waters and outside the jurisdiction of another country.

If the pay received by the nonresident alien employee during one-half or more of the payroll period of not more than 31 consecutive days constitutes wages (for example, fishing within U.S. territorial waters), all remuneration paid by such employer to the employee for the period is deemed to be wages. If the pay received by the employee during more than half of the payroll period does not constitute wages (for example, fishing outside U.S. territorial waters), then none of the remuneration paid by the employer to the employee is wages or subject to tax. Thus, an alien employee on a vessel doing mostly tuna fishing may have some U.S. source income, but would be deemed to have no "wages" and, consequently no withholding. Similarly, the income of a nonresident alien employee on a vessel that fishes mostly in U.S. territorial waters could be entirely wages and subject to withholding.

For income tax purposes and income tax withholding the sourcing rules will determine whether there is a tax consequence.

If the vessel is operated in the United States, then there will be income tax ramifications and if the vessel is operated outside the United States, then there will be no income tax issues. Most fishing is within the United States. Tuna and certain other species are fished by U.S. vessels outside of the United States. This is not true for salmon, crab, and most bottom fish.

In the third situation discussed above, "technicians" are found on processing vessels and factory trawlers. These individuals have specialized skills. As economic and regulatory pressures force fishermen to find ways to receive more income out of the same volume of catch, these "technicians" are expected to show up on smaller vessels.

Two questions arise from consideration of process "technicians." The first question is, "Does an employment relationship exist between the ship's owner and the technician?" The second is, "If the technician is an independent contractor, then who is the withholding agent for purposes of Forms 1042?"

The first question is partially answered above. The technician is operating under a contract with a foreign entity and may not be in the country for a period of greater than 90 days. (The roe season may not be this long, but these individuals will certainly fail the third test.) They will be paid greater than $3,000. (The compensation should be determined by the contract with the Japanese or other foreign firm. These contracts frequently note additional payment for the health care and pension of the technician.)

In this situation, the nonresident alien is subject to the same graduated income tax rates as U.S. citizens because the income is "effectively connected" with a U.S. trade or business. Self-employment tax is not collected on a nonresident alien. In this situation, the U.S. contracting company is the withholding agent.

The "roe technician" is an individual who has skills and knowledge of the processing of fish roe for the Asian (mostly Japanese) market. These individuals work on board the vessel. They work when the fish are available to be processed. This is frequently on the order of a 24-hour shift. This is not unlike the shift of any other process worker. The work of the roe technician is to remove the roe sack, salt, freeze, and pack the product. Secondary duties involve supervision and training of other employees on board to perform the same tasks.

In Japan, the skill of a technician is passed down from generation to generation in a fashion similar to a feudal age guild.

The duties of the technician while shipboard are not that of a consultant, observer, or guarantor of quality, but one of process worker. The skills may be more obscure by western standards but no more specialized than the captain or the engineer.

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Section 982 Letter

Dear Taxpayer

This letter, including the attachments, constitutes a FORMAL DOCUMENT REQUEST under Internal Revenue Code Section 982, and relates to documentation necessary to determine your United States tax liability for taxable years [YEARS]. We are providing you with the following information as required by Section 982.

1. TIME AND PLACE FOR PRODUCTION OF DOCUMENTATION

2. WHY PREVIOUSLY SUBMITTED DOCUMENTATION IS NOT SUFFICIENT

3. DESCRIPTION OF DOCUMENTS REQUESTED

   The documents are those shown on Form 4564, Information Document Request, which is attached and made part of this request. You are required to provide a certified translation into English for requested documents that are in any language other than English.

4. CONSEQUENCES OF FAILURE TO COMPLY

   Code Section 982(a) states that if a taxpayer "fails to substantially comply with any formal document request arising out of the examination of tax treatment of any item (hereinafter in this section referred to as the 'examined item') <u>before the 90th day after the date of the mailing of such request</u> on motion of the Secretary, any court having jurisdiction of a civil proceeding in which the tax treatment of the examined item is an issue shall prohibit the introduction by the taxpayer of any foreign-based documentation covered by such request." Emphasis added.

Further, if the requested items are not received before the 90th day after the date of mailing of this Formal Document Request, interest and/or other unreported income generated by the funds deposited into your foreign bank account(s) will be determined based upon information at hand and will be included in your income for [YEAR] as an addition to income representing unreported earnings. Additionally, adjustments as deemed appropriate will be made due to consequential changes of items related to the preceding operations. Thus, under the provisions of Section 982, you will lose your opportunity to present any of the requested documents to any court having jurisdiction to adjudicate your case in a civil proceeding.

We further advise you that Code section 982(c)(2) allows you to bring a proceeding to quash a Formal Document Request not later than the 90th day after the day such request was mailed. You may institute such a proceeding in United States District Court for the district in which you reside or are found. Under Code section 7701(a)(39), any citizen or resident of the United States, who does not reside in (and is not found in) any United States judicial district shall be treated as residing in the District of Columbia for the purposes of any provisions of the Internal Revenue laws relating to jurisdiction of courts or enforcement of summons. Should you institute a proceeding to quash, the running of the 90 day period for complying with this Formal Document Request shall be suspended while the proceeding is pending. In a proceeding to quash. Section 982 also allows the Secretary of the Treasury to seek to compel compliance with the Formal Document Request.

We urge you to promptly comply with this Formal Document Request.

Sincerely,

____

Internal Revenue Agent

Enclosure: Form 4564

GLOSSARY

Anti-Reflagging Act: The Anti-Reflagging Act states that only certain U.S. manufactured vessels and U.S. citizen owners may operate a fishing operation in within the U.S. economic zone. There is a "savings clause" which exempts certain vessels and certain foreign enterprises from these provisions.

Coastwise trade: A vessel is permitted to travel from port to port within 12 miles from shore. The Coast Guard issues permits for the right to travel in coastwise trade. Vessels without this right must travel outside the 12 mile limit after leaving port before entering another port. Special restrictions on the foreign ownership content and percentage of foreign construction on the vessel exist.

Fishmaster: For larger processor/catcher vessels, the direction of the ship is turned over to a fishmaster while the vessel is fishing. These individuals may be foreign employees and not violate the control requirements of the Anti-Reflagging Act.

Fishery: This term refers to a specific species of fish in specific geographic area as determined either by NOAA or the State Department of Fish and Game. Fishing for Coho Salmon in Bristol Bay is a different fishery from fishing for King Salmon in the same geographic area.

Gill net: This method of fishing involves the laying of a net which is designed to trap the fish in the net so that the fish cannot go through the net, but after the head is in the net the fish cannot back out of the net because the gills become trapped.

I.Q.F.: Individual Quick Frozen fish fillet. A standard method of selling in bulk containers. Blocks of I.Q.F.

I.F.Q. (Individual Fishing Quota): A proposed method of allocation of the catch for bottom fish.

Limited Entry Permits: All fisheries require permits to operate. Some fisheries limit the amount of permits which will be issued as a means to limit the catch. These permits may be issued to an individual indefinitely. Because the rights to fish vest in the permit, these permits may acquire a value in the hundreds of thousands of dollars. Not all permits hold these values.

Long line: This method of catching fish is for the vessel to lay a line from which is attached multiple (hundreds) of auxiliary lines with baited hooks. The end of the line is marked with a buoy or float. After laying numerous lines, the vessel will return to retrieve the catch. Long line is used for salmon and various bottom fish. The value of long line over other methods is that the quality of the fish is improved because there is no contact with the net or other fish.

Mate's receipt: The nautical equivalent of a bill of lading, the title is shifted while in transport to the shipper. This bill is frequently in poundage of the shipment and will use the language "Said to weigh" or "Said to contain."

Magnuson Act: Enacted in 1976, this law provided for the 200 mile U.S. economic zone, restricted entry into the fisheries by foreign interests and mandated use of U.S. constructed vessels.

Tender: A tender is a transport vessel which takes fish from the catcher vessel to the processing site. The processor may be shore based or may be at sea. The tender is generally contracted by the processor to haul fish either on a tonnage basis or by the day, plus expenses. Some tenders, particularly crabbers, also fish in other seasons.

Seine net or purse seine: A purse seine operation is to lay net via an auxiliary boat, in a large circle around the location of the fish the net. The bottom of the net is then drawn together trapping the fish inside (forming the purse). The total net is then pulled from the water. The net may be pulled on board or simply drawn together, concentrating the fish, at which point a fish pump is used to take the fish from the water.