Rev. Rul. 91-19

ISSUE

Are amounts received by fishing boat owners and operators and crew members under the circumstances described below included in their net earnings from self-employment for purposes of the Self-Employment Contributions Act (SECA)?

FACTS

X, a corporation, compensated certain commercial fishing boat owners and operators and crew members (collectively referred to as "fishers") for losses suffered during the year because of X's alleged negligence. The losses incurred by the fishers arose because they could not fish due to certain alleged negligent acts of X. 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.

Two categories of fishers made claims to X: (1) boat owners and operators who held limited entry permits to fish (permits that allow the holder to fish for a specific kind of fish using a particular method for a designated geographic area and period of time); and (2) crew members who worked for shares of the catch and otherwise meet the requirements of sections 3121(b)(20) and 1402(c)(2)(F) of the Internal Revenue Code.

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.

The fishing boat owners and operators are considered self-employed for SECA purposes. In addition, crew members who do meet the requirements of sections 3121(b)(20) and 1402(c)(2)(F) are, for purposes of the SECA only, considered to be engaged in a trade or business, and thus the earnings of these crew members are subject to SECA taxes.

LAW AND ANALYSIS

Section 1401 of the Code imposes taxes on the self- employment income of every individual. Section 1402(b) defines "self-employment income" as the net earnings from self-employment derived by an individual, with certain limitations. Section 1402(a) defines an individual's "net earnings from self- employment" as the "gross income derived by an individual from any trade or business carried on by such individual," also with certain limitations.

Whether an individual is carrying on a trade or business for purposes of section 1402 of the Code is a question of fact that may depend on an analysis of the individual's intent as determined from all the facts and circumstances. It is generally not essential that an individual currently be engaged in the day-to-day conduct of a trade or business in order to be carrying on a trade or business. A taxpayer can still be engaged in a trade or business even if there is a temporary hiatus in the conduct of the activities of that trade or business. See Reisinger v. Commissioner,71

T.C. 568, 572 (1979); Haft v. Commissioner,40 T.C. 2, 6 (1963); see also Rev. Rul. 75-120, 1975-1 C.B. 55 (job search costs may be deductible trade or business expense even if taxpayer is temporarily unemployed).

Similarly, whether a payment is derived from a trade or business carried on by an individual for purposes of section 1402 of the Code depends on whether, under all the facts and circumstances, a nexus exists between the payment and the carrying on of the trade or business. The Tax Court articulated this "nexus" requirement in Newberry v. Commissioner,76 T.C. 441, 444 (1981), where it observed that, under section 1402.

[T]here 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.

Generally, the required nexus exists if it is clear that a payment would not have been made but for an individual's conduct of a trade or business. The fact that a payment represents compensation for lost income of a trade or business rather than income generated directly by the day-to-day conduct of the trade or business is generally irrelevant in determining whether this required nexus exists. In Rev. Rul. 76-500, 1976-2 C.B. 254, for example, a farmer suffered an $8,000 crop loss resulting from a drought. The farmer received an $8,000 loan from the Farmers Home Administration, of which $5,000 of the principal was immediately canceled. The revenue ruling concludes that the amount of the canceled portion of the loan represents a replacement of a portion of the farmer's lost profits, and must be taken into account in computing net earnings from self-employment. See also Rev. Rul. 60-32, 1960-1 C.B. 23; Notice 87-26, 1987-1 C.B. 470.

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

The Service does not agree with the Tax Court's decision in Newberry to the extent that it is inconsistent with this analysis. Specifically, while the Service agrees with the court's statement that, under section 1402 of the Code, there must be a nexus between a payment and the carrying on of a trade or business in order for the payment to be considered self-employment income, it does not agree with the court's conclusion that such a nexus cannot exist if an individual is not currently engaged in the day-to-day conduct of the trade or business, e.g., is unemployed. In Newberry, the <Page 188>petitioner owned and operated a grocery store that was destroyed by fire, 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 payments in Newberry were made, not because of a liquidation of the petitioner's business, but rather in connection with the petitioner's continuing conduct of the trade or business, even though he was temporarily unable to conduct day-to-day affairs during the store's reconstruction.

HOLDING

The amounts received by the fishers from X are included in their net earnings from self-employment for SECA purposes.

If an individual received payments based on both the individual's prior years' self-employment fishing income (income subject to the SECA tax) and the individual's prior years' fishing income as an employee (income subject to the FICA taxes), the above conclusion applies only to the portion of the payments received that represents the self-employment fishing income. The portion of the payments received that represents fishing income as an employee, while includible in gross income, is not included in net earnings from self-employment and is not wages for federal employment tax purposes.

The Internal Revenue Service will not follow the decision in Newberry. Under the rationale of this revenue ruling, amounts received by a taxpayer under facts similar to those in Newberry would be included in net earnings from self-employment for purposes of the Self-Employment Contributions Act.

EFFECTIVE DATE

Under the authority contained in section 7805(b) of the Code, the holding of this revenue ruling that the amounts received by the fishers from X are included in their net earnings from self-employment for SECA purposes will be applied only to payments received in taxable years beginning after December 31, 1990. This section 7805(b) relief is limited to situations described in the facts of this revenue ruling. In other situations, the analysis and holding in this revenue ruling apply for all taxable years.