Income Averaging—

Tax hedge softens volatile seasons

by Gregory L. White, CPA

The new tax law has an important provision affecting many fishermen. It reinstates income averaging for most fishermen (see discussion below), beginning with the 2004 tax year. This special tax break is not available for most taxpayers. Only fishermen and farmers can benefit from it. This will help fishermen who are generally in a higher tax bracket in 2004 than they were in the prior three years.

How it Works: Essentially, you elect to treat all or a portion of your fishing income as if it were earned in the prior three years. So if you were in a lower bracket in the previous three years, your tax bill should be reduced.

Example: You had a great year fishing halibut in 2004 because prices were high. Your top tax bracket was 35 percent in 2004, but only 15 percent in 2001, 2002 and 2003. You should benefit from the new law. If you elect to use income averaging for $30,000 of your fishing income, you might drop your 2004 tax bill buy as much as $6,000. You should note, however, that typical savings would be substantially less.

Example: You had a major breakdown in 2002, and therefore actually lost money. In 2004, you have significant income from fishing. You will likely benefit from the new rules.

In order to use income averaging, you must complete Schedule J of Form 1040 and attach it to your tax return.

Who's Covered: It is not clear that the new law will benefit all fishermen:

Vessel Owners—It is very clear that vessel owners will benefit from the rules. The benefits will accrue whether or not you fish your vessel. Even if a vessel owner never goes aboard the vessel, income averaging will be available for fishing income. Further, even if the vessel is owned indirectly through an S Corporation, Partnership or LLC, the benefits will accrue. However, the rules do not benefit owners of a vessel owned by a C Corporation.

Fishermen on Catcher Vessels—Fishermen who work on vessels which normally have fewer than 10 crewmembers and who are paid on a crew-share basis are generally not treated as employees. The new rules will likely cover such captains, deckhands and other crewmembers who file Schedule C (i.e., who are not treated as employees, but rather as independent contractors). There is some uncertainty here. The IRS's instructions to the income averaging form (Schedule J) provide that generally fishing income doesn't include wages (unless received from an S Corporation, and you are a shareholder in the corporation). However, crew members on catcher vessels normally report their income on Schedule C, and therefore, aren't treated as receiving wages.

Fishermen on C-P Vessels—Crewmembers on large vessels normally treat their fishermen as employees and issue Form W-2 to them. If you follow the IRS's instructions (see discussion above) these crewmembers would not normally qualify to use income averaging. These instructions appear to be based on the treatment accorded under regulations to farmers. An employee on a farm does not qualify for income averaging. However, farm employees are normally not paid according to the value of the crop, and are therefore substantially different than many fishermen.

It is almost certain that a processor or other crewmember who is paid on an hourly basis or salary basis does not qualify for the benefits of income averaging.

Lease of Fishing Vessel or Fishing Rights—It is possible that income from leasing a vessel or fishing rights may qualify for income averaging. The term fishing includes "any other activity which can reasonably be expected to result in the catching, taking or harvesting of fish." Certainly, the leasing of a vessel or fishing rights (including IFQ's) would normally meet this standard.

Also, as a point of comparison, the Treasury has specifically approved income averaging for farm landlords where there is a written lease in effect before the tenant begins significant activities on the land, and where the lease payments are based upon a share of the tenant's production. Most fishing vessel or fishing right leases meet this standard. Additionally, the very purpose of income averaging (as set forth in the preamble to current regulations) was "limiting the adverse effects" where income varies significantly from year to year. This variation affects lessors of farms and lessors of fishing vessels and fishing rights equally. By analogy there is a good argument for including lease income in income averaging.

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Sale of a Vessel or Fishing Rights—Gain from the sale of a fishing vessel or fishing rights will normally qualify.

What Taxes are Covered: The new law does not affect computations of self-employment tax. This will continue to be computed as before.

Alternative minimum tax is not increased as a result of using income averaging. This is good news for many fishermen.

Gregory L. White is a founder of White Thompson & Co. PS located in Seattle, Wash. He is a CPA, has a Masters Degree in Taxation, and is admitted to practice in United States Tax Court. His firm specializes in the taxation of fishing vessel owners and fishermen.