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Final regulations on income averaging for farmers*

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The proposed regulations for the income averaging provisions for farmers were made final on January 7, 2002. The final regulations addressed several of the shortcomings in the proposed regulations issued in 1999.

Farm landlords

The proposed regulations did not address the question of whether farm landlords were eligible for income averaging. However, the final regulations provide that rental income that is based on a tenant's production (a share rent lease) is treated as income from a farming business if, after December 31, 2002, the landlord's share of a tenant's production is set in a written rental agreement entered into before the tenant begins significant activities.

The final regulations make it clear that a landlord is not considered to be engaged in a farming business if the rental is either a fixed rent (cash rent) or, for amounts received on or after January 1, 2003, even share rents based on a share of a tenant's production determined under an unwritten agreement or a written agreement entered into after the tenant has begun significant activities on the land. Surprisingly, the final regulations specify that whether the landlord materially participates in the tenant's farming business "is irrelevant for purposes of section 1301." Therefore, non-materially participating filers under Form 4835 or even filers on Schedule E are eligible for income averaging if the landlord's share of a tenant's production is set in a written rental agreement before the tenant begins significant activities on the land.

This places a premium on assuring that leases are in writing.

Eligibility of wages

The proposed regulations stated that, in general, income items passed through to partners or other owners in a pass-through entity, were eligible for income averaging. For S corporations, the character of income from corporate distributions continues in the hands of the shareholders who are eligible to average their incomes. However, under the proposed regulations, farm income did not include "wages."

The final regulations state specifically that "a shareholder of an S corporation engaged in a farming business" may treat compensation received from the corporation that is attributable to the farming business as farm income.

The summary to T.D. 8972 (but not the final regulations themselves) states that the income attributable to a farming business carried on by a partnership can be averaged without regard to the partner's level of participation in the partnership or the size of the ownership interest.

Negative taxable income

The final regulations embrace the change in position first announced in the 2001 Farmers Tax Guide and in the Schedule J instructions allowing a base year's taxable income to be negative. However, amounts such as a net operating loss or capital loss that may be deducted in one or more other taxable years in the form of a carryback or carryforward must be added back in computing negative taxable income.

Change in filing status

As did the proposed regulations, the final regulations state that an individual is not prohibited from making an income averaging election solely because the individual's filing status is not the same as in the base years. However, the final regulations do not provide guidance on how the remaining bracket amounts are to be divided between the spouses if both spouses have elected farm income in a year following marriage dissolution, which was a shortcoming of the proposed regulations.

Amending returns

Under the proposed regulations, an individual could not make a late election, change an election or revoke an election unless there had been an adjustment to taxable income or tax liability or the Commissioner of Internal Revenue had consented. That requirement has been eliminated in the final regulations with the provision now stating simply that an election can be made on a "late or amended return if the period of limitations on filing a claim for credit or refund has not expired..." and that a previous election can be changed or revoked if the period of limitations has not expired.

Effective dates

In general, the final regulations are effective for taxable years beginning after December 31, 2001. However, the requirement for a written lease agreement does not apply until after December 31, 2002.

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