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INCOME AVERAGING

— by Neil E. Harl*

Although the possibility of a return to income averaging¹ had been discussed for several years, enactment of income averaging for farm income² came as a great surprise to many. The provision is not effective until 1998, and remains available for 1999 and the year 2000, and sunsets at the end of 2000 unless extended by legislative action.³

As is often the case with a new tax rule, the legislation is sketchy and unclear on several points. Interpretative guidance would be helpful but the burden on the Internal Revenue Service to fill in the voids on many of the provisions in the Taxpayer Relief Act of 1997⁴ will likely leave little time to clarify this code section.

The general approach

The basic configuration of the new income averaging provision is deceptively simple (303 words) and, unlike some of the sections in the 1997 legislation, is relatively easy to follow.

Under the provision, I.R.C. § 1301, an individual, engaged in a farming business, can elect to spread whatever portion of current income is desired (termed “elected farm income”)⁵ evenly over the three prior taxable years.⁷ The current year’s income tax liability is calculated by determining the current year’s tax (without the amount of elected farm income) plus the increases in income tax for each of the three prior taxable years by taking into account the allocable share of elected farm income for each of those years.⁸ It is important to note that any adjustment for any taxable year is taken into account for income averaging purposes in subsequent taxable years.⁹

Who’s eligible?

The statute makes it clear that only individuals are eligible to utilize the provision.¹⁰ Estates and trusts are specifically made ineligible¹¹ and C corporations are not considered to be individuals.

Presumably, entities taxed as partnerships pass through income items to the partners who, if they are individuals should be able to elect income averaging.¹²

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For S corporations, the character of income from corporate distributions continues in the hands of the shareholders and does not necessarily produce dividends.¹³ As stated in the statute, “the character of any item included in a shareholder’s pro rata share...shall be determined as if such item were realized directly from the source from which realized by the corporation, or incurred in the same manner as incurred by the corporation.”¹⁴

Meaning of “farming business” (type of operation)

An individual electing income averaging under the new rule must be “engaged in a farming business.”¹⁵ Presumably, that means an individual must be engaged in a farming business in the year for which the election is made but need not have been necessarily engaged in a farming business in the three prior carryback years. The definition of the term “farming business” is found in I.R.C. § 263A(e)(4).¹⁶

Several questions as to the meaning of “farming business” are answered in the regulations under that provision—

- “Farming business,” under the regulations, “means a trade or business involving the cultivation of the land or the raising and harvesting of any agricultural or horticultural commodity. Examples include the trade or business of operating a nursery or sod farm; the raising or harvesting of crops; the raising or harvesting of trees bearing fruit, nuts or other crops; the raising of ornamental trees; and the raising, shearing, feeding, caring for, training, and management of animals.”¹⁷

- The term “farming business” does not include the processing of commodities or products “beyond those activities which are normally incident to the growing, raising or harvesting of such products.”¹⁸

Meaning of “farming business” (relationship to operation)

Another critical question for income averaging is where the line is drawn in terms of the relationship of the “individual” to the “farming business.”

- Operators of farming businesses, bearing the risks of production and the risks of price change and providing

substantial involvement in management, are clearly eligible.

- Landowners under material participation crop share and livestock share leases¹⁹ have generally been considered to be engaged in a business, file Schedule F and are generally treated the same as farm operators for federal tax purposes.

- The major question is whether landlords under non-material participation share leases who report their income and expenses on Form 4835 are engaged in a “farming business.” Although that is not completely clear, it appears likely that such landlords will be eligible to average their farm incomes.

- It is certain that landlords under cash rent leases are not considered to be engaged in a “farming business.”

- It would seem that individuals who have ceased farming operations with the only activity in the year in question being the sale of inventory and the sale of machinery are not engaged in a “farming business” in that year.

Income eligible for averaging

Under the statute, gains from the “sale or other disposition of property (other than land) regularly used by the taxpayer in such a farming business for a substantial period” are eligible for averaging.²⁰

- Clearly, gains from the sale or exchange of land do not qualify.²¹ Although not completely clear, it would appear that gain from land sales is ineligible for averaging whether that gain is taxed as capital gain, ordinary income, recaptured depreciation²² or “unrecaptured section 1250 gain”²³ and whether that gain is attributable to the soil or to assets considered to be part of the land (buildings, fences and tile lines, for example).

- The meaning of “substantial period” is unclear with no guidance provided in the committee reports. Presumably, IRS will publish some guidelines on the meaning of the term.

Applicability to other taxes

The income averaging statute refers clearly to averaging for purposes of the “tax imposed by section 1.”²⁴ Thus, the provision does not apply for purposes of alternative minimum tax, which is imposed by I.R.C. § 55, and does not apply for employment tax purposes, which are imposed under other code sections.

Moreover, the provision does not seemingly require the recalculation of the income tax liability of any other taxpayer such as a minor child who is required to use the federal income tax rates of his or her parents under I.R.C. § 1(g).

Conclusion

Year-end planning for 1997 may be influenced by the availability of income averaging in 1998, 1999 and 2000.

Hopefully, additional guidance will be published before 1998 income tax returns must be filed.

FOOTNOTES

- ¹ The concept of income averaging was repealed in 1986. Tax Reform Act of 1986, Pub. L. 99-514, Sec. 141, 100 Stat. 2117 (1986), repealing I.R.C. § 1301 (providing for spreading averagable income over four prior years).
- ² I.R.C. § 1301, enacted by TRA-97, Sec. 933(a).
- ³ TRA-97, Sec. 933(c).
- ⁴ Pub. L. 105-34, 111 Stat. 788 (1997).
- ⁵ I.R.C. § 1301(b)(1).
- ⁶ I.R.C. § 1301(a).
- ⁷ *Id.*
- ⁸ *Id.*
- ⁹ *Id.*
- ¹⁰ *Id.*
- ¹¹ I.R.C. § 1301(b)(2).
- ¹² See I.R.C. § 701.
- ¹³ I.R.C. § 1366(b). See Ann. 84-39, I.R.B. 1984-15, 53.
- ¹⁴ I.R.C. § 1366(b).
- ¹⁵ I.R.C. § 1301(a).
- ¹⁶ I.R.C. § 1301(b)(3).
- ¹⁷ Temp. Treas. Reg. § 1.263A-4T(c)(4)(i)(A). An evergreen tree more than six years old at the time severed from the roots is not treated as an ornamental tree. I.R.C. § 263A(e)(4).
- ¹⁸ Temp. Treas. Reg. § 1.263A-4T(c)(4)(i)(C).
- ¹⁹ See I.R.C. § 1402(a)(1).
- ²⁰ I.R.C. § 1301(b)(1)(B).
- ²¹ *Id.*
- ²² I.R.C. §§ 1245, 1250.
- ²³ I.R.C. § 1(h)(1)(B)(i).
- ²⁴ I.R.C. § 1301(a).