New Income Averaging Regulations

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NEW INCOME AVERAGING REGULATIONS

— by Neil E. Harl

The long-awaited proposed regulations on income averaging were issued on October 7, 1999. The new regulations provide guidance in several areas although some questions remain unanswered.

Engaged in a farming business

The proposed regulations acknowledge that the term “farming business,” has the same meaning as in I.R.C. § 263A. The regulations go on to clarify that an “individual engaged in a farming business” includes a partner in a partnership engaged in a farming business and a shareholder of an S corporation engaged in a farming business as well as a sole proprietor of a farming business.

The proposed regulations do not, however, address eligibility of landlords for income averaging. Thus, operators of farming businesses are clearly eligible but the regulations do not address eligibility of landlords under a material participation share lease reporting on Schedule F (who should be considered eligible) and landlords under non-material participation share leases reporting on Form 4835 (who should be considered eligible if there is substantial involvement in management and decision making under the lease even though falling short of material participation).

It has been thought that non-material participation share landlords with little or no involvement in management and cash rent landlords were probably not eligible. The proposed regulations did not provide answers to those questions.

Elected farm income

The proposed regulations specify that “elected farm income” includes all income and gains less deductions and losses (including loss carryovers and carrybacks and including non-farm losses) attributable to an individual’s farming business. The proposed regulations state, however, that income, gain or loss from “the sale of development rights, grazing rights and other similar rights” are not treated as attributable to a farming business. Moreover, “farm income” does not include wages.

Thus, farm employees are not eligible for income averaging and, presumably, neither are wages paid to employee-shareholders of an S corporation or other entity.

The term “elected farm income” may not exceed taxable income for the taxpayer and net capital gain attributable to a farming business may not exceed total net capital gain for the taxpayer. A significant question is whether “elected farm income” for the election year can be negative. The income averaging statute defines elected farm income as “taxable income” which, in turn, is defined as gross income less allowed deductions. Thus, it appears that elected farm income could be negative. However, the statute requires the “increase in tax imposed by section 1” from the three preceding years to be added to the tax computation. Therefore, if a farm taxpayer had negative elected farm income, a strong argument could be made that the negative amount cannot be factored in when computing the electing year’s tax.

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liability. Unfortunately, the proposed regulations do not address the issue.

In an important determination, the proposed regulations state that an individual with both ordinary income and net capital gain farm income (presumably including Section 1231 gains) may elect, up to elective farm income, any combination of ordinary income and net capital gains.\(^\text{14}\) In making that determination, net capital losses first offset net capital gains, both farm and non-farm, before reducing ordinary income.\(^\text{15}\) The rule that capital losses can only offset up to $3,000 of ordinary income per year\(^\text{16}\) still applies for purposes of elected farm income calculations, also.\(^\text{17}\)

Thus, a taxpayer can elect to carryback only ordinary income, only capital gain income or any combination after making these adjustments.

Once the taxpayer decides how much and what type of elected farm income to carry back to the three prior years, one-third of each type of elected farm income is then allocated to each of the base years.\(^\text{18}\)

**Sale or other disposition of property**
The proposed regulations echo the statute in stating that gain or loss from the sale or other disposition of property regularly used in the individual’s farming business “for a substantial period” is treated as attributable to the farming business.\(^\text{19}\) Regrettably, the regulations do not provide a “bright line” test for “substantial period” and state merely that it is a facts and circumstances question.\(^\text{20}\)

The proposed regulations, as does the statute, specifically exclude gains from land from eligibility for income averaging.\(^\text{21}\) Unlike the statute, the regulations do not exclude gains or losses from structures on the land from eligibility for income averaging.\(^\text{22}\) Presumably, gains and losses (and recapture income) from buildings, fences, tile lines and other improvements to land are included as gains or losses eligible for inclusion in income averaging calculations.\(^\text{23}\)

In gains or losses from such property after cessation of the farming business, the gain or loss is treated as attributable to a farming business if the property is sold within a reasonable time after cessation of the farming business.\(^\text{24}\) A sale or other disposition within one year of cessation of the farming business is presumed to be within a reasonable time.\(^\text{25}\) Beyond one year, it becomes a facts and circumstances question.\(^\text{26}\)

**Calculating the tax**
The proposed regulations make it clear, as does the statute,\(^\text{27}\) that income averaging affects only “Section 1 tax” (federal income tax) and has no application to employment taxes (FICA, FUTA, SECA or income tax withholding).\(^\text{28}\) Moreover, the proposed regulations state that income averaging does not apply for purposes of figuring alternative minimum tax.\(^\text{29}\) The inapplicability of income averaging to AMT confirms that benefits of income averaging are severely limited.

The Section 1 tax is to be determined by allocating elected farm income to the base years only after all other adjustments and determinations have been made.\(^\text{30}\) Thus, any net operating loss carryovers or net capital loss carryovers are applied to an election year before allocating elected farm income to the base years.\(^\text{31}\) Similarly, the determination of whether there is a net Section 1231 gain or loss in the election year and the character of the Section 1231 items are made before allocating elected farm income to the base years.\(^\text{32}\)

The allocation of elected farm income to the base years does not affect any determination (other than for the calculation of the Section 1 tax attributable to the elected farm income) with respect to the election year or the base years.\(^\text{33}\) As the regulations note, in applying the limitation on itemized deductions\(^\text{34}\) to the election year, adjusted gross income for that year includes any elected farm income allocated to the base years.\(^\text{35}\) Likewise, the same limitation for the base years is not recomputed to take into account any allocation of elected farm income to the base years.\(^\text{36}\)

The calculation of the Section 1 tax on elected farm income allocated to a base year is made without any additional adjustments or determinations with respect to that year.\(^\text{37}\) Thus, if a base year had a partially used capital loss, the rest of the loss could not be used to reduce the elected farm income allocated to that year.\(^\text{38}\) The same is true of credits for the base year.\(^\text{39}\)

**Status of the taxpayer**
Under the regulations, an individual is not prohibited from making a farm income averaging election solely because the individual’s filing status is not the same in the election year and the base years.\(^\text{40}\) Thus, an individual who files as a married taxpayer filing jointly in the election year but filed as a single taxpayer in all of the base years may still elect to average income.\(^\text{41}\) The regulations do not, however, address problems with community property states or situations more generally when the spouses are both involved in the business. Presumably, farm income must be identified and associated with the appropriate taxpayer.

**The election**
The statute is unclear as to whether the income averaging election could be made on an amended return.\(^\text{42}\) The proposed regulations state that if an individual has an adjustment for the election or a base year, the individual may also make a late income averaging election or revoke or change a previous election.\(^\text{43}\) If there is no adjustment for the election year or a base year, a late election, revocation or change may be made only with the Commissioner’s consent.\(^\text{44}\) It is anticipated that the Commissioner’s consent will be obtained by requesting a letter ruling from the national office.

**In conclusion**
The biggest disappointment in the proposed regulations is the failure to provide guidance in several important areas, as noted. Hopefully, the final regulations or other guidance will provide insights into these areas badly needing illumination.

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FOOTNOTES


\(^2\) Prop. Treas. Reg. § 1.1301-1(b).

\(^3\) *Id.*


\(^5\) *Id.*

\(^6\) Prop. Treas. Reg. § 1.1301-1(e)(ii), Ex. 2.

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*"Agricultural Law Manual" (ALM).*
BANKRUPTCY

CHAPTER 12-ALM § 13.03[8].

On October 9, 1999, President Clinton signed S. 1606, sponsored by Sen. Charles Grassley of Iowa, which extended Chapter 12 bankruptcy through June 30, 2000. Chapter 12 had expired at midnight on September 30 but the new legislation was retroactive to October 1. Legislation has been introduced to make Chapter 12 permanent (S. 260, the "Safeguarding America's Farms Entering the Year 2000 Act," and H.R. 1763).

CLAIMS. The debtors filed for Chapter 12 and listed a fertilizer creditor’s claim on their schedules as an unsecured claim. The claim was also included in the plan as part of the unsecured claims. The creditor did not participate in the case until filing an objection to the plan eight days after the claims bar date and did not actually file a claim until 160 days after the claims bar date. The debtor sought to disallow the claim, except as provided in the plan, as untimely filed. The creditor argued that (1) the objection to the plan should have been treated as an informal claim filing, allowing the late filing to relate back to the objection date, (2) the claim should be allowed for excusable neglect, and (3) the debtor’s listing of the claim on the bankruptcy schedules acted as an informal claim. The court held that (1) even if the objection to the plan operated as an informal claim, the objection was filed after the claims bar date and was untimely; (2) excusable neglect was not allowed under Chapter 12 to allow untimely filed claims; and (3) only the creditor could file an unsecured claim. In re Boudinot, 237 B.R. 413 (Bankr. S.D. Ohio 1999).

FEDERAL TAX-ALM § 13.03[7].

AUTOMATIC STAY. The debtors filed for Chapter 13 in May 1996 and listed an unsecured IRS claim for $193. The debtors’ plan was confirmed in September 1996 without objection. The debtors filed their 1996 tax return in February 1997 and claimed a refund. The IRS imposed a freeze on the debtors’ tax account because the debtors were delinquent on their plan payments. The court adopted the holding of some prior cases that, upon confirmation, the estate property revested in the debtors but the estate includes all property acquired by the debtors post-confirmation; thus, the refund was estate property protected by the automatic stay. The court also held that the IRS refusal to pay the refund was a violation of the automatic stay and awarded the debtors $1000 in general damages, $12,000 in attorneys’ fees and $7000 in emotion damages. In re Holden, 236 B.R. 156 (Bankr. D. Vt. 1999).

DISCHARGE. The debtor did not file a tax return for the 1981 tax year and the IRS constructed a substitute return in order to make an assessment of taxes for that year. The debtor did not provide any evidence of filing a return for 1981. The court held that the 1981 taxes were nondischargeable under Section 523(a)(1) because the debtor had not filed a return for that year. In re Barber, 236 B.R. 655 (Bankr. N.D. Ind. 1998).

POST-PETITION CLAIMS. The debtors filed for Chapter 13 in January 1994 and their plan was confirmed in September 1994. In 1998, when the plan was substantially consummated, the IRS filed a claim for 1994, 1995 and 1996 taxes. The Chapter 13 trustee moved to dismiss the case because it was