

Notice of Proposed Rulemaking and Notice of Public Hearing

Averaging of Farm Income

REG-121063-97

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations for averaging farm income under section 1301 of the Internal Revenue Code. The regulations reflect the enactment of the provision by the Taxpayer Relief Act of 1997, as amended by the Omnibus Consolidated and Emergency Supplemental Appropriations Act, 1999. The regulations provide guidance to individuals engaged in a farming business who may elect to reduce their regular tax liability by treating all or a portion of the current year's farming income as if it had been earned in equal proportions over the prior three years. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments and requests to speak (with outlines of oral comments) at a public hearing scheduled for February 15, 2000, must be received by January 14, 2000.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG-121063-97), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG-121063-97), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at http://www.irs.gov/tax_regsg/regsglist.html. The public hearing will be held in room 2615, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, John M. Moran, at (202) 622-4940; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Guy Traynor, at (202) 622-7190 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collection of information should be sent to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, OP:FS:FP, Washington, DC 20224. Comments on the collection of information should be received by December 7, 1999. Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the functions of the IRS, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information (see below);

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collection of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information.

The collection of information in this proposed regulation is in §1.1301-1(c). This collection of information is required by the IRS to verify compliance with sec-

tion 1301. This information will be used to determine whether the amount of tax has been calculated correctly. The collection of information is required to obtain a benefit. The respondents are certain individuals engaged in the trade or business of farming.

Taxpayers provide the information on Schedule J, Farm Income Averaging, which is attached to Form 1040, U.S. Individual Income Tax Return, for the taxable year in which income averaging is elected. The burden for this requirement is reflected in the burden estimate for Schedule J. The estimated burden for the 1998 Schedule J is 1.31 hours per respondent.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

This document contains proposed amendments to the Income Tax Regulations (26 CFR part 1) for averaging farm income under section 1301 of the Internal Revenue Code (Code). Section 1301 was enacted by section 933 of the Taxpayer Relief Act of 1997, Public Law 105-34 (111 Stat. 788) (the TRA of 1997), effective for taxable years beginning after December 31, 1997, and ending before January 1, 2001. Section 2011 of the Tax and Trade Relief Extension Act of 1998, which is part of the Omnibus Consolidated and Emergency Supplemental Appropriations Act, 1999, Public Law 105-277, 112 Stat. 2681, amended section 933 of the TRA of 1997 by deleting the January 1, 2001 ending date.

Section 1301(c) authorizes the Secretary to prescribe regulations as may be appropriate to carry out the purposes of this section, including regulations regarding (1) the order and manner in which items of income, gain, deduction, or loss, or

limitations on tax, shall be taken into account in computing the tax imposed by chapter 1 (Normal Taxes and Surtaxes) of subtitle A (Income Taxes) of the Code on the income of any taxpayer to whom this section applies for any taxable year, and (2) the treatment of any short taxable year.

Explanation of Provisions

I. In general

Under section 1301, an individual may elect to compute the section 1 tax for the current taxable year by designating all or a portion of the individual's farm income (subject to certain limitations) as elected farm income, and subtracting it from taxable income. One-third of the elected farm income is allocated to each of the three prior years' taxable income and the increase in the section 1 tax that results from these additions is calculated. The prior years are referred to as base years. The tax for the current year is the sum of (1) the section 1 tax for the current year without the elected farm income and (2) the increase in the section 1 tax for the three base years that is attributable to elected farm income.

II. Engaged in a farming business

The proposed regulations provide that the term *farming business* has the same meaning as provided in section 263A(e)(4) and the regulations thereunder. The proposed regulations also provide that an individual engaged in a farming business includes a sole proprietor of a farming business, a partner of a partnership engaged in a farming business, and a shareholder of an S corporation engaged in a farming business.

III. Making, changing, or revoking an election

The proposed regulations provide that a farm income averaging election is made by filing Schedule J, Farm Income Averaging, with an individual's timely filed Federal income tax return (including extensions). In general, the proposed regulations provide that if an individual has an adjustment for an election year or base year, the individual may also make a late farm income averaging election or change or revoke a previous election. An adjust-

ment is any change in taxable income or tax liability that is permitted to be made by filing an amended Federal income tax return, or a change in taxable income or tax liability resulting from an IRS examination. If there is no adjustment for an election year or a base year, a late election, change, or revocation may be made only with the consent of the Commissioner. The IRS and the Treasury Department anticipate that the Commissioner's consent will be obtained by requesting a letter ruling from the national office.

IV. Calculation of section 1 tax

Farm income averaging allocates one-third of elected farm income from an election year to each of the base years only for the purpose of calculating the section 1 tax attributable to the elected farm income allocated to each base year. The proposed regulations provide that the section 1 tax for the election year is determined by allocating elected farm income to the base years only after all other adjustments and determinations have been made. For example, any net operating loss carryover is applied to an election year before allocating elected farm income to the base years.

The regulations provide that the allocation of elected farm income to the base years does not affect any determination (other than the calculation of the section 1 tax attributable to the elected farm income) with respect to the election year or the base years. Thus, for example, in applying the section 68 overall limitation on itemized deductions to the election year, adjusted gross income for the election year includes any elected farm income allocated to the base years. Similarly, the section 68 limitation for a base year is not recomputed to take into account any allocation of elected farm income to such base year.

The proposed regulations provide that 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. For example, if a base year had a partially used capital loss, the remaining capital loss may not be applied to reduce the elected farm income allocated to such year. Similarly, if a base year had a partially used credit, the remaining credit may not be applied to reduce the section 1

tax attributable to the elected farm income allocated to such year.

V. Elected farm income

The proposed regulations provide that farm income includes all income, deductions, gains, and losses attributable to an individual's farming business. An individual may designate what type, and how much of each type, of farm income is to be treated as elected farm income. The elected farm income may not exceed an individual's taxable income. In addition, elected farm income from net capital gain attributable to a farming business may not exceed total net capital gain. One-third of each type of elected farm income is then allocated to each base year.

Proposed Effective Date

The regulations, as proposed, apply to any taxable period ending on or after the date of publication of a Treasury decision adopting these rules as final regulations in the **Federal Register**. However, the rules in these proposed regulations may be relied on by individuals for taxable periods ending before the publication of the Treasury decision.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that the collection of information imposed by this regulation is not significant as reflected in the estimated burden of information collection for Schedule J, which is 1.31 hours per respondent. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Before these proposed regulations are adopted as final regulations, consideration will be given to any electronic or written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. The IRS and Treasury Department request comments on the clarity of the proposed rules and how they can be made easier to understand. In addition, comments are specifically requested regarding whether wages paid to a shareholder of an S corporation may be elective farm income. All comments will be available for public inspection and copying.

A public hearing has been scheduled for February 15, 2000, beginning at 10 a.m. in room 2615 of the Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must enter at the 10th Street entrance, located between Constitution and Pennsylvania Avenues, NW. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit electronic or written comments and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by January 14, 2000. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these regulations is John M. Moran, Office of Assistant Chief Counsel (Income Tax & Accounting). However, other personnel

from the IRS and Treasury Department participated in their development.

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Proposed Amendment to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.1301-1 also issued under 26 U.S.C. 1301(c). * * *

Par. 2. An undesignated center heading and §1.1301-1 are added immediately following the center heading "Readjustment of Tax Between Years and Special Limitations" to read as follows:

INCOME AVERAGING

§1.1301-1 Averaging of farm income.

(a) *Overview.* An individual engaged in a farming business may elect to compute his or her current year (election year) income tax liability under section 1 by averaging, over the prior three-year period (base years), all or a portion of the individual's current year elective farm income (as defined in paragraph (e) of this section. To average farm income, the individual—

(1) Designates all or a portion of his or her elective farm income for the election year as elected farm income;

(2) Allocates one-third of the elected farm income to each of the three base years; and

(3) Determines the election year section 1 tax by determining the sum of—

(i) The election year section 1 tax without regard to the elected farm income; plus

(ii) For each base year, the increase in section 1 tax attributable to the elected farm income allocated to such year.

(b) Individual engaged in a farming business. Farming business has the same meaning as provided in section 263A(e)(4) and the regulations thereunder. An individual engaged in a farming business includes a sole proprietor of a farming business, a partner in a partner-

ship engaged in a farming business, and a shareholder of an S corporation engaged in a farming business. An individual is not required to have been engaged in a farming business in any of the base years in order to make a farm income averaging election.

(c) *Making, changing, or revoking an election—(1) Making an election.* A farm income averaging election is made by filing Schedule J, Farm Income Averaging, with an individual's timely filed (including extensions) Federal income tax return for the election year.

(2) *Making a late election, or changing or revoking an election—(i) Adjustments in an election or base year.* An individual who has an adjustment for an election year or any base year may make a late farm income averaging election, change the amount of elected farm income in a previous election, or revoke a previous election, if the period of limitation on filing a claim for credit or refund has not expired for the election year. For purposes of this paragraph (c)(2), an adjustment is any change in taxable income or tax liability that is permitted to be made by filing an amended Federal income tax return or a change in taxable income or tax liability made as the result of an IRS examination.

(ii) *No adjustment.* If an individual does not have an adjustment described in paragraph (c)(1)(i) of this section, the individual may not make a late farm income averaging election, change the amount of elected farm income in a previous election, or revoke a previous election, without the consent of the Commissioner.

(d) *Calculation of section 1 tax—(1) In general.* The section 1 tax for the election year is determined by allocating elected farm income to the base years only after all other adjustments and determinations have been made. For example, any net operating loss (NOL) carryover or net capital loss carryover is applied to an election year before allocating elected farm income to the base years. Similarly, the determination of whether there is a net section 1231 gain or loss in the election year and the determination of the character of the section 1231 items are made before allocating elected farm income to the base years. The allocation of elected farm income to the base years does not affect

any determination (other than the calculation of the section 1 tax attributable to the elected farm income) with respect to the election year or the base years. Thus, for example, in applying the section 68 overall limitation on itemized deductions to the election year, adjusted gross income for the election year includes any elected farm income allocated to the base years. Similarly, the section 68 limitation for a base year is not recomputed to take into account any allocation of elected farm income to such base year. 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 such year. For example, if a base year had a partially used capital loss, the remaining capital loss may not be applied to reduce the elected farm income allocated to such year. Similarly, if a base year had a partially used credit, the remaining credit may not be applied to reduce the section 1 tax attributable to the elected farm income allocated to such year.

(2) *Base year was previously an election year or another base year.* If a base year for a current farm income averaging election was previously an election year for another farm income averaging election, the base year's section 1 tax is determined after reducing the base year's taxable income by the elected farm income for that prior election year. If a base year for a current farm income averaging election was previously a base year for another farm income averaging election, the base year's section 1 tax is determined after increasing the base year's taxable income by the elected farm income allocated to that year by that prior election.

(3) *Example.* The rules of paragraph (d)(2) of this section are illustrated by the following example:

Example. (i) In each of years 1996, 1997 and 1998, T had taxable income of \$20,000. In 1999, T had taxable income of \$30,000 (prior to any farm income averaging election) and electible farm income of \$10,000. T makes a farm income averaging election with respect to \$9,000 of his electible farm income for 1999. Thus, \$3,000 of elected farm income is allocated to each of years 1996, 1997 and 1998. T's 1999 tax liability is the sum of—

(A) The section 1 tax on \$21,000 (1999 taxable income minus elected farm income); plus

(B) For each of years 1996, 1997, and 1998, the section 1 tax on \$23,000 minus the section 1 tax on \$20,000 (the increase in section 1 tax attributable to the elected farm income allocated to such year).

(ii) In 2000, T has taxable income of \$50,000 and electible farm income of \$12,000. T makes a farm income averaging election with respect to all \$12,000 of his electible farm income for 2000. Thus, \$4,000 of elected farm income is allocated to each of years 1997, 1998 and 1999. T's 2000 tax liability is the sum of—

(A) The section 1 tax on \$38,000 (2000 taxable income minus elected farm income); plus

(B) For each of years 1997 and 1998, the section 1 tax on \$27,000 minus the section 1 tax on \$23,000 (the increase in section 1 tax attributable to the elected farm income allocated to such years after increasing such years' taxable income by the elected income allocated to such year by the 1999 farm income averaging election); plus

(C) For year 1999, the section 1 tax on \$25,000 minus the section 1 tax on \$21,000 (the increase in section 1 tax attributable to the elected farm income allocated to such year after reducing such year's taxable income by the 1999 elected farm income).

(e) *Electible farm income—(1) Identification of items attributable to a farming business—(i) In general.* Farm income includes items of income, deduction, gain, and loss attributable to the individual's farming business. Farm losses include a NOL carryover or carryback, or a net capital loss carryover, to an election year that is attributable to a farming business. Income, gain or loss from the sale of development rights, grazing rights, and other similar rights is not treated as attributable to a farming business. Farm income does not include wages.

(ii) *Gain or loss on sale or other disposition of property—(A) In general.* Gain or loss from the sale or other disposition of property (other than land, but including a structure affixed to the land) that was regularly used in the individual's farming business for a substantial period of time is treated as attributable to a farming business. Whether property was regularly used for a substantial period of time depends on all of the facts and circumstances.

(B) *Cessation of a farming business.* If gain or loss described in paragraph (e)(1)(ii)(A) of this section is realized after cessation of a farming business, such 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. A sale or other disposition within one year of cessation of the farming business is presumed to be within a reasonable time. Whether a sale or other disposition that occurs more than one year after cessation of the farming business is within a reasonable time de-

pends on all of the facts and circumstances.

(2) *Determination of amount that may be elected farm income—(i) Electible farm income.* The maximum amount of income that an individual may elect to average (electible farm income) is the sum of any farm income and gain minus any farm deductions or losses (including loss carryovers and carrybacks) that are allowed as a deduction in computing the individual's taxable income. However, electible farm income may not exceed taxable income. In addition, electible farm income from net capital gain attributable to a farming business cannot exceed total net capital gain. An individual who has both ordinary and net capital gain farm income may elect (up to electible farm income) any combination of such ordinary and net capital gain farm income.

(ii) *Examples.* The rules of paragraph (e)(2)(i) of this section are illustrated by the following examples:

Example 1. A has farm gross receipts of \$200,000 and farm ordinary deductions of \$50,000. A's taxable income is \$150,000 (\$200,000-\$50,000). A's electible farm income is \$150,000, all of which is ordinary income.

Example 2. B has ordinary farm income of \$200,000 and nonfarm losses of \$50,000. B's taxable income is \$150,000 (\$200,000-\$50,000). B's electible farm income is \$150,000, all of which is ordinary income.

Example 3. C has a farm capital gain of \$50,000 and a nonfarm capital loss of \$40,000. C also has ordinary farm income of \$60,000. C has taxable income of \$70,000 (\$50,000-\$40,000+\$60,000). C's electible farm income is \$70,000. C can elect up to \$10,000 of farm capital gain and up to \$60,000 of farm ordinary income.

Example 4. D has a nonfarm capital gain of \$40,000 and a farm capital loss of \$30,000. D also has ordinary farm income of \$100,000. D has taxable income of \$110,000 (\$40,000-\$30,000+\$100,000). D's electible farm income is \$100,000 ordinary farm income minus \$30,000 farm capital loss, or \$70,000, all of which is ordinary income.

Example 5. E has a nonfarm capital gain of \$20,000 and a farm capital loss of \$30,000. E also has ordinary farm income of \$100,000. E has taxable income of \$97,000 (\$20,000-\$23,000+\$100,000). E has a farm capital loss carryover of \$7,000 (\$30,000-\$23,000 allowed as a deduction). E's electible farm income is \$100,000 ordinary farm income minus \$23,000 farm capital loss, or \$77,000, all of which is ordinary income.

(f) *Miscellaneous rules—(1) Short taxable year—(i) In general.* If a base year or an election year is a short taxable year, the rules of section 443 and the regula-

tions thereunder apply for purposes of calculating the section 1 tax.

(ii) *Base year is a short taxable year.* If a base year is a short taxable year, the increase in section 1 tax attributable to the elected farm income allocated to such year is determined after the taxable income for such year has been annualized.

(iii) *Election year is a short taxable year.* If an election year is a short taxable year, any elected farm income is first annualized before being allocated to the base years. The increase in section 1 tax attributable to the elected farm income allocated to the base years is the same part of the tax computed on an annual basis as the number of months in the short election year is of 12 months.

(2) *Changes in filing status.* An individual is not prohibited from making a farm income averaging election solely because the individual's filing status is not the same in an election year and the base years. For example, an individual who files married filing jointly in the election year, but filed as single in all of the base years, may still elect to average farm income.

(3) *Employment tax.* A farm income averaging election has no effect in determining the amount of wages for purposes of the Federal Insurance Contributions Act (FICA), the Federal Unemployment Tax Act (FUTA), and the Collection of Income Tax at Source on Wages (Federal income tax withholding), or the amount of net earnings from self-employment for purposes of the Self-Employment Contributions Act (SECA).

(4) *Alternative minimum tax.* A farm income averaging election does not apply for purposes of determining the section 55 alternative minimum tax in the election year or any base year. However, an election will apply for purposes of determining the regular tax under sections 53(c) and 55(c).

(5) *Unearned income of minor child.* In an election year, if a minor child's investment income is taxable under section 1(g) and a parent makes a farm income averaging election, the tax rate used for purposes of applying section 1(g) is the rate determined after application of the election. With respect to a base year, however, the tax on a minor child's investment income is not affected by a farm income averaging election.

(g) *Effective date.* The rules of this section apply to taxable years ending on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**.

John M. Dalrymple,
*Acting Deputy Commissioner
of Internal Revenue.*

(Filed by the Office of the Federal Register on October 7, 1999, 8:45 a.m., and published in the issue of the Federal Register for October 8, 1999, 64 F.R. 54836)