

Section 1301.—Averaging of Farm Income

26 CFR 1.1301-1: Averaging of farm income.

T.D. 8972

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Parts 1 and 602

Averaging of Farm Income

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the election to average farm income in computing tax liability. The regulations reflect changes to the law made by the Taxpayer Relief Act of 1997, as amended by the Tax and Trade Relief Extension Act of 1998, and provide guidance to individuals engaged in a farming business.

DATES: *Effective Date:* These regulations are effective January 8, 2002.

Applicability Date: These regulations apply to taxable years beginning after December 31, 2001. However, taxpayers may rely on the rules in these final regulations in computing tax liability for taxable years beginning on or before December 31, 2001.

FOR FURTHER INFORMATION CONTACT: John M. Moran (202) 622-4940 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these final regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507) under control number 1545-1662. 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.

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.

The burden for this requirement is reflected in the burden estimate for Schedule J. The estimated burden for the 2000 Schedule J is 2 hours per respondent.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, W:CAR:MP:FP:S:O, Washington, DC 20224, and 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.

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

Section 1301 was added to the Internal Revenue Code (the Code) by section 933(a) of the Taxpayer Relief Act of 1997 (Public Law 105-34; (111 Stat. 788, 881-82)), as amended by section 2011 of the Tax and Trade Relief Extension Act of

1998 (Division J of H.R. 4328, Omnibus Consolidated and Emergency Supplemental Appropriations Act, 1999) (Public Law 105-277 (112 Stat. 2681, 2681-886, 2681-902)). On October 8, 1999, a notice of proposed rulemaking (REG-121063-97, 1999-2 C.B. 540) containing proposed regulations under section 1301 was published in the **Federal Register** (64 FR 54836). A number of comments responding to the notice were received and a public hearing was held on February 15, 2000. After consideration of the comments, the proposed regulations are adopted as revised by this Treasury decision.

Explanation of Provisions

Treatment of Wages

The income averaging election is available only to individuals engaged in a farming business and only with respect to income from that business. The proposed regulations provide that farm income does not include wages but the notice of proposed rulemaking invited public comment on whether a different rule should apply to wages paid to a shareholder of an S corporation. Several comments on this issue supported a rule that would permit wages paid by an S corporation to a shareholder to qualify as income from a farming business, and the final regulations adopt this rule.

This change results in comparable treatment for S corporation shareholders, partners, and sole proprietors. A sole proprietor's Schedule F income, whether attributable to capital or labor, is treated as income from the business conducted through the proprietorship. In the case of a partnership engaged in a farming business, income earned by the partners that is attributable to the farming business is similarly treated as farm income for purposes of the income averaging rules whether the income takes the form of a distributive share or a guaranteed payment.

S corporations, like partnerships, are passthrough entities for Federal income tax purposes. In an S corporation, amounts paid to shareholders as wages would, if retained by the corporation, increase the shareholders' income qualifying for the income averaging election. There is no indication in the legislative

history of section 1301 that Congress intended disparate treatment of S corporation shareholders depending on whether amounts are paid to the shareholders as wages or allocated to shareholders as a *pro rata* share of the corporation's income. Accordingly, the final regulations provide consistent treatment for shareholders in S corporations and partners in partnerships. Thus, a shareholder's income that is attributable to the S corporation's farming business qualifies as farm income for purposes of the income averaging rules whether paid to the shareholder as wages or allocated to the shareholder as a *pro rata* share.

In contrast, a C corporation is not a passthrough entity for Federal income tax purposes. Accordingly, the final regulations do not treat any amounts paid by a C corporation to its shareholder-employees as farm income.

Treatment of Rental Income

The proposed regulations contain no provision for treating rental income as income from a farming business. This is consistent with the general principle that lessors of farmland are not ordinarily treated as engaged in a farming business with respect to the leased land. Commentators were divided over whether rental income based on a tenant's production (e.g., a crop share) should be treated as income from a farming business for purposes of section 1301. The final regulations provide that income from such arrangements is treated, subject to an anti-abuse rule, as income from a farming business. This rule is consistent with the policy underlying section 1301 of limiting the adverse effects of a progressive rate structure on farmers whose income varies significantly from year to year in response to fluctuations in the farm economy. A landlord's income from a crop-share lease or similar arrangement is affected by fluctuations in the farm economy to the same extent as that of any other farmer. Moreover, regulations under other Code sections provide precedent for the rule in the final regulations. For example, a similar rule in the regulations under section 175 (relating to the deduction for certain soil and water conservation expenditures) treats a landlord who receives rent (either cash or in kind)

based on farm production as engaged in the business of farming.

Under the final regulations, a landlord's crop share income reported on Form 4835, "*Farm Rental Income and Expenses*," Schedule F, "*Profit or Loss From Farming*," or Part II of Schedule E, "*Supplemental Income or Loss*," is 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. If a landlord receives a fixed rent or a share of a tenant's production that is set after the tenant begins significant activities, the landlord is not considered to be engaged in a farming business with respect to the leased land, and the rental income is not eligible for income averaging, even if the landlord materially participates in the tenant's farming business.

Treatment of Income from Partnerships

A commentator asked whether income attributable to a farming business carried on by a partnership is farm income without regard to the size of a partner's interest in the partnership or the activities of the partner. The commentator also asked how the farm income of a partnership may be allocated. Farm income is allocated under the partnership rules in Subchapter K of the Code, and these regulations do not modify those rules. The final regulations, like the proposed regulations, permit income attributable to a farming business carried on by a partnership to be averaged without regard to the partner's level of participation in the partnership or size of ownership interest.

Effect of Adjustments

A commentator requested that the final regulations expressly require an amended return if there is a change to a base year return as a result of either an IRS or taxpayer initiated adjustment. The IRS and Treasury do not believe that a special rule in the final regulations is necessary to address this point, as the situation is not unique to section 1301. If the election year tax liability is changed as a result of an adjustment to a base year, then, as with any correction, an amended return should be made for the election year if the statute of limitations is open.

Making, Changing, or Revoking an Election

Under the proposed regulations an individual may not make a late election, change an election, or revoke an election unless there has been an adjustment to taxable income or tax liability or the Commissioner has consented. One comment suggested that these limitations on a taxpayer's ability to make, change, or revoke an election should be eliminated. This suggestion has been adopted. Under the final regulations, a taxpayer may make a late election, change an election, or revoke an election subject only to the generally applicable rules on the period of limitations on filing a claim for credit or refund.

Negative Taxable Income

A number of commentators criticized the computational rules contained in Schedule J, *Farm Income Averaging*, for 1999 and earlier years. These rules prohibited the use of a negative amount for a base year's taxable income. The commentators suggested that taxpayers should be permitted to use a negative amount if appropriate adjustments are made for amounts, such as net operating losses, that may provide a tax benefit in another taxable year.

The final regulations adopt this suggestion. Thus, a base year's taxable income may be negative but amounts, such as a net operating loss or certain capital losses, that may be deducted in one or more other taxable years in the form of a carryover or carryback must be added back in computing negative taxable income. The Schedule J for years after 1999 includes worksheets and instructions for determining negative taxable income for purposes of the income averaging computation.

Calculation of Section 1 Tax

The proposed regulations provide that the tax is computed by reducing the election year taxable income by the applicable amount and increasing taxable income for the base years by one-third of that amount. One commentator suggested that taxable income for the election year should be computed by excluding the elected amount from the taxpayer's gross

income. This would reduce adjusted gross income, which in turn might reduce the effect of limitations and phase-outs based on adjusted gross income. The statutory language unambiguously provides, however, that any election-year decrease (or base-year increase) must be made to taxable income. Moreover, consistent application of the rule suggested in the comment would require recomputation of adjusted gross income and all related limitations and phase-outs in base years. This would substantially increase the complexity of the income averaging computation. Accordingly, the final regulations do not adopt this suggestion.

Farm Income

A commentator suggested that the final regulations list specific items of income and deductions to clarify which items are attributable to a farming business under section 1301. The regulations are not a suitable format for providing the comprehensive guidance requested because of the difficulty in identifying the myriad items of income and expense that may be attributable to a farming business and because, in each case, a determination based on specific facts and circumstances is necessary. Taxpayers are encouraged to raise questions they may have concerning any specific types of income so that guidance can be given by revenue ruling, instructions, or other appropriate means.

The proposed regulations treat gain from the sale or other disposition of property (other than land) as attributable to a farming business if, taking into account all the facts and circumstances, the property was regularly used in the farming business for a substantial period of time. A commentator asked that the final regulations provide more specific guidance on what constitutes a substantial period of time. The final regulations provide that property that has always been used solely in the farming business by the individual is deemed to meet both the regularly used and substantial period tests. For property not used solely in the farming business, what constitutes regular use or a substantial period of time is likely to vary significantly, depending upon the facts of the taxpayer's business. Accordingly, the final regulations retain the facts-and-circumstances test for such property.

The proposed regulations establish a presumption that sales or dispositions of property used in a farming business are attributable to that business if they occur within one year of its cessation. One comment expressed concern that this presumption may be construed as establishing a contrary presumption for sales or dispositions occurring after that one-year period. The comment suggested extending the period to two years, arguing that it is not uncommon for sales or dispositions of farm property to continue for more than one year after the cessation of the farming business, particularly in economically depressed areas.

The final regulations do not adopt this suggestion. The regulatory presumption is, however, only a safe harbor for sales or dispositions of property occurring within the one-year period; no contrary presumption is stated or implied for sales or dispositions occurring after that period. Rather, the determination of whether those sales or dispositions are attributable to a farming business appropriately depends upon all the facts and circumstances.

One commentator proposed an example to illustrate that elected farm income may not exceed taxable income, using a gross farm income amount reduced by farming deductions and the standard deduction. The regulations illustrate, as simply as possible, that elected farm income cannot exceed taxable income. These computations are illustrated in greater detail in Pub. 225, “*Farmer’s Tax Guide*,” which provides a sample tax return including a Schedule J.

Similarly, one commentator requested examples demonstrating calculations involving capital gains. Although no such examples are provided in the final regulations, Pub. 225 does provide an example, and the IRS will consider including other examples in future guidance.

Married Taxpayers

Several comments were received regarding the application of the rules to married taxpayers. Two commentators asked how farm income reported on a joint return is associated with the proper spouse in a noncommunity property state. Two other commentators asked about the application of community property laws.

The final regulations do not provide specific guidance on these issues. As a general matter, however, an individual’s filing status does not affect determinations regarding whether the individual is engaged in a farming business or the amount of profit or loss from that business reported on the individual’s Schedule F, *Profit or Loss From Farming*, or Schedule K–1, *Partner’s (Shareholder’s) Share of Income, Credits, Deductions, etc.* Thus, if only one spouse engages in farming in the election year, only that spouse may have elected farm income, and if both spouses engage in farming, each spouse may have elected farm income from the business in which that spouse is engaged. Similarly, as a general matter, community property laws determine income and property ownership for Federal income tax purposes. Although the Code may provide otherwise in specific instances, there are no such exceptions in either section 1301 or the final regulations.

Alternative Minimum Tax

One commentator requested that the final regulations provide an example showing that the alternative minimum tax limits the benefits of an income averaging election. Although the final regulations do not provide an example of the application of the alternative minimum tax, they continue to note that the income averaging election does not apply for purposes of determining the alternative minimum tax in the election year or any base year, except to the extent the election is taken into account in determining the regular tax offset to the tentative minimum tax. There is no exception in the Code provisions relating to the alternative minimum tax that would permit the minimum tax to be computed without regard to the effect of farm income averaging on the regular tax.

Special Analyses

It has been determined that these final regulations are 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 regula-

tions. 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 on the fact that the collection of information imposed by these regulations is not significant as reflected in the estimated burden of information collection for Schedule J, which is 2 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, the IRS submitted the notice of proposed rulemaking to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is John M. Moran of the Office of Associate Chief Counsel, Procedure and Administration (Administrative Provisions and Judicial Practice Division). However, other personnel from the IRS and Treasury Department participated in their development.

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are 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 in part 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 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 electible 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 electible farm income for the election year as elected farm income; and

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

(i) The section 1 tax that would be imposed for the election year if taxable income for the year were reduced by elected farm income; plus

(ii) For each base year, the amount by which the section 1 tax would be increased if taxable income for the year were increased by one-third of elected farm income.

(b) *Individual engaged in a farming business*—(1) *In general.* *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 partnership engaged in a farming business, and a shareholder of an S corporation engaged in a farming business. Services performed as an employee are disregarded in determining whether an individual is engaged in a farming business for purposes of section 1301. 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.

(2) *Certain landlords.* A landlord is engaged in a farming business for purposes of section 1301 with respect to rental income that is based on a share of production from a tenant's farming business and, with respect to amounts received on or after January 1, 2003, is determined under a written agreement entered into before the tenant begins significant activities on the land. A landlord is not engaged in a farming business for purposes of section 1301 with respect to amounts received on or after January 1, 2003, rental income based on a share of a tenant's production determined under an unwritten agreement or a written agreement entered into after the tenant begins significant activities on the land. Whether the landlord materially participates in the

tenant's farming business is irrelevant for purposes of section 1301.

(c) *Making, changing, or revoking an election*—(1) *In general.* A farm income averaging election is made by filing Schedule J, "*Farm Income Averaging*," with an individual's Federal income tax return for the election year (including a late or amended return if the period of limitations on filing a claim for credit or refund has not expired).

(2) *Changing or revoking an election.* An individual may change the amount of the elected farm income in a previous election or revoke a previous election if the period of limitations on filing a claim for credit or refund has not expired for the election year.

(d) *Guidelines for calculation of section 1 tax*—(1) *Actual taxable income not affected.* Under paragraph (a)(2) of this section, a determination of the section 1 tax for the election year involves a computation of the section 1 tax that would be imposed if taxable income for the election year were reduced by elected farm income and taxable income for each of the base years were increased by one-third of elected farm income. The reduction and increases required for purposes of this computation do not affect the actual taxable income for either the election year or the base years. Thus, for each of those years, the actual taxable income is taxable income determined without regard to any hypothetical reduction or increase required for purposes of the computation under paragraph (a)(2) of this section. The following illustrates this principle:

(i) Any reduction or increase in taxable income required for purposes of the computation under paragraph (a)(2) of this section is disregarded in determining the taxable year in which a net operating loss carryover or net capital loss carryover is applied.

(ii) The net section 1231 gain or loss and the character of any section 1231 items for the election year is determined without regard to any reduction in taxable income required for purposes of the computation under paragraph (a)(2) of this section.

(iii) The section 68 overall limitation on itemized deductions for the election year is determined without regard to any reduction in taxable income required for

purposes of the computation under paragraph (a)(2) of this section. Similarly, the section 68 limitation for a base year is not recomputed to take into account any allocation of elected farm income to the base year for such purposes.

(iv) 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 the year for purposes of the computation under paragraph (a)(2) of this section.

(v) 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 the year for purposes of the computation under paragraph (a)(2) of this section.

(2) *Computation in base years*—(i) *In general.* As provided in paragraph (a)(2)(ii) of this section, the election year section 1 tax includes the amounts by which the section 1 tax for each base year would be increased if taxable income for the year were increased by one-third of elected farm income. For this purpose, all allowable deductions (including the full amount of any net operating loss carryover) are taken into account in determining the taxable income for the base year even if the deductions exceed gross income and the result is negative. If the result is negative, however, any amount that may provide a benefit in another taxable year is added back in determining base year taxable income. Amounts that may provide a benefit in another year include—

(A) The net operating loss (as defined in section 172(c)) for the base year;

(B) The net operating loss for any other year to the extent carried forward from the base year under section 172(b)(2); and

(C) The capital loss deduction allowed for the base year under section 1211(b)(1) or (2) to the extent such deduction does not reduce the capital loss carryover from the base year because it exceeds adjusted taxable income (as defined in section 1212(b)(2)(B)).

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

Example. In 2001, F and F's spouse on their joint return elect to average \$24,000 of income attributable to a farming business. One-third of the elected farm income, \$8,000, is added to the 1999

base year income. In 1999, F and F's spouse reported adjusted gross income of \$7,300 and claimed a standard deduction of \$7,200 and a deduction for personal exemptions of \$8,250. Therefore, their 1999 base year taxable income is -\$8,150 [$\$7,300 - (\$7,200 + \$8,250)$]. After adding the elected farm income to the negative taxable income, their 1999 base year taxable income would be zero [$\$8,000 + (-\$8,150) = -\$150$]. If F and F's spouse elected to income average in 2002, and made the adjustments described in paragraph (d)(3) of this section to account for the 2001 election, their 1999 base year taxable income for the 2002 election would be -\$150.

(3) *Effect on subsequent elections*—(i) *In general.* The reduction and increases in taxable income assumed in computing the election year section 1 tax (within the meaning of paragraph (a)(2) of this section) for an election year are treated as having actually occurred for purposes of computing the election year section 1 tax for any subsequent election year. Thus, if a base year for a farm income averaging election is also an election year for another farm income averaging election, the increase in the section 1 tax for that base year is determined after reducing taxable income by the elected farm income from the earlier election year. Similarly, if a base year for a farm income averaging election is also a base year for another farm income averaging election, the increase in the section 1 tax for that base year is determined after increasing taxable income by elected farm income allocated to the year from the earlier election year.

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

Example. (i) In each of years 1998, 1999, and 2000, T had taxable income of \$20,000. In 2001, 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 2001. Thus, for purposes of the computation under paragraph (a)(2) of this section, \$3,000 of elected farm income is allocated to each of years 1998, 1999, and 2000. T's 2001 tax liability is the sum of—

(A) The section 1 tax on \$21,000 (2001 taxable income minus elected farm income); plus

(B) For each of years 1998, 1999, and 2000, the section 1 tax on \$23,000 minus the section 1 tax on \$20,000 (the amount by which section 1 tax would be increased if one-third of elected farm income were allocated to such year).

(ii) In 2002, 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 2002. Thus, for purposes of the computation under paragraph (a)(2) of this section, \$4,000 of elected farm

income is allocated to each of years 1990, 2000, and 2001. T's 2002 tax liability is the sum of—

(A) The section 1 tax on \$38,000 (2002 taxable income minus elected farm income); plus

(B) For each of years 1999 and 2000, the section 1 tax on \$27,000 minus the section 1 tax on \$23,000 (the amount by which section 1 tax would be increased if one-third of elected farm income were allocated to such years after increasing taxable income for such years by the elected income allocated to such years from the 2001 election year); plus

(C) For year 2001, the section 1 tax on \$25,000 minus the section 1 tax on \$21,000 (the amount by which section 1 tax would be increased if one-third of elected farm income were allocated to such year after reducing taxable income for such year by the 2001 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 net operating loss 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. In general, farm income does not include compensation received by an employee. However, 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.

(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 that was regularly used in the individual's farming business for a substantial period of time is treated as attributable to a farming business. For this purpose, the term *property* does not include land, but does include structures affixed to land. Property that has always been used solely in the farming business by the individual is deemed to meet both the regularly used and substantial period tests. Whether property not used solely in the farming business was regularly used in the farming business 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 only 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 depends 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 gains 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. Subject to these limitations, an individual who has both ordinary and net capital gain farm income may elect to average 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 ordinary 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 to average 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 \$70,000 ($\$100,000$ ordinary farm income minus \$30,000 farm capital loss), 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 ($\$20,000 - \$23,000 + \$30,000$).

loss limited by section 1211(b))+\$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 \$77,000 (\$100,000 ordinary farm income minus \$23,000 farm capital loss), 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 regulations 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, elected farm income is allocated to such year for purposes of paragraph (a)(2) of this section after the taxable income for such year has been annualized.

(iii) *Election year is a short taxable year*. In applying paragraph (a)(2) of this section for purposes of determining tax computed on the annual basis (within the meaning of section 443(b)(1)) for an election year that is a short taxable year—

(A) The taxable income and the electible farm income for the year are annualized; and

(B) The taxpayer may designate all or any part of the annualized electible farm income as elected farm income.

(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 one or more of the base years, may still elect to average farm income using the single filing status used in the base year.

(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 in determining the section 55 alternative minimum tax for any base year or the section 55(b) tentative minimum tax for the election year or any base year. The election does, however, apply in determining the regular tax under sections 53(c) and 55(c) for the election year.

(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. In 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 beginning after December 31, 2001, except with respect to the written agreement requirement of paragraph (b)(2) of this section.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 3. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 4. In §602.101, paragraph (b) is amended by adding an entry in numerical order to the table to read as follows:

§ 602.101 OMB control numbers.

* * * * *

(b) * * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.1301-1	1545-1662
* * * * *	

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

Approved December 12, 2001.

Mark Weinberger,
Assistant Secretary of the Treasury.