electing shareholder also shall pay interest, pursuant to section 6601, on the underpayment of tax for the taxable year of termination. An electing shareholder that realizes a loss shall report the loss on Form 8621, but shall not recognize the loss.

(2) *Information to be included in the election.* If a statement is used, the statement should be identified, in a heading, as an election under section 1297(b)(1). The statement must include the following information and representations:

(i) The name, address and taxpayer identification number of the electing shareholder;

(ii) The name, address and taxpayer identification number, if any, of the PFIC;

(iii) A statement that the shareholder is making the election under section 1297(b)(1);

(iv) The period in the electing shareholder's holding period in the stock during which the foreign corporation was a PFIC, the period during which it was a QEF (and whether the shareholder elected under section 1294 to defer payment of its tax liability attributable to any portion of such period), and the termination date;

(v) The manner in which the PFIC lost the characteristics of a PFIC;

(vi) A schedule listing the shares in the PFIC held by the electing shareholder on the termination date, listing the date(s) each share or block of shares was acquired, the number of shares acquired on each date listed, and the tax basis of each share;

(vii) The fair market value of the stock in the PFIC on the termination date; for this purpose, the fair market value of the stock shall be determined according to the rules of §1.1295–1T(b)(9); and

(viii) A schedule showing the computation of the gain recognized on the deemed sale, and a calculation of the deferred tax amount, as defined in section 1291(c).

(3) *Adjustment to basis; treatment of holding period.* An electing shareholder that recognizes gain on the deemed sale of stock shall increase its adjusted basis in the stock by the amount of gain recognized. An electing shareholder shall not adjust the basis in stock with respect to which the shareholder realized a loss on the deemed sale. An electing shareholder shall thereafter treat its holding period in the stock, for purposes of sections 1291 through 1297, as beginning on the day following the termination date without regard to whether it recognized gain on the deemed sale; for section 1223 purposes, the holding period in the stock in the PFIC shall include the period prior to the deemed sale.

(c) *Application of deemed dividend election rules*—(1) *In general.* A shareholder of a former PFIC, within the meaning of §1.1291–9(j)(2)(iv), that was a controlled foreign corporation, within the meaning of section 957(a) (CFC), during its last taxable year as a PFIC under section 1296(a), may apply the rules of section 1291(d)(2)(B) and §1.1291–9 to an election under section 1297(b)(1) and this section made by the time and in the manner provided in paragraph (b) of this section.

(2) *Transition rule.* If the time for making an election under this section, as provided in paragraph (b) of this section, expired before January 2, 1998, a shareholder that applied rules similar to the rules of section 1291(d)(2)(A) and §1.1291–10 to an election under this section made with respect to a corporation that was a CFC during its last taxable year as a PFIC under section 1296(a) may file an amended return for the taxable year that includes the termination date, as defined in paragraph (a) of this section, and apply the rules of section 1291(d)(2)(B) and §1.1291–9 at any time before the expiration of the period of limitations for the assessment of taxes for that taxable year.

(3) *Effective date.* The rules of this paragraph are effective as of January 2, 1998.

[T.D. 8178, 53 FR 6779, Mar. 2, 1988, as amended by T.D. 8750, 63 FR 24, Jan. 2, 1998]

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 either fixed rent or, 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 1999, 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.

[T.D. 8972, 67 FR 819, Jan. 8, 2002; 67 FR 5203, Feb. 5, 2002]

READJUSTMENT OF TAX BETWEEN YEARS AND SPECIAL LIMITATIONS

MITIGATION OF EFFECT OF LIMITATIONS AND OTHER PROVISIONS

§ 1.1311(a)–1 Introduction.

(a) Part II (section 1311 and following), subchapter Q, chapter 1 of the