

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 de-

duction 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.

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Internal Revenue Service, Treasury

§ 1.1311(a)-2

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 Code, provides certain rules for the correction of the effect of an erroneous treatment of an item in a taxable year which is closed by the statute of limitations or otherwise, in cases where, in connection with the ascertainment of the tax for another taxable year, it has been determined that there was an erroneous treatment of such item in the closed year.

(b) In most situations falling within this part the correction of the effect of the error on a closed year can be made only if either the Commissioner or the taxpayer has taken a position in another taxable year which is inconsistent with the erroneous treatment of the item in the closed year. If a refund or credit would result from the correction of the error in the closed year, then the Commissioner must be the one maintaining the inconsistent position. For example, if the taxpayer erroneously included an item of income on his return for an earlier year which is now closed and the Commissioner successfully requires it to be included in a later year, then the correction of the effect of the erroneous inclusion of that item in the closed year may be made since the Commissioner has maintained a position inconsistent with the treatment of such item in such closed year. On the other hand, if an additional assessment would result from the correction of the error in the closed year, then the taxpayer must be the one maintaining the inconsistent position. For example, if the taxpayer deducted an item in an earlier year which is now closed and he successfully contends that the item should be deducted in a later year, then the correction of the effect of the erroneous deduction of that item in the closed year may be made since the taxpayer has taken a position inconsistent with the treatment of such item in such earlier year.

(c) There are two special circumstances which fall within this part but which do not require that an inconsistent position be maintained. One of these circumstances relates to the inclusion of an item of income in the correct year and the other relates to the allowance of a deduction in the correct year. In the first situation, if the Commissioner takes the position by a deficiency notice or before the Tax Court that an item of income should be included in the gross income of a taxpayer for a particular year and it is ultimately determined that such item was not so includible, then such item can be included in the income of the proper year if that year was not closed at the time the Commissioner took his position. In the second situation, if the taxpayer claims that a deduction should be allowed for a particular year and it is ultimately determined that the deduction was not allowable in that year, then the taxpayer may take the deduction in the proper year if that year was not closed at the time the taxpayer first claimed a deduction.

[T.D. 6500, 25 FR 12031, Nov. 26, 1960]

§ 1.1311(a)-2 Purpose and scope of section 1311.

(a) Section 1311 provides for the correction of the effect of certain errors under circumstances specified in section 1312 when one or more provisions of law, such as the statute of limitations, would otherwise prevent such correction. Section 1311 may be applied to correct the effect of certain errors if, on the date of a determination (as defined in section 1313(a) and the regulations thereunder), correction is prevented by the operation of any provision of law other than sections 1311 through 1315 and section 7122 (relating to compromises) and the corresponding provisions of prior revenue laws. Examples of provisions preventing such corrections are sections 6501, 6511, 6532, and 6901 (c), (d) and (e), relating to periods of limitations; section 6212(c) and 6512 relating to the effect of petition to the Tax Court of the United States on further deficiency letters and on credits or refunds; section 7121 relating to closing agreements; and sections 6401 and 6514 relating to payments, refunds,