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Farm Income Averaging Strategies

This release summarizes a tax reduction opportunity for farm taxpayers in the highest income tax bracket, and reminds that the benefits of averaging can be attained through an amended return.

Background

Individuals engaged in farming are allowed to elect to average farm income back three years to obtain the benefit of applying lower income tax rates from prior years [Sec. 1301]. A taxpayer may elect any amount of taxable income from farming businesses. An averaging election can be made in a late tax return and in an amended tax return; once made, the election amount can be changed in an amended return or revoked [Reg. 1.1301-1(c)].

Effective for years beginning in 2013, the highest individual income tax rate is 39.6%. The maximum "regular" capital gains rate is 20% (up from 15% for years before 2013). This increase in rates provides tax reduction opportunities for all taxpayers with net farm income otherwise subject to tax at the 39.6% rate for the years 2013 through 2015.

The Opportunity

Income averaging will always provide a tax benefit to a top-bracket individual tax filer for 2013, 2014 and 2015. Even if the taxpayer had higher amounts of income in the years previous to 2013, the maximum tax rate was 35%. Accordingly, pulling income out of the current top rate of 39.6% in order to tax some or all of that income at the former top 35% rate is beneficial.

For 2013, the optimal amount of farm income to average is the amount that lowers the 2013 taxable income to the bottom of the 35% bracket ($398,350 for both a single filer and for taxpayers using the married filing joint (MFJ) status). The minimum tax savings, regardless of taxable income in the 2010-2012 years, is 4.6% of the elected farm income that would otherwise be taxed at 39.6%.

For 2014 and 2015, the target taxable income for the current year, after reduction for the elected farm income, is the top of the 35% bracket (for 2014, $406,750 for a single filer and $457,600 for MFJ status). For 2014, the tax savings will be at least two-thirds of 4.6% of elected farm income. For 2015, the tax savings will be at least one-third of the elected farm income.

Example 1: Averaging for a top rate filer in 2014

Curt and Shelley are married and use married filing joint status. Their taxable income for 2014 is $1 million, almost entirely from farming. Their taxable income in 2011, 2012 and 2013 exceeded $500,000 in each year. By electing to average $542,400 (lowering 2014 taxable income to $457,600 for tax computation purposes), their tax liability will be reduced by $16,634 ($542,400 x 4.6% x 2/3).

Capital Gains Also Provide Benefit

The benefit of averaging is not limited to ordinary farm income. Averaging may be elected for eligible capital gain income attributable to property regularly used in a farming business, other than gains attributable to land [Sec. 1301(b)(1)(B)]. The tax reductions are similar: a five percentage-point reduction in elected farm capital gain income for 2013, and a similar 2/3rds and 1/3 benefit for 2014 and 2015, respectively.

Many livestock operations have substantial capital gain income from the sale of raised breeding or dairy animals.

Example 2: Using averaging to reduce a capital gain rate

Assume the same facts as in Example 1, except that Curt and Shelley's 2014 farm income also includes $50,000 of capital gain income. $50,000 of the $542,400 elected farm income should be from the farm capital gain because the tax reduction benefit is 5%, which is slightly better than the 4.6% savings on ordinary income. Their tax savings will be $16,767 ($50,000 x 5% x 2/3, plus $492,400 x 4.6% x 2/3).

Opportunity by Amending Prior Years

In the throes of preparing tax returns for the farmers, especially those who expect delivery of their completed tax returns before March 1 (in order to benefit from the exception from the requirement to pay estimated taxes), some of the nuances of the farm income averaging benefit may have been missed. In addition, the election may be modified to strategically target specific levels of taxable income in order to provide a greater benefit from a future year's farm income averaging election. The link to this example, appearing in our Farm Tax Seminar materials for 2015, illustrates the opportunity:

Software and IRS Frustrations

Tax preparation software might automatically determine the amount of farm income on which to elect farm income averaging based upon multiple iterations of computed amounts. This method has two flaws. First, the software only considers the current year computed taxable income and farm income and the amount of base year information that was input into the software. The software cannot take into account the tax planning opportunities from future potential farm income averaging elections. Indeed, it does not need to consider the future, because elected farm income may be amended for years that are open under the statute of limitations.

Second, there is often a range of elected farm income that will provide the same benefit (other than rounding differences).Our experience is that the software will choose the result within the range that averages the least amount of current year farm income. The better result, however, is to elect the amount of farm income that reduces current year taxable income to the lowest amount in the range. This will provide an opportunity for a greater benefit in a future year's farm income averaging election.

The software is merely a tool, and as professionals, it is up to use to determine the optimal amount of current year farm income to average. We suggest testing the optimal computation provided by the software by increasing and decreasing the computer-selected farm income (assuming the computer didn't choose to average all of the eligible farm income) in order to determine if the resulting tax liability changes and by how much. Averaging an additional $50,000 at a cost of $15 rounding may provide significant benefits for a future year's farm income averaging election.

Lastly, we are frustrated with the IRS attempts to "help" taxpayers. In our planning, we take into account expectations of future taxable income. Farm income averaging is available even if it increases the current year tax liability. If our client is expecting to retire from farming in the next year and will recognize substantial deferred farm income offset by no expenses, it may be appropriate to elect to average farm income that results in a higher current tax liability rather than making no election. For example, a taxpayer might elect to average income in 2014 that is in the 33% bracket, with the result that most of that income is taxed at 33% in the three base years other than a small portion taxed at 35%. Averaging increases the current tax by a small amount, but opens up 2014 as a base year for a 2015 averaging election when the taxpayer is in the 39.6% top rate.

In cases that increase the tax through averaging, taxpayers have received computer-generated notices from the IRS correcting the tax liability and issuing a refund. Consequently, a farm income averaging election that will increase the taxpayer's tax liability should be made on an amended income tax return. The explanation on the Form 1040X should describe the election and the taxpayer's deliberate choice to pay additional income tax.

Conclusion

The U.S. income tax continues to increase in its complexity. Our clients are relying on us to assist and advise them in complying with tax obligations, and not merely to place numbers on a tax form. With the post-2012 increase in tax rates, farm income averaging is a powerful tool available to farmers to lower their tax liability.

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