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Effect of Electing Farm Income Averaging on Qualified Business Income Deduction

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The IRS has issued guidance¹ on the interaction of the farm income averaging election² and the qualified business income (QBI) deduction.³ The guidance is short and perhaps less than clear, so in this issue, I will look at the two provisions for the most likely interpretation.

Farm Income Averaging

Electible Farm Income. “Electible farm income” is the income attributable to a farming business and which is eligible to be elected for the election. All, none or part of the current year’s farm income may be elected for averaging in any year.⁴ Farm income for this purpose does not include any gain from land sales, but it does include taxable gain from property (such as tractors) regularly used by the farmer in the farming business.

Electible farm income includes income, deductions, gains, losses, NOL deductions attributable to farming, and any net capital loss carryover from the farm.⁵ A taxpayer can elect to carryback only ordinary income, only capital gain income or any combination after making these adjustments. Income in a base year may be negative and include a net operating loss deduction, but operating losses that may provide a tax benefit in another year are added back to base year income. Electible farm income may not exceed taxable income, and electible farm income from net capital gain attributable to a farming or fishing business may not exceed total net capital gain. Subject to these limitations, an individual who has both ordinary income and net capital gain from a farming or fishing business may elect to average any combination of the ordinary income and net capital gain.⁶

Calculating the Effect of the Election. Individuals⁷ may elect to spread their elected farm income evenly over the three prior tax years.⁸ Thus, the farmer/taxpayer first calculates the current year tax without consideration of the election and then calculates the current year taxes reduced by the amount of proposed elected farm income. The tax savings, if any, are then compared to the effect on the taxes owed for the three prior tax years if the election is made. If the election produces a reduction in current taxes greater than the increase for the past three years, most taxable would choose the election.

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The elected farm income is divided by three and the taxes for each of the prior tax years are calculated by adding one-third of the elected farm income to the taxable income for each year.⁹ If the increase of the total taxes for the prior three years is less than the savings in taxes for the current tax year created by the election, the taxpayer has a financial incentive to make the election by filing Schedule J and claim the tax savings.

It is important to note that any adjustment for any taxable year is similarly taken into account for farm income averaging purposes in subsequent taxable years.¹⁰

Qualified Business Income

As discussed in earlier article on QBI,¹¹ the TCJA defines the term qualified business income as the net amount of qualified items of income, gain, deduction, and loss with respect to any qualified trade or business of the taxpayer.¹² QBI is reduced by any portion of the business income taxable as a capital gain, such as long-term capital gain and qualified dividends.¹³ QBI is not reduced by the QBI deduction; therefore, the income limitations¹⁴ are applied prior to application of the QBI deduction.¹⁵

The IRS Guidance

On the IRS web site under Forms and Instructions, “Post Release Changes to Forms,” the IRS states:

“In figuring the amount to enter on Form 1040, line 9, Qualified Business Income Deduction, income, gains, losses, and deductions from farming or fishing should be taken into account, but only to the extent that deduction is attributable to your farming or fishing business and included in elected farm income on line 2a of Schedule J (Form 1040).”¹⁶

What Does This Mean? As is often the case with bumper stickers, the benefit of brevity in this guidance is offset by the lack of completeness. The guidance could be interpreted to require farmers and fishermen to file Schedule J in order to qualify their income for the QBI deduction. Of course a taxpayer could put zero on line 2a of Schedule J, indicating no farm income was averaged, but this author can find no support for any requirement that Schedule J must be filed to qualify for the QBI deduction.

The more reasonable interpretation is that, if a farmer/fisherman uses the income averaging election, the farmer/fisherman must use the current farm income reduced by the elected farm income in determining QBI. If this interpretation is correct, this guidance would be clearer if the IRS statement was ended with “only if a farmer or fisherman makes the election to average farm or fishing income.”

What About Capital Gains? Another issue not addressed by the guidance is the treatment of net capital gains. Electible farm income may include some types of capital gains¹⁷ but QBI excludes capital gains.¹⁸ This leaves open the question as to whether taxpayers who use the Schedule J, line 2a amount will incorrectly include some capital gains in QBI.

Given that the IRS is still developing forms and instructions for QBI, perhaps guidance in the instructions will answer these issues for the 2019 tax season.

ENDNOTES

¹ See <https://www.irs.gov/forms-pubs/elected-farm-income-may-be-used-to-figure-qualified-business-income-deduction-19-apr-2019>.

² See Harl and Achenbach, *Agricultural Law* § 26.08 (2019) and Achenbach, *Farm Income Tax Manual*, § 1.11 (2019).

³ See Harl and Achenbach, *Agricultural Law* § 28.12 (2019) and Achenbach, *Farm Income Tax Manual*, § 3.30 (2019).

⁴ I.R.C. § 1301(b).

⁵ Treas Reg § 1.1301-1(e)(i).

⁶ Treas. Reg. § 1.1301-1(e)(2)(D).

⁷ The election is not available to corporations, trusts or estates and is limited to partners and S corporation shareholders who are considered engaged in farming. See Treas. Reg. § 1.1301-1(b). However, the final regulations state that wages attributable to a farming business are eligible for income averaging for an S corporation employee. Treas Reg § 1.1301-1(e)(1)(i).

⁸ I.R.C. § 1301(a), (b).

⁹ The instructions to Schedule J provides worksheets to recalculate the taxes for the prior three years.

¹⁰ I.R.C. § 1301(a); see Treas. Reg. § 1.1301-1(b).

¹¹ See Achenbach, “New IRS Guidance on the Qualified Business Income Deduction,” 30 *Agric. L. Dig.* 17 (2019).

¹² I.R.C. § 199A(c).

¹³ I.R.C. § 199A(a)(2).

¹⁴ The trade or business of farming is not a specified service trade or business, and a taxpayer in the trade or business of farm leasing is eligible for the QBI deduction as a qualified trade or business, subject to the W-2 wages and adjusted basis limitations for the QBI deduction. See I.R.C. § 199A(d). See Achenbach, *Farm Income Tax Manual*, § 3.30 (2019).

¹⁵ I.R.C. § 199A(c).

¹⁶ See <https://www.irs.gov/forms-pubs/elected-farm-income-may-be-used-to-figure-qualified-business-income-deduction-19-apr-2019>.

¹⁷ See Treas. Reg. § 1.1301-1(e)(2)(D).

¹⁸ See text *above* at N. 13.