

Income averaging for farmers and fishermen

The taxable income of most farmers and fishermen, varies greatly from year to year. As a result of this income variation, your applicable tax rate may vary from 0% to 35%. I wanted to make sure that you were aware that income averaging is available to farmers and fishermen. The purpose of the income averaging rules is to alleviate the problem of your paying more tax overall if a substantial portion of your income happens to be bunched in one year.

As a farmer (or a fisherman), you can elect to average all or part of your taxable "farming income" or "fishing income" over three years. If you make the election, your farming or fishing income subject to the election (elected farm or fishing income) is treated as if earned in the three previous years. Thus, the elected farm or fishing income is allocated to the three previous years (base years) in equal amounts.

For this purpose, farming (or fishing) income includes income from the trade or business of farming or fishing; but, farming (or fishing) income does not include income, gain, or loss from the sale of development rights, grazing rights, and other similar rights. Although farming (or fishing) income does not generally include compensation received as an employee, a shareholder of an S corporation (or a partner in a partnership) engaged in a farming (or fishing) business may generally treat compensation from the S corporation (or partnership) as income from farming or fishing. It also includes income from certain crop-share arrangements, the sale or disposition of property (other than land), regularly used for a substantial period in a farming or fishing business. Thus, investment income is not eligible for income averaging. A farming business includes operating a nursery or sod farm and raising or harvesting ornamental trees or trees bearing fruit, nuts, or other crops. A fishing business includes the conduct of commercial fishing (i.e., fishing in which all or part of the fish harvested are intended to enter commerce).

Here's a simple example of how averaging works. Assume that F, a single farmer, sold some of his farm machinery and more corn than usual, and all of this happened in 2005. F's 2005 taxable income is \$50,000, of which \$30,000 is from his farming business. F had no taxable income in 2004, \$5,000 of taxable income in 2003, and \$10,000 of taxable income in 2002. Since F's income is higher than in previous years, F elects to average \$30,000 of his 2005 income over the three base years (2004, 2003, and 2002). F figures his 2005 tax in this manner:

- (1) He subtracts the elected portion of his current year's taxable farm income ("elected farm income") from his total taxable income. Thus, in 2005, F subtracts the elected farm income (\$30,000) from his taxable income of \$50,000. F's remaining 2005 taxable income is \$20,000.
- (2) He figures the tax on the amount in (1) using the tax tables or tax rate schedules for the current year (in this case, 2005). Under the 2005 tax tables, the tax on \$20,000 is \$2,639.
- (3) For each of the three base years (2004, 2003, and 2002), F adds one-third of the current year's (2005) elected farm income (\$10,000 each year) to his taxable income for that year and figures the tax on that amount. Then, in each of the three base years (2004, 2003, and 2002), F subtracts his actual tax from the tax computed for the base year.

For 2004, F adds \$10,000 to his 2004 taxable income (\$0) for a taxable income of \$10,000. The tax (computed using the 2004 tax tables) was \$1,146. Since F didn't pay any tax in 2004, there is no reduction for his actual tax paid in 2004.

For 2003, F adds \$10,000 to his 2003 taxable income of \$5,000 for a taxable income of \$15,000. The tax (computed using the 2003 tax tables) on this amount is \$1,904. F reduces this amount (\$1,904) by the actual tax he paid in 2003 (\$503) to \$1,401.

For 2002, F adds \$10,000 to his 2002 taxable income (\$10,000) for a taxable income of \$20,000. The tax (computed using the 2002 tax tables) on this amount is \$2,704. F reduces this amount (\$2,704) by the actual tax he paid in 2002 (\$1,204) to \$1,500.

(4) Then, F adds the amounts computed for the three base years (2004, 2003, and 2002) to the amount of tax computed for the current year (2005) (\$1,146 + \$1,401 + \$1,500 + \$2,639) for a total tax of \$6,686. If F had not elected to average his farm income, his 2005 tax would have been \$9,171. Thus, by making the election, F saved \$2,485.

Although your tax situation is considerably more complicated than F's situation (in the example described above), we need to consider whether you will benefit from making an income averaging election this year. Generally, you will benefit from the election if the income allocated to the three previous years will be subject to a lower tax rate than it would be in the current year.

With careful year-end tax planning, we may be able to maximize the benefits of averaging for you. For example, it could be beneficial to accelerate income this year (e.g., sell appreciated farm equipment this year). This acceleration would increase this year's farming or fishing income (the income that is potentially subject to averaging) and the increase would receive the benefits of averaging. The reduction in your taxable income in the next year as a result of the acceleration of income might result in overall tax savings. However, we also need to keep in mind that any amounts allocated to the three previous years as additional income will continue to be allocated to those years should you elect to average your farming or fishing income in future years. Thus, the allocated amounts will increase your taxable income in those years and may reduce any benefits that you might get from an election in later years.

Before making an election, you will need to consider all of the tax implications of the election. For example, we would need to determine the appropriate portion of your farm or fishing income that should be subject to the election.