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Milk marketing order reform enjoined

A federal district court has enjoined until further order the implementation and enforcement of the milk marketing order reforms promulgated by the Secretary of Agriculture pursuant to the 1996 farm bill. *St. Albans Cooperative Creamery, Inc., v. Glickman*, No. 99 CV 274, 1999 WL 781609 (D. Vt. Sept. 28, 1999). A hearing on the plaintiff's motion for a preliminary injunction has been scheduled for late October. If the economic studies cited by the court are correct, this litigation warrants attention because one projection before the court estimated "that dairy farmers across the nation stand to lose $272 to $404 million dollars annually under the new milk pricing system." *Id*. at *5 (citation omitted).

The 1996 farm bill, the Federal Agriculture Improvement and Reform Act of 1996, directed the Secretary to review the milk marketing order system and to reduce the number of orders from 32 to not less than 10 nor more than 14 orders. 7 U.S.C. § 7253(a)(1). The bill also specified that "[a]mong the issues the Secretary is authorized to implement as part of the consolidation" of the orders were the use of utilization rates and multiple basing points for the pricing of fluid milk and the use of uniform multiple component pricing in developing one or more basic formula prices for manufacturing milk. *Id*. § 7253(a)(3). Using the informal rulemaking process expressly authorized in the bill, the Secretary published the challenged final rule and order amending the federal milk marketing order program on September 1, 1999, following producer referendums in each order area. 64 Fed. Reg. 47,898-48,021 (1999).

Milk marketing orders are authorized by the Agricultural Marketing Agreement Act of 1937, specifically, 7 U.S.C. § 608c. Though called "orders," they are legislative rules having the force and effect of law. The orders are intended to promote the orderly marketing of milk by establishing the minimum price that persons who buy milk, known as "handlers," must pay for Grade A milk within the geographic area covered by a particular order. They do not, however, necessarily establish the price that dairy farmers actually receive for their milk since supply and demand forces sometimes result in an "over-order premium" being paid for milk within a marketing order area. Moreover, not all milk production is covered by an order. Nonetheless, in 1995, about 80 percent of the nation's Grade A milk production was covered by an order. U.S. Gen. Accounting Office, *Federal Dairy Programs: Information on Dairy Pricing and Related 1995 Farm Bill Issues* (RCED-95-97BR, Mar. 1995) at 13

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Limited liability company dissolution

In *Investcorp, L.P. v. Simpson Investment Co., L.C., No. 80,804, 1999 Kan. LEXIS 411 (Kan. Sup. Ct. Jul. 16, 1999)*, members of a limited liability company (LLC) were deadlocked on managerial issues. The LLC members were of different factions from the same family. Several LLC members withdrew to effect dissolution of the LLC. The issue was whether the withdrawing members could participate in dissolution, including liquidation of the LLC's assets. The trial court determined that the withdrawing members were no longer members of the company and, therefore, could not participate in dissolution and subsequent liquidation of the LLC's assets. The sole asset of the LLC was 104 acres of commercial property that had been held in the family since 1941. The property's worth was estimated as over $10 million. Each faction of the family had contradictory ideas concerning the disposition of the 104 acres. The LLC's operating agreement did not allow partition of the property.

On appeal, the court noted that various sections of the LLC's operating agreement referred to the *members* of the LLC while other sections referred to *remaining members*. In particular under the continuation provisions of the operating agreement, it was specified that any event that terminated the continued membership of a member in the company would not cause the company to be wound up, liquidated, or terminated, in the event all of the *remaining members* unanimously consented to

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[hereinafter *Federal Dairy Programs*]

Milk marketing orders use a classification system to set minimum prices. Classifications are based on how the milk is used. Under the system that the Secretary seeks to replace, milk is classified as Class I if it is used for fluid purposes, such as for drinking. Milk used in "soft" dairy products, such as yogurt or ice cream, is designated as Class II milk. Class III milk is milk used to manufacture "hard" dairy products, such as cheeses. Class III-A milk is milk used for nonfat dry milk.

The order system assigns the milk used to produce each class a specific price. Under the system the Secretary seeks to replace, the Class III price is set at a price known as the "basic formula price" (BFP) which essentially reflects, on a monthly basis, the competitive market price paid for Grade B milk by processors in Minnesota and Wisconsin for use in manufacturing "hard" dairy products. Differentials are added to this price to establish the Class II and Class I prices. Of the two differentials, the differential added for the Class I price is the larger. The Class I price includes a fixed differential that varies from order to order based on the distance of the order area from Eau Claire, Wisconsin. This differential, sometimes called the "distance differential," is intended to reflect the cost of transporting milk from the Upper Midwest, where milk is in surplus, to milk-deficit or potentially deficit areas elsewhere. This differential is intended to encourage the movement of milk, but it also serves to encourage milk production in milk-deficit areas.

Under the system the Secretary seeks to replace, the Class I price for milk within an order area generally will be higher the greater the distance the order area is from the Upper Midwest. Handlers who purchase milk for Class I uses must pay this price. However, another variable among orders actually determines the minimum price that producers receive for their milk. This variable is a function of the "pooling" mechanism that the orders use to produce the "blend price" that is actual minimum price paid to producers. This blend price is derived by first determining the percentage of each class of milk used in an order in the preceding month. For each class, this percentage is multiplied by the minimum price per hundredweight established for each class of milk to reach an "adjusted class price." The total adjusted class price for all classes is the blend price for that order for that month. For example, assume that within a particular order 90 percent of the milk purchased in the preceding month was used as Class I milk, with the remainder equally put to Class II and Class III uses. If the minimum price per hundredweight for each class was $16.00, $11.15, and $11.00, respectively, then the adjusted class price for Class I milk would be $14.40 ($16.00 x .90 = $14.40); and the adjusted class prices for Class II and Class III milk would be $0.56 and $0.55, respectively. The sum of these three adjusted class prices, $15.51, would be the blend price that each producer within the order area would receive. *See Federal Dairy Programs, supra,* at 27.

The new orders that the Secretary seeks to implement will make significant changes to this system. First, the number of marketing orders will be reduced from 31 to 11. Second, the new system will continue to use a four-tiered use classification system, but Class III-A will become Class IV and will include butter and all milk powders. Third and most controversial, the method for establishing the Class I price for fluid milk will change. The base formula price (BFP) will be replaced with Class III and Class IV prices based on multiple component pricing, and the "base price" used to determine the Class I price before the addition of differentials will be the higher of the Class III or Class IV price using the most recent two-week average survey prices for these classes.

The new Class I pricing mechanism is controversial because the new differentials used to determine Class I prices in each order will reduce the geographic variability among the differentials they replace. In most areas, the differentials will be reduced. Some of the reductions will exceed $1.00 per hundredweight. In a few areas, they will increase or stay the same. In this respect, the "losers" will be dairy producers in the Northeast, Southeast, and Southwest, while the "winners" will be producers in the Upper Midwest and Florida. *See, e.g.,* Ken Bailey, *Dairy Policy 101: Understanding the Options* (October 9, 1999)(available at www.aers.psu.edu/dairy outlook/reports).

The *St. Albans Cooperative Creamery* litigation is but one manifestation of the controversy surrounding the changes the new system will produce for Class I minimum pricing. Affected producers have sought legislative relief, and other actions have been commenced in the District of Columbia and elsewhere. *See, e.g., Northeast Dairy Farmers Ass'n v. Glickman*, Civ. No. 1:99-CV-02459 (EGS) (D.D.C., complaint filed Sept. 16, 1999).

The core issue in the litigation, including in *St. Albans Cooperative Creamery*, is whether the Secretary was required to establish minimum prices in accordance with the mandate of the Agricultural Marketing Agreement Act (AMAA) to "reflect the price of feeds, the available supplies of feeds, and other economic conditions which affect market supply and demand for milk or its products in the marketing area to which the contemplated marketing agreement, order, or amendment relates." 7 U.S.C. § 608c(18). In *St. Albans*, for example, the plaintiffs are contending that the Secretary wholly failed to abide by this mandate in the northeastern marketing region.

The Secretary's response is twofold. First, the Secretary contends that his marketing order reform is governed by the 1996 farm bill, not the AMAA. Alternatively, the Secretary contends that if the AMAA applies, he considered the section 608c(18) factors at least indirectly through extensive computer analysis of nation's dairy economy.

In *St. Albans*, the court found nothing in the 1996 farm bill excused the Secretary from compliance with the AMAA. It also concluded that the plaintiffs were likely to show that the price of feeds and other regional economic factors were not adequately considered, finding that section 608c(18) "makes no mention of indirect consideration being adequate in meeting the requirements of § 608c(18)."

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Income averaging for farmers

By Philip E. Harris

The Department of the Treasury has issued long-awaited proposed regulations on averaging farm income.[1] These proposed regulations give taxpayers additional guidance for applying the income averaging rules under IRC §1301, which was created by §933 of the Taxpayer Relief Act of 1997,[2] effective for taxable years beginning after December 31, 1997, and ending before January 1, 2001. Section 2011 of the Tax and Trade Relief Extension Act of 1998, which is part of the Omnibus Consolidated and Emergency Supplemental Appropriations Act, 1999,[3] made the income averaging rules for farmers permanent.

Congress gave the Secretary of the Treasury broad authority to prescribe regulations as may be appropriate to carry out the purposes of the income averaging rules.[4] That authority specifically includes regulations regarding:

1. the order and manner in which items of income, gain, deduction, or loss, or limitations on tax, shall be taken into account in computing the tax imposed by chapter 1 (Normal Taxes and Surtaxes) of subtitle A (Income Taxes) of the Code on the income of any taxpayer to whom this section applies for any taxable year, and
2. the treatment of any short taxable year.

Background

The income averaging rules allow a taxpayer to calculate income taxes on taxable income in the current year by electing to treat part or all of eligible farm income as "elected farm income." Income taxes for the year of the election are the sum of:

1. the income taxes due on the current year taxable income reduced by elected farm income, and
2. the increase in taxes caused by adding one-third of the elected farm income to the taxable income for the taxpayer for each of the prior three years (the base years).

The rules are easier to understand if they are viewed as bringing unused tax brackets from the base years forward to be used in calculating income taxes due for the election year. They should not be viewed as allowing the taxpayer to carry income back to the base years.

The proposed regulations answer some questions regarding the application of the income averaging rules, but leave other questions unanswered.

Eligible income

Income that is eligible for the income averaging election is any income that is attributable to a farm business.[5] Farm business has the meaning given such term by IRC §263A(e)(4), which states:

> The term "farming business'' shall include the trade or business of–
> (i) operating a nursery or sod farm, or
> (ii) the raising or harvesting of trees bearing fruit, nuts, or other crops, or ornamental trees.
> For purposes of clause (ii), an evergreen tree which is more than 6 years old at the time severed from the roots shall not be treated as an ornamental tree.

The proposed regulations state that 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.[6] They also state that farm income does not include wages.[7] Therefore, the wages received by a C corporation shareholder/employee do not qualify for income averaging.

The proposed regulations do not give any guidance on whether a C corporation can use the income averaging rules. IRC §1301 appears to not allow C corporations to use income averaging since it allows only "individuals" to make the election.[8] IRC §1301(b)(2) specifically excludes estates and trusts from the term "individual."[9] IRS Publication 553, *Highlights of 1998 Tax Changes* states, "Corporations, partnerships, S corporations, estates and trusts cannot use farm averaging. A beneficiary does not engage in a farming business through a trust or estate."[10]

The proposed regulations also do not give any guidance on whether crop- or livestock-share landowners are eligible for income averaging. The instructions for the 1998 Schedule J (Form 1040) stated, "Generally, farm income, gains, losses, and deductions are reported on: Schedule D, Schedule E, Part II, Schedule F, and Form 4797." By including Schedule F (on which materially participating landowners report income and expenses) and excluding Form 4835 (on which non-materially participating crop- and livestock-share landowners report income and expenses), the instructions imply that materially participating landowners can use income averaging while non-materially participating landowners cannot.

The proposed regulations state that an individual is not required to have been engaged in a farming business in any of the base years in order to be eligible for the election.[11]

Note that a taxpayer who has eligible farm income can use the income averaging rules to level out an increase in off-farm income.

Example 1. Amanda Reckonwith has farm income that puts her $10,000 below the top of the 28% bracket every year. In 1999, she has $40,000 of off-farm income in addition to her normal farm income. She could elect to average $30,000 of her farm income, which would have the effect of spreading the off-farm income evenly over four tax years (1996 – 1999).

Gains from the sale of property from the sale of property

Gains from the sale of property (other than land and timber) that is used regularly for a substantial period in the farming business are eligible for income averaging.[12] The proposed regulation states, "Whether property was regularly used for a substantial period of time depends on all the facts and circumstances."[13] Therefore, there are no safe-harbors for "regularly used" and "substantial period."

Land. The proposed regulation takes the taxpayer friendly position that the term "land" does not include the improvements on the land.[14] Therefore, gain from the sale of buildings, tile line fences and other improvements is eligible for income averaging. However, the proposed regulations do not include gain or loss from the sale of development rights, grazing rights or other similar rights in eligible income.[15]

If a taxpayer sells assets that were used in a farming business within one year of quitting the business of farming, the sale is presumed to be within a reasonable time after cessation of the farming business.[16] Sales more than one year after the cessation of the farming business may be within a reasonable time depending on the facts and circumstances.

Effect on the alternative minimum tax

The proposed regulations state that income averaging does not apply for pur-

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poses of calculating the alternative minimum tax (AMT) under IRC §55 but does apply for purposes of calculating regular taxes under IRC §55.[17] This conclusion means that income averaging can create an AMT liability for taxpayers who did not have an AMT liability before income averaging.

Example 2. Guy and Barb Wire are married and have no dependents. In 1996, 1997 and 1998 they had no taxable income. In 1999 they had $150,000 of net farm profit from their Schedule F and no other income. Their regular tax on a joint tax return without income averaging is $31,827. Income averaging reduces the Wire's net taxes by $6,220 as shown below.

Regular income taxes without averaging	$31,827
Regular taxes with averaging	19,616
Reduction in regular income taxes	$12,211
AMT caused by income averaging	5,991
Net income tax savings	$ 6,220

The position taken in the proposed regulations also means that any taxpayer who has an AMT liability before making the income averaging election will not reduce the total tax liability by making the election. The income averaging election will cause the AMT to increase by an amount equal to the decrease in the regular income tax.

Example 3. Clay and Lilly Fields had $120,000 of net income from farming in 1998 and no other income. They had $50,000 of AMT deferral adjustments. Before income averaging, their 1998 income tax return showed the following:

Total Income (line 22 of Form 1040)		$120,000
1/2 of self-employ. tax (line 27 of Form 1040)		5,848
Adjusted gross income (line 34 of Form 1040)		$114,152
Standard deduction (line 36 of Form 1040)		7,100
Personal exemption deductions (line 38 of Form 1040)		5,400
Taxable income (line 39 of Form 1040)		$101,652
Regular income tax (line 40 of Form 1040)		$ 22,957
Alternative minimum tax		
Tentative minimum tax (line 26, Form 6251)	$ 31,899	
Less regular income tax (line 27 of Form 6251)	22,957	8,942
Total income tax liability		$ 31,899

After income averaging, their 1998 income tax return showed the following:

Regular income tax (line 22 of Schedule J (Form 1040))		$ 15,248
Alternative minimum tax		
Tentative minimum tax (line 26 of Form 6251)	$ 31,899	
Less regular income tax (line 27 of Form 6251)	15,248	16,651
Total income tax liability		$ 31,899

Therefore, income averaging reduced their regular income tax liability by $7,709 ($22,957 - $15,248), but increased their AMT by the same amount.

Minimum tax credit. The AMT liability caused by income averaging may or may not create a minimum tax credit depending on whether the taxpayer has deferral adjustments or preferences that increase the AMT liability.

Example 4. Guy and Barb Wire from Example 2 above do not have a minimum tax credit as a result of paying the $5,991 of AMT. Consequently, the AMT permanently reduced the benefit of income averaging by $5,991.

Example 5. Since Clay and Lilly Fields in Example 3 above had a $50,000 deferral adjustment, the $7,709 increase in their AMT caused by income averaging increased their minimum tax credit by $4,977. Their 1999 minimum tax credit resulting from their 1998 AMT liability before and after income averaging are as follows:

	Before	After
Tentative minimum tax on exclusion items (line 13 of Form 8801)	$ 17,980	$ 17,980
Regular tax for 1998 (line 27 of 1998 Form 6251)	22,957	15,248
Net minimum tax on exclusion items (line 15 of Form 8801)	$ -0-	$ 2,732
1998 AMT (line 16 of Form 8801)	$ 8,942	$ 16,651
Net minimum tax on exclusion items (line 17 of Form 8801)	$ -0-	$ 2,732
Minimum tax credit (line 18 of Form 8801)	$ 8,942	$ 13,919

Therefore, income averaging increased the Fields' minimum tax credit carried to 1999 by $13,919 - $8,942 = $4,977.

Possible argument. The committee reports for the Taxpayer Relief Act of 1997 state, "Further, the provision does not apply for purposes of the alternative minimum tax under section 55." It could be argued that this comment means the regular tax liability before income averaging is used to calculate AMT rather than the regular tax liability after income averaging. Under that interpretation, the AMT is not increased by the decrease in regular taxes caused by income averaging. For example, the Fields' regular tax liability would decrease by $7,709 but their AMT liability would remain at $8,942 in the Example 3 above.

However, since the Taxpayer Relief Act did not make any changes to IRC §55 and since it gave the Secretary of the Treasury broad powers to issue regulations that implement the income averaging provisions, it may be hard to convince a court that the proposed regulation is invalid.

Legislative solution. The AMT problem caused by income averaging would have been solved by Section 604 of the Senate amendment to HR 2488, which was followed in the conference agreement. It added the following new paragraph to IRC §55(c):

> (2) Coordination with income averaging for farmers. Solely for purposes of this section, Section 1301 (relating to averaging of farm income) shall not apply in computing regular tax.

Since President Clinton vetoed HR 2488, the above solution to the AMT problem (as well as the phase out of the AMT) did not become law.

Allocation of ordinary income and capital gains

Capital gains in elected farm income. The proposed regulations allow a taxpayer to choose how much of the elected farm income is made up of capital gains.[18]

Example 6. Paige Turner files as a single taxpayer and has $50,000 of taxable income in 1999, of which $15,000 is ordinary

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income from her Schedule F (Form 1040) and $30,000 is gain from the sale of farm assets that are reported on Form 4797 and qualify for capital gains treatment.

Paige wants to elect $24,000 of her 1999 farm income for income averaging. Paige can choose to include all $15,000 of the ordinary income and $9,000 of the capital gains in the elected farm income. Alternatively, Paige can choose to include $24,000 of capital gains or any other combination that adds to $24,000.

Since the maximum tax rate for capital gains is 28% for 1996, taxpayers who are in the 28% bracket in both 1999 and 1996 will be moving capital gains from the 20% maximum bracket in 1999 to the 28% maximum bracket in 1996 if they include capital gains in elected farm income.

Allocation of capital gain to prior years. If the elected farm income includes both ordinary income and capital gains, they must be allocated in equal portions among the tax brackets of the three prior years.[19]

Example 7. If Paige Turner from the previous example chooses to include $15,000 of ordinary income and $9,000 of capital gains in her elected farm income for 1999, she must put $5,000 of ordinary income and $3,000 of capital gains in the tax brackets for each of the three prior years.

Capital losses in prior years. Under the proposed regulations, capital gains that are included in the tax bracket of a prior year as a result of the income averaging election do not offset capital losses from that year.[20] They are taxed at the lesser of the capital gains rate for the prior year or the ordinary income tax rates for the prior year.

Example 8. Paige Turner from the previous example had a $10,000 net capital loss for 1996 and taxable income of $20,000. She does not reduce the $10,000 capital loss by the $3,000 of capital gains that are moved from her 1999 tax bracket to her 1996 tax bracket. Instead she pays a tax on the $3,000 of capital gains at the lesser of the 28% rate for capital gain in 1996 or her ordinary income tax rate.

IRC §1231 netting. The proposed regulations state that the determination of the character of IRC §1231 items is made before allocating elected farm income to the base years.[21] Therefore, the netting of gains and losses from the sale of IRC §1231 property is done before the income is reduced by the elected farm income. This means that, if §1231 gain is moved out of the tax bracket of the election year, it does not affect the character of the §1231 gains and losses that are left in the tax bracket of the election year.

Change in filing status

If the taxpayer's filing status has changed between one or more of the base years and the election year, the proposed regulations allow the taxpayer to elect income averaging.[22] IRS Publication 553 states that the taxpayer uses the status that was in effect for each of the base years.[23]

Example 9. If Paige Turner from the previous examples (who filed single in 1999) was married and filed jointly in the prior years, she simply adds one-third of her elected farm income to the taxable income shown on her joint return for each base year and uses the married filing jointly tax rates to calculate the added tax from each base tax year's brackets.

Effect of income averaging on net operating losses

The proposed regulations state that any net operating loss (NOL) carryover is applied to an election year before allocating elected farm income to base years.[24] IRS Publication 553 includes an additional statement that "any NOL that was only partially applied in a prior year is not refigured to offset the elected farm income added to that prior year."[25]

Example 10. Allen Wrench had a $30,000 NOL carryover to 1999 that reduced his taxable income for 1999 to $50,000. Allen can elect no more than $50,000 as elected farm income in 1999. His elected farm income is subtracted from the $50,000 to compute his tax liability using income averaging.

Example 11. Tommy Gunn had $20,000 of taxable income in 1998 before subtracting a $45,000 NOL carryover to 1998. The NOL carryover reduces his taxable income to zero. Tommy's modified taxable income in 1998 is $32,000, so his NOL carryover to 1999 is $13,000 ($45,000 - $32,000). Tommy elects to treat $60,000 as elected farm income in 1999. The $20,000 (1/3 of $60,000) of elected farm income that is carried to the 1998 tax brackets is not offset by the $25,000 of unused NOL in 1998 and does not change the NOL absorption calculation. The $20,000 is added to Tommy's zero 1998 taxable income for purposes of the income averaging tax calculation.

Making, changing or revoking the election

The committee reports for the Tax Relief Act of 1997 say that an election shall be made in the manner prescribed by the Secretary of the Treasury and except as provided by the Secretary, shall be irrevocable. The proposed regulations state that an election can be made, changed or revoked only if there is another change on the tax return for the election year or for a base year.[26]

Example 12. Jim Nastics sold 100 raised beef cows for $50,000 in 1998 because of a drought. On his 1998 income tax return, he made the IRC §1033(e) election to roll the gain into replacement cows. Since the $50,000 gain was not recognized in 1998, he did not need the income averaging election and did not make the election.

In 2000, Jim decided not to replace the cows and therefore filed an amended return for 1998 to report the $50,000 of gain. Since there is another change on his 1998 return, Jim is allowed to make the income averaging election the amended return.

If an individual does not have an adjustment for the election year or the base year, the individual may not make a late income averaging elections, change the amount of the election or revoke an election without the consent of the Commissioner.[27]

Effect of a prior year election

The proposed regulations state that the starting point for taxable income in a base year is the taxable income for that year decreased by any elected farm income for that base year and increased by any elected farm income that was carried to that base year from a previous income averaging election.[28] The regulations provide the following example.

Example 13. In each of years 1996, 1997 and 1998, T had taxable income of $20,000. In 1999, T had taxable income of $30,000 (prior to any farm income averaging election) and electable farm income of $10,000. T makes a farm income averaging election with respect to $9,000 of his electable farm income for 1999. Thus, $3,000 of elected farm income is allocated to each of years 1996, 1997 and 1998. T's 1999 tax liability is the sum of –

(A) The section 1 tax on $21,000 (1999 taxable income minus elected farm income); plus

(B) For each of years 1996, 1997, and 1998, the section 1 tax on $23,000 minus the section 1 tax on $20,000 (the increase in section 1 tax attributable to the elected farm income allocated to such year).

(ii) In 2000, T has taxable income of $50,000 and electable farm income of $12,000. T makes a farm income averag-

Income averaging/Cont. on page 7

ing election with respect to all $12,000 of his electable farm income for 2000. Thus, $4,000 of elected farm income is allocated to each of years 1997, 1998 and 1999. T's 2000 tax liability is the sum of—

(A) The section 1 tax on $38,000 (2000 taxable income minus elected farm income); plus

(B) For each of years 1997 and 1998, the section 1 tax on $27,000 minus the section 1 tax on $23,000 (the increase in section 1 tax attributable to the elected farm income allocated to such years after increasing such years' taxable income by the elected income allocated to such year by the 1999 farm income averaging election); plus

(C) For year 1999, the section 1 tax on $25,000 minus the section 1 tax on $21,000 (the increase in section 1 tax attributable to the elected farm income allocated to such year after reducing such year's taxable income by the 1999 elected farm income).

Issues on 1999 Schedule J (Form 1040)

The instructions for line 22 state that the taxpayer does not qualify for income averaging and cannot file Schedule J (Form 1040) if income averaging does not reduce the tax liability. That instruction will prevent a taxpayer from using the income averaging rules to do the following income tax planning.

Elect income averaging in 1999 to empty the 1999 15% bracket.

Elect income averaging in 2000, 2001 and/or 2002 to move income from a higher bracket in those years into the 1999 15% bracket (and the bracket of two the other prior years.)

Example 14. Sue S. Canal had $14,000 of taxable income in 1996, 1997 and 1998 because she is building up a herd of goats. In 1999, she sold a champion billy goat and had $25,000 of taxable income. She plans to sell very few animals in 2000 and 2001 and therefore expects her taxable income to be about zero in those years. In 2002 she will have several animals ready for sale and expects about $100,000 in taxable income.

If Sue elects $25,000 of eligible farm income in 1999 for income averaging, she will not reduce her 1999 tax liability, but she will increase the tax savings from an income averaging election in 2002. If Sue's predictions are accurate, income averaging in 1999 will empty her 15% bracket so that an income averaging election in 2002 will move income from her 28% and 31% bracket in 2002 to her 15% brackets in 1999, 2000 and 2001. If she does not income average in 1999, one-third of her elected farm income from 2002 will be moved into her 28% bracket for 1999 instead of her 15% bracket. Therefore, income averaging in 1999 will reduce her tax liability in 2002.

The instructions for line 22 of the 1999 Schedule J (Form 1040) say that she does not qualify for income averaging and cannot file Schedule J (Form 1040). However, there is nothing in IRC §1301 that prohibits a taxpayer from using income averaging if averaging does not reduce his or her tax liability. IRC §1301(a), simply states:

> At the election of an individual engaged in a farming business, the tax imposed by section 1 for such taxable year shall be equal to the sum of—
> (1) a tax computed under such section on taxable income reduced by elected farm income, plus
> (2) the increase in tax imposed by section 1 which would result if taxable income for each of the 3 prior taxable years were increased by an amount equal to one-third of the elected farm income.

Conclusion

As enacted by Congress, the income averaging rules contained only a bare skeleton of a provision for allowing farmers to spread income from their high years to the income tax brackets of the prior three years. The proposed regulations give useful guidance on several issues, but leave some questions unanswered. IRS Publication 553, *Highlights of the 1998 Tax Changes*, (Revised December 1998) and the instruction for Schedule J (Form 1040) give some additional guidance. A few issues, such as whether a materially participating landowner can use income averaging have not been addressed. These issues may be clarified in final regulations or the full instructions to the 1999 Schedule J. A hearing on the proposed regulations will held on February 15, 2000.

[1] REG-121063-97; Prop. Reg. § 1301.1.
[2] Public Law 1105-34 (111 Stat. 788).
[3] Public Law 105-277, 112 Stat. 2681.
[4] IRC § 1301(c).
[5] IRC § 1301(b)(1)(A)(i).
[6] Prop. Reg. § 1301-1(b).
[7] Prop. Reg. § 1301-1(e)(1).
[8] IRC § 7701(a) defines person as an individual, a trust, estate, partnership, association, company or corporation. Therefore, by implication, an individual does not include any of the other entities.
[9] Note that the specific exclusion of trusts and estates could be used as an argument that corporations are not excluded.
[10] IRS Publication 553, *Highlights of the 1998 Tax Changes*, (Revised December 1998) at page 11.
[11] Prop. Reg. § 1301-1(b).
[12] IRC §1301(b)(1)(B).
[13] Prop. Reg. §1301-1(e)(1)(ii).
[14] *Id.*
[15] Prop. Reg. § 1301-1(e)(1)(i).
[16] Prop. Reg. § 1301-1(e)(1)(ii)(B).
[17] Prop. Reg. § 1301-1(f)(4).
[18] Prop. Reg. § 1301-1(e)(2)(i).
[19] IRS Publication 553, *Highlights of the 1998 Tax Changes*, (Revised December 1998) at page 11.
[20] Prop. Reg. §1301-1(d)(1).
[21] *Id.*
[22] Prop. Reg. § 1301-1(f)(2).
[23] IRS Publication 553, *Highlights of the 1998 Tax Changes*, (Revised December 1998) at page 11.
[24] Prop. Reg. §1301-1(d)(1).
[25] IRS Publication 533, *Highlights of the 1998 Tax Changes*, (Revised December 1998) at page 11.
[26] Prop. Reg. § 1301-a(c)(2).
[27] Prop. Reg. § 1301-1(c)(2)(ii).
[28] Prop. Reg. § 1301-1(d)(2).

Dissolution/*Cont. from page 1*

the continuation of the company. The court also referenced a paragraph in the operating agreement that referred to members as of a *relevant* time period. The court agreed with the withdrawing members' argument that the term "members" included those that had withdrawn from the LLC but still had an economic interest in the LLC. As such, the court concluded that the term "member" included a withdrawing member that had a financial interest in the company's assets. Thus, until dissolution has run its course, the withdrawing members were still members for purposes of dissolution and subsequent liquidation of the LLC's assets.

—Roger A. McEowen, Kansas State University

Milk marketing/*Cont. from page 2*

St. Albans at *10. Instead, according to the court, the AMAA requires direct consideration of the section 608c(18) factors. *Id.*

The court also found that the producer and producer cooperative plaintiffs had standing, notwithstanding the Secretary's contention that only handlers had standing to challenge marketing orders. It concluded that the balance of the hardships tipped in favor of a temporary restraining order and that the public interest would be best served by maintaining the status quo.

Though the briefing on the plaintiffs' motion for a preliminary injunction in *St. Albans* is to be completed by late October, the briefing in the District of Columbia litigation is not scheduled for completion until December 1. Therefore, the Secretary's milk marketing order reforms are unlikely to be implemented this year.

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