1970

Income Averaging

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INCOME AVERAGING

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Let me first thank you, Dr. Atkeson and the other Conference Directors, for providing this opportunity for me to participate in the Sixteenth Annual William and Mary Tax Conference. It is always a pleasure to participate in the functions of the College and the Law School.

As a continuing part of the analysis of the individual income tax return (Form 1040) for 1970, I would like to discuss the income averaging provisions of Internal Revenue Code Sections 1301 through 1305,[1] with greatest emphasis on the revision in these sections provided by the Tax Reform Act of 1969.

Background

Sections 1301-1305 as they existed prior to the Tax Reform Act of 1969 were added to the Code by the Revenue Act of 1964, generally applicable with respect to taxable years beginning after December 31, 1963. Prior to the enactment of these income averaging provisions, the law did not provide any generally available averaging device for persons whose income fluctuated widely from year to year. There were instead six specific averaging provisions applicable to very specific types of situations.

Congress, in recognizing that existing specific devices were unsatisfactory because they were available only for a small proportion of the situations where income averaging was needed and, even then, were unduly complicated in the computation of the tax, deleted all of the specific devices. The general averaging provisions were thus enacted to sustain the view of the House Ways and Means Committee that income averaging should be desiged so as to treat all individuals as nearly equally for tax purposes as possible, while at the same time be structured in a form which is workable from the standpoint of both the Internal Revenue Service and the taxpayer.[2]

Scope and Effect of Income Averaging

The basic need for income averaging exists because Federal individual income tax rates are progressive, thereby requiring persons whose annual taxable incomes vary widely to pay, over a period of years,

[1] Unless otherwise stated, references in this discussion to various sections are to sections of the Internal Revenue Code of 1954.

[2] H. R. Rep. No. 749, 88th Cong., 1st Sess. 110 (1963).

substantially more income taxes than persons whose taxable incomes are equivalent in total but recognized evenly over the years involved.

The averaging provisions, both prior and subsequent to the Reform Act, are not mandatory but rather are elected by the individual taxpayer by attaching a completed Schedule G (Income Averaging) to his individual tax return (Form 1040). The provisions bring five taxable years into the computations—the current, or "computation year", and the four immediately preceding, or "base period years". Broadly speaking, the provisions effect a spreading of the computation year's extraordinarily high income over the five years, thereby taxing the averaged income at lower rates, but without the requirement that the base period years' income and taxes must be recomputed, as the law read prior to 1964.

Application of Income Averaging Provisions to Actual Practice

Beyond this basic outline of the income averaging method, most persons who have dealt in practice with the averaging provisions will concur that they have historically presented one of the most complicated individual tax computations in the Code. Simplification in computation and the extension of the benefits of income averaging to a greater number of taxpayers were the principal reasons stated by the Congress for revising the averaging provisions as a part of the Tax Reform Act of 1969.[3] In order to determine the effectiveness with which the Reform Act achieved the stated Congressional intent, and to more specifically describe the mechanics of the income averaging provisions, I would like to devote the remainder of this discussion to the effect of the Act on Code Sections 1301-1305.

Income Averaging and the Tax Reform Act of 1969

The history of the general income averaging provisions reveals that during the period 1964-1969, no reported cases were decided and less than ten revenue rulings were issued with respect to such provisions. It would therefore appear that the averaging provisions were not vague or otherwise in need of substantial interpretation. What had become evident by 1969, however, as recognized in the Congressional reports accompanying the Reform Act, was that simplification of the averaging computation and the required Schedule G was necessary and, additionally, that the benefits of income averaging were being denied to those taxpayers whose increase in income could be considered substantial. Section 311 of the Reform Act was the amending legislation enacted to overcome the objections noted by Congress, effective for computation years beginning after December 31, 1969, and to base period years applicable to these computation years.

[3] H. R. Rep. 413, 91st Cong., 1st Sess. 84, 85 (1969).

Extension of Benefits

In order to overcome the first objection of undue complexity in the computation of the tax under the income averaging provisions, the Reform Act dropped the provision that net long term capital gains, net income from wagering and net income from gifts, bequests or inheritances are ineligible for averaging. Under prior law, such items of income, as well as proscribed distributions from a self-employed retirement fund plan, were generally ineligible, thus requiring the adjustments to computation and base period years which resulted in the undesirable complexity of the tax calculation.[4] In addition to the liberalization of income subject to averaging, the possible adjustment required in determining averagable income due to average base period capital gains is no longer required.

The inclusion of net long term capital gain income in the category of income subject to averaging results in a substantial benefit to the taxpayer whose exceptionally high income in the computation year is attributable to such capital gains, i.e. the taxpayer first benefits from the 50 percent long term capital gain deduction, and is then eligible to pay at a lower tax rate on the remaining taxable portion by averaging his income. The taxpayer, will not, however, be entitled to use the alternative tax computation available prior to the Reform Act.

Income Ineligible for Averaging

Under post-Reform Act law, there exist only three types of income now ineligible for income averaging. As under prior law, a proscribed (premature or excessive) distribution from a self-employed retirement fund plan to an owner-employee which is subject to the penalty imposed by Code Section 72(m)(5) continues to be ineligible. Also, ineligible as under prior law is the category of "excess community income," i.e. community property income not earned by a married taxpayer who files a separate return in the computation year. The third category of income ineligible for averaging was added by the Reform Act as a corollary to the new throwback rules of Code Section 668. Where a beneficiary under an income accumulation trust receives a distribution subject to the throwback rules, this distribution is not eligible for income averaging. The reason for its ineligibility is that Section 668 itself provides a special averaging device for such distributions, and to allow a supplementary averaging under Sections 1301-1305 would, in the opinion of the drafters of the Reform Act, provide an unwarranted double benefit. Taxable income in the computation

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[4] Adjustments to base period year taxable incomes under pre-Reform Act law for income attributable to interests in property received as a gift, bequest, devise or inheritance were required only if the amount of such income exceeded $3,000 in the current, or computation year.

and all base period years must be reduced in the amount of such accumulation distributions for income averaging purposes.

Increase in Amount of Averagable Income

Under prior law, the current year's adjusted taxable income was eligible for averaging only to the extent it exceeded 133 percent of the average base period income, with the additional requirement that such excess must be greater than $3,000. Averagable income is now defined as the excess of current year's adjusted taxable income over 120 percent of average base period income, although the $3,000 cut-off test still exists. For example, if, after making any appropriate adjustments to taxable income, a taxpayer has an average base period income of $30,000, he can elect to average his income in excess of $36,000, provided his income exceeds $39,000, whereas under prior law he would have needed income in excess of $43,000 in order to have averaged his income.

By lowering the percentage requirement in determining averagable income, the Reform Act has met the second Congressional objective of extending the benefits of income averaging to those taxpayers to whom an increase in income could be considered substantial, but who would otherwise be denied such benefits under prior law.

Restrictions and Limitations

In order to be eligible for income averaging prior to the Reform Act, individuals had to satisfy certain citizen or residency requirements as well as meeting a support test. These limitations on eligibility to average continue under current law.

Basically stated, the taxpayer must be either a citizen or a resident of the United States throughout the computation year and not have been a nonresident alien during the computation year or the base period years. Also, the taxpayer may not elect income averaging where he claims an exclusion for income earned abroad in the computation year. Although he may have claimed such an exclusion in any base period year, the excluded income must be added back to his base period income in the determination of current year's averagable income. The purpose of these limitations and adjustments is to insure that the individual's income has been subject to tax by the United States during the five-year averaging period.

In addition to the citizen or residency requirements, an individual must have provided at least one-half of his own support during each of the four base period years, to which three exceptions may apply. This support test is designed to prevent the use of income averaging by individuals whose incomes increase materially because they begin full-time employment upon leaving school.

No complications arise where the individual who averages his income files his return in the computation year with the same tax status (and, in the case of married individuals, with the same spouse) as in all base period years. In those cases where each filing status is not identical, a reconstruction of income will be required in order to reflect the appropriate comparison between computation year income and average base period income. This reconstruction, as provided in the prior law, also remains unchanged as a result of the Reform Act.

Other tax benefits which were restricted under prior law from use by individuals who averaged their income, and which continue to be denied following the Reform Act include use of the optional tax tables under Code Section 3 and the special averaging computation provided by Code Section 72(n)(2) for certain distributions from qualified self-employed retirement plans.

The Reform Act provides additional limitations on the use of other tax benefits of the Code by taxpayers electing the income averaging device. As discussed earlier, the alternative tax computation for capital gains is no longer available since such income is now eligible for averaging under the Reform Act. Two new tax benefits created by the Reform Act are also expressly restricted from use by taxpayers electing to average their incomes. These benefits are the new 50 percent maximum tax rate on earned taxable income provided by Code Section 1348[5] and the special seven-year "forward" averaging formula otherwise available for the portion of lump-sum distributions from qualified employee plans which are no longer eligible for capital gain treatment under amended Code Sections 402 and 403.[6]

Schedule G for 1970

Because the changes made in the income averaging provisions by the Reform Act are effective for computation years beginning after December 31, 1969 and to base period years applicable to these computation years, Schedule G for 1970 reflects these changes in the law.

Schedule G is printed on four pages—page 1 provides the basic schedules for determining eligibility and computing the tax liability under the income averaging provisions; page 2 provides a schedule for the computation of the standard deduction for 1970 where the taxpayer's adjusted gross income is under $10,000—this schedule appears at the place formerly occupied on prior year's schedules by the computation of the alternative tax, which is no longer available for

[5] The maximum tax rate on earned taxable income is 60 percent for taxable years beginning after December 31, 1970 and before January 1, 1972. For taxable years beginning after December 31, 1971, the rate is 50 percent.

[6] This special averaging device is restricted from use by individuals who average their income by virtue of the restriction of section 1304(b)(2) on section 72(n)(2), amended at section 72(n)(4) by Reform Act section 515(b)(2).

the taxpayer who averages his income; pages 3 and 4 provide general and specific instructions pertaining to Schedule G.

Referring specifically to page 1, 1970 is shown as the current, or computation year, and 1966-69 appear as the four immediately preceding, or base period years. Because of the Reform Act changes regarding types of income eligible for averaging, column (a) for the computation year no longer reflects adjustments to taxable income for net income from capital gains, wagering and gifts and inheritances. In their place are the adjustments at line 3 for excess community income and retirement fund distributions subject to a penalty under Code Section 72(m)(5), and the adjustment at line 4 for distributions from accumulation trusts subject to Section 668(a). As discussed earlier, the adjustments required at line 3 were required prior to the Reform Act, however they were not specifically set out on page 1 of the prior years' schedules but rather were referred to in the accompanying instructions.

Adjustments to the taxable incomes of base period years must be made in columns (b)-(e) for income earned abroad and excluded under sections 911 and 931, at line 2, and Section 668(a) accumulation distributions, at line 4. No adjustment in the computation year at column (a) is required for excluded foreign income since the income averaging provisions are not available to taxpayers who elect to exclude such income under Sections 911 and 931.

A significant change in the 1970 Schedule G appears at line 7, reflecting the Reform Act definition of averagable income as the excess of the current year's adjusted taxable income over 120 percent of average base period income, rather than the 133 percent standard of prior years.

In general, the 1970 Schedule G has a much less forbidding appearance than its predecessors, and requires substantially fewer computations in arriving at the ultimate tax.

As a comprehensive example, the facts as presented in Appendix A reflect the significant revisions made in the area of income averaging by the Reform Act. The example, which contrasts the law as it existed prior to the Reform Act with the current law, reveals a difference of $25,000 in averagable incomes.

Planning Considerations

Limited tax planning may be made in the area of income averaging. Owing to the difficulty in predicting income levels over a five-year period and the fact that only the excess of the computation year's income over 120 percent of average base period income is subject to the averaging provisions, it would appear that the most appropriate planning would be to avoid the necessity of applying the averaging provisions, i.e., to spread income as evenly as possible over the years.

Where this method is not possible, as in the case of an unexpected and uncontrollable large receipt of income, certain voluntary actions could be taken to utilize the averaging provisions to the greatest extent. These actions could include the proper timing of capital gains and losses, distributions from the earnings and profits of a closely held corporation and payment of employee bonuses, so that, as between the five years reflected in the calculations, the base period years will reflect the lowest possible income, and the computation year will reflect the highest possible income.

Taxpayers and practitioners may find useful the maintainance of a schedule of income averaging information similar to the one presented as Appendix B. By maintaining a moving average of base period income and applying the appropriate percentage thereto, it can be readily determined whether the taxpayer has a possible opportunity to apply the income averaging provisions. In the example provided in the Appendix, the taxpayer could average his income in 1970 if otherwise eligible.

Those persons who have maintained such schedules in the past must revise them for 1970 and subsequent years to give effect to both the application of the Reform Act to base period year incomes as well as the change in the percentage requirement for averaging.

Summary

In summary, it appears that the stated Congressional intent accompanying the Tax Reform Act of simplification of the income averaging computations and extension of the benefits of income averaging to a greater number of taxpayers has been fulfilled by section 311 of the Reform Act.

The amendments to Code Sections 1301-1305 are, when considered in their entirety, of substantial benefit to the taxpayer and tax practitioner and should successfully augment the original objective in enacting the averaging provisions, that of treating all individuals as nearly equally as possible for tax purposes.

APPENDIX A

Effect of the Tax Reform Act of 1969 on Income Averaging

Before the Reform Act:

	1970	1969	1968	1967	1966
Taxable income	$100,000	$60,000	$50,000	$20,000	$10,000
Less income from:					
Capital gains	20,000	10,000	4,000	2,000	—
Gifts and bequests	10,000	8,000	6,000	7,000	—
Wagering	10,000	10,000	10,000	2,000	—
	$ 60,000	$ 32,000 +	$30,000 +	$ 9,000 +	$10,000

$$\underbrace{\$\ 32{,}000 + \$30{,}000 + \$\ 9{,}000 + \$10{,}000}_{\$81{,}000}$$

1970 Income	$ 60,000
33⅓% of $81,000	27,000
Averagable income	$ 33,000

After the Reform Act:

	1970	1969	1968	1967	1966
Taxable income	$100,000	$60,000 +	$50,000 +	$20,000 +	$10,000

$$\underbrace{\$60{,}000 + \$50{,}000 + \$20{,}000 + \$10{,}000}_{\$140{,}000}$$

1970 Income	$100,000
30% of $140,000	42,000
Averagable Income	$ 58,000

APPENDIX B

Income Averaging Information

Name of Taxpayer: ______________________

Year	Col. 1 Taxable Income	Col. 2 Adjustments[1]	Col. 3 Base Period Income[2]	Col. 4 Total Base Period Income —4 Years	Col. 5 30% of Total Base Period Income[3]
1966	$19,323	—	$19,323		
1967	22,608	—	22,608		
1968	21,302	—	21,302		
1969	19,206	—	19,206	$ 82,439	$24,732
1970	56,209	—	56,209	119,325	35,798
1971					
1972					

[1]Adjustments for foreign income excluded under Code sections 911 and 931 and accumulation distributions subject to section 668(a).

[2]Column 1 less column 2.

[3]If current year taxable income exceeds this figure, the taxpayer *may* be entitled to apply the income averaging provisions. In that case, any adjustments for excess community income and certain retirement fund distributions must be determined, and other factors considered before eligibility can be finally established.