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Taxation

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CURRENT LEGISLATION

FEDERAL TAXATION

Most significant among the equitable revisions of the tax system embodied in the Revenue Act of 1964 is a provision for "income averaging."[1]

The Senate Finance Committee explained income averaging as a technique designed to limit the income tax liability of individuals whose taxable incomes fluctuate or increase by substantial amounts and percentages.[2] The need for the limitation arises from the hardships resulting from the application of progressive tax rates to persons whose income varies widely from year to year.

Although applicable to almost all individuals (as noted below), the provision will primarily benefit professional persons (attorneys, architects, and others), athletes, artists and authors. However, it can apply in appropriate cases to salaried persons, entrepreneurs, and even to investors. It applies equally to businessmen, whether proprietors, partners, or corporate executives. It encompasses income from the sale of merchandise and dividend income, as well as salaries, commissions and bonuses. The objective is to:

> . . . treat everyone as nearly equally for tax purposes as possible, without regard to how their income is spread over a period of years and without regard to the type of income involved.[3]

A second objective is to simplify the complex computation requirements resulting from averaging under the former law. The purpose of this article is to analyze the new rules by the use of illustrative computations and factual examples.

The previous rules which permitted averaging of certain types of income[4] were unsatisfactory since they did not provide a general income averaging provision for those persons whose income fluctuated from year to year.[5] They also proved unduly complicated, where applicable, because of the requirement that the prior years' incomes and taxes be recomputed as if the income had actually been received in those prior years.[6]

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1 Revenue Act of 1964; U.S. Code Cong. & Ad. News (Feb. 29, 1964), amending Internal Revenue Code of 1954, §§ 1301-05, 68A Stat. 335. Hereafter, all reference to the Internal Revenue Code of 1954 will be to the amended version, unless otherwise indicated.

2 S. Rep. No. 830, 8[illegible]h Cong., 2d Sess. 139 (1964).

3 Id. at 140.

4 The prior provis[illegible]n applied only to certain compensation for personal services, income from inventio[illegible] or artistic work, income from back pay, compensation for damages due to pate[illegible]fringement, breach of contract damages, and damages for injuries under the [illegible] laws. Int. Rev. Code of 1954, ch. 736, §§ 1301-07, 68A Stat. 334.

5 See S. Rep. [illegible]upra note 2, at 140.

6 To determin[illegible]ax effect of the application of these former sections, it was necessary in each ca[illegible]o make alternative computations; one based on an inclusion of the entire amount received or accrued in the taxable income of the year of receipt or accrual; another, excluding the entire amount from the taxable income of the current year; and a third, a recomputation of the tax of each taxable year to which the income may be spread back, with the spread back income added to the previously determined

The scope of the new averaging provisions contained in Section 232 of the Revenue Act of 1964[7] is much broader than that of the earlier provisions. They may be utilized by all taxpayers regardless of occupation if certain mechanical dollar and cent tests are met. However, the broadened scope of coverage is reduced in part in that only *individuals* may employ income averaging. Corporations, partnerships, estates, and trusts may not use the technique. In addition, gamblers are forbidden access to the averaging technique. Prior years' taxes need not be recomputed since the tax is computed by treating the income subject to averaging as a component part of current taxable income and by using the rates applicable to the current taxable year. The new provision in effect provides for the averaging of income over a five-year period where the income in the current year exceeds the average of the four prior years by more than one-third and this excess equals at least $3,000. These provisions can result in a change of thinking about the tax advantages of deferring compensation, of keeping dividends to a minimum, of selling on the installment basis and so on. A few examples of situations in which individuals can derive tax benefits from the new provision are: (1) where an executive is given a substantial performance bonus; (2) a commission salesman closing the largest sale he ever made; (3) a business proprietor acquiring a new customer, thereby tripling his previous sales income; (4) the owner of a closely held corporation distributing a large amount of its earnings and profits to himself as a dividend; and (5) a professional man receiving the largest fee in his career.

The improved rules are contained in Sections 1301-05 of the Internal Revenue Code of 1954, and are effective for all taxable years beginning after December 31, 1963. They replace the previous averaging provisions, with the one exception, indicated by the Senate Finance Committee Report, that if a taxpayer receives or accrues compensation from "employment" (as defined in old Section 1301(b) of the 1954 Code) which began before February 6, 1963, he can choose between the benefits of the old provision and the new rules.[8]

Generally, an individual is eligible for averaging, if he was a citizen or resident of the United States throughout the "computation year" (the current taxable year),[9] and all of the prescribed "base period years" (the preceding four taxable years).[10] If less than one-half of an individual's support during any base period year was furnished by himself and his spouse, he is ineligible for averaging unless certain exceptions apply.[11] The exceptions are: (1) an individual who was at least twenty-five years old by the end of the computation year and who was not a full-time student during [illegible] least four of his taxable years beginning after he became twenty-one [illegible] old and ending with

taxable income. The tax for the current year would be th[illegible] the tax first computed plus the aggregate of the additional amounts of tax [illegible] by the third series of computations. See generally, Montgomery, Federal Taxes [illegible] (37th ed. 1958).

[7] Int. Rev. Code of 1954, § 1301.

[8] S. Rep. No. 830, supra note 2, at 140-41.

[9] Int. Rev. Code of 1954, § 1303(a).

[10] Int. Rev. Code of 1954, § 1303(b).

[11] Int. Rev. Code of 1954, § 1303(c)(1).

the computation year; (2) an individual whose "adjusted taxable income" (a new term defined below) is attributable to period years; (3) an individual who files a joint return for the computation year, and to whom is attributable not more than twenty-five per cent of the adjusted gross income on such return.[12] Exception (1) permits an individual who was unemployed during the base period to average his income as long as he was not a full-time student supported by someone other than himself or his wife. Exception (2) would permit averaging by, for example, an artist who was supported by others during all or part of the base period during which he produced paintings which he sold at a large profit in the current year. Exception (3) would permit the newly married man to average his income even though his wife was supported by her parents during all or part of the base period.

Averaging applies to all types of income, except long-term capital gains, the investment *income* from property recently received as a gift or inheritance, premature payouts from self-employed retirement plans, and wagering gains.[13] How the new rules affect these types of income is set forth more fully below. When income is solely from personal services, averaging is available in a year (the computation year) in which the taxable income, as adjusted, exceeds 4/3 of average base period income provided the excess is more than $3,000.[14] The tax attributable to the excess is limited to five times the tax attributable to one-fifth the excess. For example, averaging would be available where adjusted taxable income for the computation year is $7,500 and the average base period income is $3,000, but it would not be available if such amounts were $100,000 and $75,000 respectively. In the latter situation adjusted taxable income does not *exceed* 4/3 of average base period income. The situation is somewhat more complex where there is capital gain income and certain other types of income for the computation year or any base period year.

Taxable income is the starting point in both computation and base period years. Income subject to averaging (averageable income) is "adjusted taxable income" for the computation year less 4/3 of average base period income. Averageable income is decreased by the excess, if any, of average base period capital gain net income[15] over computation year capital gain net income. In order to apply the several exceptions noted above and in order to compute averageable income, a determination of "adjusted taxable income" must be made.

"Adjusted taxable income" is taxable income of the computation year decreased by the sum of:

a. Capital gain net income for the year (50 per cent of the excess of long-term capital gains over short-term capital losses);

b. Investment income, less allowable deductions, attributable to gifts

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12 Int. Rev. Code of 1954, § 1303(c)(2)(A)-(C).

13 Int. Rev. Code of 1954, § 1302(b).

14 Unless the excess amount subject to averaging is reasonably substantial, there is no need for relief from bunching. Therefore, averaging is not available unless the excess amount exceeds $3,000. Int. Rev. Code of 1954, § 1301.

15 Average base period "capital gain net income" is ¼ of the total of 50% of the excess of net long-term capital gains over net short-term capital losses for the four base

or bequests received by the taxpayer in the current taxable year or any of the preceding four taxable years;

c. Wagering income less wagering losses;

d. Amounts received by owner-employees subject to penalties under Section 72(m)(5) of the Internal Revenue Code of 1954.[16] Unless the taxpayer shows otherwise, the income from a gift or bequest will be deemed to be six per cent of its fair market value at the date of the gift or bequest. It is important to note that no adjustment is required for income attributable to a gift or bequest received in a year prior to the base period. Moreover, this adjustment is required only if the income from gifts or bequests exceeds $3,000 for the computation year, in which case the entire amount of such income must be excluded.[17]

The base period for a computation year is the preceding four taxable years. Base period income is taxable income for each base period year adjusted (but not below zero) by the following items taken in order:

a. *Increased* by amounts, less allowable deductions, excluded under Section 911 (earned income from sources without the United States) and Sections 931-34 (income from sources within possessions of the United States) of the Internal Revenue Code of 1954;

b. *Decreased* by capital gain net income for the year;[18]

c. *Decreased* by net income for the year on gifts and bequests received during the year or in an earlier base period year even if such income from such sources was excluded in computing adjusted taxable income for the computation year.

"Averageable income" means the amount by which adjusted taxable income for the computation year exceeds 4/3 of average base period income less the amount, if any, by which average base period capital gain net income exceeds fifty per cent of the excess of net long-term capital losses for the computation year.[19] If the amount so determined exceeds $3,000, and the individual is not otherwise ineligible, then the benefits of income averaging are available to him.[20]

Assuming all income for all years is from services rendered in the United States, the method for applying the limitation is:

a. Determine taxable income for the computation year.

b. Determine the average taxable income for the four preceding base period years (AVERAGE BASE PERIOD INCOME) and multiply by 4/3.

period years. For this purpose, the capital gain net income may not exceed the base period income for each base period year computed before the deduction for capital gains. Int. Rev. Code of 1954, § 1302(d)(1)-(2).

[16] In effect, income from these sources is not subject to averaging. Int. Rev. Code of 1954, § 1302(b)(4).

[17] Int. Rev. Code of 1954, § 1302(b)(2)(C).

[18] Capital gain net income equals 50% of the excess of net long-term capital gains over net short-term capital losses for each year.

[19] Int. Rev. Code of 1954, § 1302(a).

[20] The $3,000 minimum on averageable income is applied to the total combined income on a joint return, not to the income of each spouse. Int. Rev. Code of 1954, § 1304(d).

c. Compute AVERAGEABLE INCOME by subtracting b. from a.

d. Determine the tax on an assumed taxable income equal in amount to the sum of 4/3 average base period income (b. above) and 1/5 of averageable income.

e. Determine the tax on 4/3 of average base period income (b. above).

f. Determine the tax attributable to 1/5 of averageable income by subtracting e. from d. Then multiply by 5 to determine the tax attributable to averageable income and add to the tax computed in e. to determine the maximum tax.

ILLUSTRATION:

Assuming a joint return, 1964 rates and all income for personal services rendered in the United States.

a. Taxable Income in 1964	\$52,000
b. 4/3 Average Base Period Income	
1963—\$14,000	
1962— 12,000	
1961— 13,000	
1960— 9,000	
48,000 ÷ 4 × 4/3	\$16,000
c. Averageable Income (a. — b.)	\$36,000

TAX COMPUTATION:

d. Tax on sum of b. and 1/5 c. (\$16,000 + \$7,200)	\$ 5,808
e. Tax on b.	\$ 3,500
f. 5 times difference between d. and e. (\$2,308)	\$11,540
g. Maximum tax (e. and f.)	\$15,040

The tax saving with averaging is the difference between the tax on \$52,000 and the tax computed above (\$19,200 — \$15,040) or \$4,160.

From the above illustration, it can be seen that, in general, if averageable income is more than \$3,000, the tax attributable to averageable income is limited to five times the increase in tax which would result from adding 1/5 of averageable income to the sum of 4/3 average base period income and average base period capital gain net income. The device of including 1/5 of the averageable income in the tentative tax base, computing the tax attributable to this amount, and then multiplying this result by five, achieves a result which is substantially similar (except when there are rate changes during the five years) to including 1/5 of the income eligible for averaging in the taxable income base of each of the prior four years and of the current year. The Senate Finance Committee Report indicated that the advantage of making the computation in this manner is that it is not necessary to recompute the tax for each of the prior four years in order to obtain the result.[21]

21 S. Rep. No. 830, supra note 2, at 141.

This general rule is complicated, however, by special rules to be applied in computing the tax not attributable to averageable income. The effect is that the total tax is computed in a series of increments by adding various segments of income in a prescribed order, the tax increment attributable to 1/5 of the averageable income being multiplied by five.

The example below illustrates the procedure in detail. The following figures, modified to some extent, are taken from the example contained in the House Ways and Means Committee Report.[22] The individual concerned is unmarried, income is from salary and long-term capital gains for all years, except that 1964 includes $5,000 of net income attributable to a bequest, and 1964 rates are used.

TAXABLE INCOME

Year	Total	Ordinary income	Capital gains
1960	$ 8,250	$ 2,000	$12,500
1961	$ 7,750	$ 4,000	$ 7,500
1962	$ 7,500	$ 3,500	$ 8,000
1963	$ 8,500	$ 2,500	$12,000
1964	$59,000	$49,000	$20,000

1. Initial computations to determine eligibility for averaging.

a. Adjusted taxable income for 1964 (the computation year)

(i) Taxable income for 1964		$59,000
Less:		
(ii) Capital gain net income for the computation year (50 per cent of $20,000)	$10,000	
(iii) Income attributable to bequest	$ 5,000	
TOTAL	$15,000	
Adjusted taxable income		$44,000

b. 4/3 average base period income is the sum of ordinary income for the years of the period 1960-1963 ($12,000) multiplied by 4/3 ($16,000) and divided by 4 — $ 4,000

c. Average base period capital gain net income is the sum of the base period capital gain ($40,000) divided by 2 (50 per cent or $20,000) and then divided by 4 — $ 5,000

d. Averageable income for 1964

(i) Adjusted taxable income	$44,000	
Less:		
(ii) 4/3 of average base period income	$ 4,000	
Total		$40,000

2. Computation of tax for 1964

[22] H.R. Rep. No. 749, 88th Cong., 1st Sess. A180 (1963).

Item	Amount	Tax
a. 4/3 average base period income	$ 4,000	(i) $ 740
Add		
b. Average base period capital gain net income.	$ 5,000	(ii) $ 1,315(2,055-740)
Subtotal	$ 9,000	$ 2,055
Add		
c. 1/5 of averageable income ($40,000 ÷ 5)	$ 8,000	(iii) $ 3,000(5,055-2,055)
Subtotal	$17,000	$ 5,055
Add		
d. Income attributable to bequest	$ 5,000	(iv) $ 2,405(7,460-5,055)
Subtotal	$22,000	$ 7,460
e. Excess of computation year capital gain net income over average base period capital gain net income	$ 5,000	(v) $ 2,700(10,160-7,460)
Total	$27,000	$10,160
f. The tax for 1964 is the sum of the tax attributable to:		
(i) 4/3 average base period income		$ 740
(ii) Average base period capital gain net income		$ 1,315
(iii) Tax on averageable income (5 × $3,000)		$15,000
(iv) Income attributed to bequest		$ 2,405
(v) Tax on excess capital gain net income		$ 2,700
		$22,160
g. The tax liability without averaging but utilizing the alternative tax computation would be		$28,305
h. Tax saving with averaging is ($28,305-$22,160)		$ 6,145[23]

Income averaging applies to a taxable year only if the taxpayer chooses to have it apply.[24] The House Committee Report indicated that an election

[23] The effect of the 25% limitation on the excess of net long-term capital gains over net short-term capital loss resulting from the alternative capital gains tax is preserved by subtracting from the tax liability determined with income averaging, the difference between the tax attributable to capital gain net income for the computation year and 25% of the excess of the net long-term capital gain over net short-term capital loss.

[24] Int. Rev. Code of 1954, § 1304(a).

is not binding for future years and can be exercised at any time before the expiration of the statute of limitations for filing a claim for refund.[25] If the taxpayer chooses the benefits of averaging income for any taxable year, he may not (1) use the optional tax table; (2) limit his tax under Section 72 (n)(a) of the Internal Revenue Code of 1954 (relating to limitation of tax in case of certain distributions with respect to contributions by self-employed individuals to annuities); or (3) exclude income under Sections 911 or 931 of the Internal Revenue Code of 1954.[26]

If a taxpayer files a joint return or a surviving spouse return for the computation year, his base period income must be reconstructed as if he and his present spouse had filed joint returns for each base period year. If he files an individual return for the computation year, his base period income is the higher of (1) his actual base income; (2) 50 per cent of the combined income of himself and his present spouse for each base period year; or (3) 50 per cent of the combined income of himself and any other person who was his spouse during the base period.[27] Income from personal services is attributed to the spouse who earned it regardless of local community property laws.[28] When income and deductions can be shifted between years, it seems that income averaging should be considered in tax planning calculations.

The greatest tax benefit from income averaging can be obtained where the base period income is lowest and the base period capital gains are lowest. The presence of net long-term capital gains in the base period cuts the averageable income where the base period capital gains exceed the current capital gains, and the tax on the averageable income starts at a tax bracket above that of 4/3 of the base period income plus the average base period capital gains. Since the current taxable year in which income averaging is used will become part of the base period for the following year, the use of income averaging requires some sharp tax planning. In effect it is a benefit once every five years.

In evaluating the income averaging provision of the Revenue Act of 1964, "equity" must be the measure of effectiveness, since revision of the tax system on an "equitable basis" was the purpose of the Act.[29] A general averaging system now applies to almost all types of income—as opposed to what were piecemeal averaging devices under the old provision. Thus, the new provision increases the equity of the persons in the bunched income situation—regardless of when income is earned and regardless of whether or not there was an employment (as required by the old sections). If one's income makes a change upward, he can now average provided: (1) the increase occurred after 1963; (2) the "averageable income" is above $3,000; and (3) the current income is 4/3 (or 133 ⅓ per cent) of the average base period income.

[25] H.R. Rep. No. 749, supra note 22, at A185.

[26] Int. Rev. Code of 1954, § 1304(b)(1)-(4).

[27] Int. Rev. Code of 1954, § 1304(c)(2).

[28] Int. Rev. Code of 1954, § 1304(c)(4).

[29] Tax message by the late President Kennedy to Congress, 88th Cong., 1st Sess., 109 Cong. Rec. 919 (1963).

In conclusion, the income averaging provisions do achieve the equitable goal which was the purpose of the tax revision. However, a study of the treatment accorded income from gifts and bequests and capital gain income may very well cause a dissent to the Senate Finance Committee's implied posture[30] that the new rules are not unduly complicated.

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30 S. Rep. No. 830, supra note 2, at 140.