

Choices for Your Farm Operating Loss

George F. Patrick
Department of Agricultural Economics
Purdue University

Midwestern producers, especially livestock producers, may find that their projected farm expenses exceed anticipated farm income for the current tax year. These farm losses are likely to cause cash flow difficulties. However, for some producers, farm losses may generate cash inflows in the form of tax refunds. Tax law allows choices with respect to farm losses. Losses in one tax year may be carried back two years or five years to obtain refunds of taxes previously paid, or losses may be carried forward to offset tax liabilities in future years. Many farmers had high incomes in 2007 and 2008, and carrying back a 2009 loss is likely to generate an income tax refund. If carrying a 2009 loss back two or five years has little or no tax benefit, a producer can elect to carry the loss forward. Therefore, producers with farm losses should analyze their carryback and carryforward alternatives and not just file their current year's tax return.

The farm loss reported on Schedule F (Form 1040) is generally not the same as a net operating loss (NOL) for income tax purposes. The NOL concept is simple, but computation of the NOL deduction and NOL carryback can be quite complex. This complexity arises because various tax benefits must be removed by modifying the deductions of the loss year and modifying the income in the carryback year or years. Similar modifications are made if the loss is carried forward. Because of these modifications, the tax benefits of the loss may be reduced significantly. Before briefly discussing these modifications, this publication addresses some possible loss situations and general strategies for producers to avoid an NOL if possible.

Loss Situations and General Strategies

When farm expenses, including depreciation, exceed farm income on Schedule F, a farm loss exists. For sole proprietorships, partnerships, S corporations and limited liability companies taxed like partnerships, this farm loss flows through to the individual owners. (For regular or C corporations, a loss remains at the corporate level and is not discussed here. Perhaps an S election is warranted if years of losses are anticipated.) For the individual owner, these farm losses can create four different situations.

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First, if the farm family has other income (such as gains from the sale of cull breeding stock, other business assets, nonbusiness assets or an off-farm job) which is equal to or greater than the current year's Schedule F farm loss, then the farm loss is allowed in full and there is no NOL.

Second, farmers may be able to make adjustments in farm receipts and expenses to avoid an NOL when other income looks insufficient to offset the farm loss. Accelerating sales of grain, livestock and other commodities into the current tax year may help cash basis farmers avoid the NOL. Farmers who purchased depreciable assets in the current year have some flexibility with respect to depreciation. They may be able to avoid or reduce the size of this year's farm loss by electing to use straight-line depreciation methods and alternative longer useful lives for these assets. Also, major repairs done during the year could be capitalized rather than deducted as current expenses. Payment of some expenses could be delayed until the next tax year. The tax deductions associated with these adjustments would be recovered in future years.

Third, if the farm loss is greater than other income, the negative taxable income in this loss year must be recomputed to remove some tax benefits. For example, personal and dependent deductions, nonbusiness deductions in excess of nonbusiness income, capital losses in excess of capital gains and the domestic production activity deduction are added back. If the recomputed taxable income is not negative, there is no NOL for the year and nothing to be carried back or forward to other tax years.

Fourth, if the recomputed taxable income is negative, there is an NOL which can be carried to another tax year. Farmers may carry the NOL back two years, elect to carry a farm NOL back five years, or elect to carry the NOL forward up to 20 years. Because of high incomes in 2007 and 2008, many farmers will use the two-year carryback. If the carryback period is used, the NOL may create a refund of part or all of the income taxes paid by offsetting taxable income in the carryback year. If carrying back the NOL will not result in a tax refund, or only a small refund, an election to use only the 20 year carryforward period can be made and the carryforward will be available to reduce taxes in future years. In all of these cases, the NOL reduces taxable income but not earnings for the self-employment tax. The best choice with respect to the carryback vs. carryforward decision is the one that provides the highest net present value of expected tax savings for a family's specific situation.

Calculating and Distributing the NOL

To determine the NOL deduction and the portion of it which can be deducted in another year, a number of adjustments are necessary. Form 1045, Application for Tentative Refund, is used for calculating the NOL and reporting the adjustments. The five-year farm NOL carryback requires two Form 1045s to show the effects. Basically business income, including nonfarm wages and gains on disposition of business assets, minus business losses, including losses on disposition of business assets is adjusted in two ways. First, nonbusiness deductions (i.e., standard or itemized deductions) are deductible for computing an NOL only to the extent of nonbusiness income (i.e., interest, dividends, pensions, capital gains from nonbusiness investments, etc.). Second, capital losses are deductible for computing the NOL only to the extent of capital gains. After making these adjustments on Schedule A of Form 1045, the NOL which can be carried to other tax years has been determined.

If the two-year carryback is used, the current year NOL available for carryback must first offset income of two years ago. If the five-year farm NOL carryback is elected, the current NOL would offset income from five years ago. The income of that year must also be modified to determine the amount of the NOL that is used or "absorbed" using Schedule B of Form 1045. Personal exemptions are not allowed as deductions in computing taxable income. The capital loss deduction is limited to the amount of capital gain included in income. Deductions based on or limited by a percentage of adjusted gross income (e.g., medical expenses and

miscellaneous itemized deductions) must be recomputed. If the NOL is not fully absorbed by the modified taxable income of the first carryback year, then the amount which was not absorbed can be carried forward to the next eligible year (last year for the two-year carryback and four years ago for the five-year carryback). Similar modifications of the income for that year are also necessary to determine the amount of the NOL to be absorbed in that year. Any remaining NOL would be carried to the next tax year.

If an individual wishes to forgo the carryback and carry the current year's NOL forward, the election must be made on a timely filed tax return. Generally, the election to forgo the carryback period would be made in situations in which a carryback of the loss would result in little or no tax refund. In future years, the income adjustments discussed above will be needed to determine the amount of the NOL absorbed each year. If the election to forgo the carryback is not made on the current year's return, then individual must carry the NOL back two years before any remaining NOL may be carried forward. Tax benefits will be wasted if the carryback does not result in an income tax refund.

A current year NOL can interact with a farm income averaging election (Schedule J, Form 1040) from a prior year. Determination of the NOL is unaffected, and the full amount of the NOL is deducted to determine the income of a base year for income averaging. If a base year's income is reduced below zero, any NOL contributing to that negative income is required to be added back to compute to base year taxable income if the NOL may provide a tax benefit in another tax year. The Schedule J Instructions have a worksheet to perform the necessary add back calculations.

The carryback and carryforward provisions of the NOL can also be affected by other tax law provisions. A shift between joint and separate returns, divorce, marriage, or other changes in filing status can involve additional complications. In general, an individual's NOL is only allowed to offset that individual's income.

Summary

Taxpayers will generally seek to avoid an NOL, when possible, because of the loss of tax benefits in the recalculation of income. Year-end tax planning can identify potential NOL situations and possible adjustments to avoid the NOL. When an NOL does occur, a producer has choices as to how to use the NOL and will generally seek the largest tax-savings possible. The best use of an NOL will depend on an individual's circumstances and may require considerable analysis of the alternatives. The calculations associated with computing an NOL and the amount absorbed in a carryforward/carryback year can be complex and time consuming. Producers should make decisions about the use of an NOL before they file their current year's tax returns. Competent tax advice, analysis, and planning is essential to make the most of an operating loss.

References

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