

4. Income Tax Management in Low Income Years To Maximize After-Tax Income

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Abstract/Summary

Farm income potential for 2016 and the next few years does not look as bright as it has for the last decade, so tax planning and management will likely become a lower priority. However, tax planning in low income years is still important in order to avoid the pitfalls associated with low or negative taxable income, especially Net Operating Losses (NOLs). This presentation will provide an introduction to NOLs as well as discuss several tax planning opportunities when faced with low or negative farm or ranch income.

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INCOME TAX MANAGEMENT IN LOW INCOME YEARS

NOLs & Other Tax Issues in Low Income Years

- Net Operating Loss (NOL)
 - Definitions and background
 - Calculations
 - How they affect you
- Avoid NOLs!
 - Why?
 - How can you avoid them?
 - Minimize the negative impact

NOLs & Other Tax Issues in Low Income Years

⦿ Other Issues

- Prepaid farm expenses
- Optional Method of SE tax calculation
- Retirement Savings Contribution Credit
- Farm losses and applicable subsidies
- Hobby loss rules
- Capital vs operating leases

Your Tax Preparer

- ⦿ Does your tax preparer know you?
- ⦿ Does your tax preparer know farm tax?
- ⦿ Do you trust your tax preparer completely?
- ⦿ Does your preparer give you options before filing?
- ⦿ Do you think your tax preparer does what is best for you?

NET OPERATING LOSSES

Net Operating Losses (NOLs)

- ◉ Simple definition: An NOL is loss that is created when deductions exceed income
- ◉ NOLs are created by:
 - Non-farm business (Schedule C)
 - Casualty or theft of personal property
 - Small business property loss due to a federally declared disaster (includes farm businesses)
 - Farm (Schedule F)

Net Operating Losses (NOLs)

- Cannot be created when taxable income is positive, even if farm income is negative
- Is *not always* created when taxable income is negative
- By default, an NOL is carried back and first offsets income in prior years, then carried forward
- Election available to skip carryback and carry NOL forward only
- Self-employment tax not affected by carryback or carry forward

Net Operating Losses (NOLs)

- The source of the loss determines the default carryback period:
 - Non-farm business NOLs - 2 years
 - Eligible (casualty) losses - 3 years
 - Farm NOLs - 5 years
- If NOL remains after the carryback period, it is carried forward 20 years after the loss year
- If NOL remains after carried forward 20 years, it is lost

Farm NOLs

- ⦿ A farm NOL is the smaller of:
 - The NOL for the year or
 - The NOL created when only considering farm income and deductions

Farm NOLs

- ⦿ By election, a farmer can waive the 5-year carryback and carry the NOL back 2 years
 - Election must be made on a timely filed return (including extension)
 - If not made on an unextended return, amendment can be filed within 6 months of due date

Farm NOLs

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Do You Carry Forward or Back?

- ◉ Has there been taxable income in the last 5 years? The last 2?
 - Is there one year with enough taxable income to consume the entire NOL?
- ◉ Do you anticipate higher income in the future?
- ◉ What will your tax preparer charge to carry back?

5- or 2-Year Carryback?

- Is taxable income in preceding year 5 or preceding year 2 more than the NOL?
- If not, which carryback period will consume the NOL the quickest?
- For each year the NOL is carried to, NOL may be consumed even though no income is offset

How Do You Carryback?

- 1045 – Application for Tentative Refund
 - Must be filed within 1 year of end of loss year
- 1040X – Amended US Individual Income Tax Return
 - Must be filed within 3 years of the due date of the return for the loss year
 - 2016 loss, return due 4/15/17
 - 2011-2015 amendments due by 4/15/20
 - Or 10/15/20 if an extension was filed in 2017 for 2016 return
 - 8 years after oldest original return was filed....

1045 or 1040X?

- ⦿ 1045
 - One filing
 - Quicker refund
 - Short window to file
- ⦿ 1040X
 - File amendment for each year separately
 - More time to file
 - Refunds will be spread out

Recalculate Years with Carried NOL

- ⦿ Carried NOL reduces taxable income
- ⦿ Reduced taxable income results in lower tax liability
- ⦿ NOL also changes Adjusted Gross Income (AGI) for that year which may affect:
 - Taxable portion of Social Security
 - Eligibility to make Traditional IRA contributions
 - Tuition deduction
 - Student loan interest deduction
 - Passive loss limit from rentals (25,000 loss limit)

How Do You Carryforward?

- ⦿ Attach election waiving carryback period
- ⦿ Attach a statement showing calculation

NOL Calculation

- ⦿ Technical method:
 - Start with negative taxable income
 - Add back exemptions
 - Add back non-business deductions in excess of non-business income
 - Add back capital losses in excess of capital gain
 - Add back NOLs from another year

NOL Calculation

- What does non-business deductions in excess of non-business income mean?

Non-business deductions

- Standard deduction
- Itemized deductions
- HSA deductions
- IRA contributions
- SEP, SIMPLE, 401(k) deductions
- Student loan interest

Non-business income

- Interest
- Dividends
- Taxable state tax refunds
- IRA, pension, annuity distributions
- Some Schedule E income
- Taxable social security
- Some Other income

NOL Calculation

- Simplified method:
 - Total all business income
 - W2 wages, C, F, E page 2, 4797
 - Subtract all business deductions
 - ½ SE tax deduction, SE health insurance, DPAD

NOL Calculation Example 1

Wages (Spouse)	25,000
Interest	600
Dividends	350
Schedule F (Taxpayer)	(50,000)
Schedule C (Spouse)	(2,000)
AGI	(26,050)
Exemptions	(8,000)
Standard Deduction	(12,600)
Taxable Income	(46,650)

NOL Calculation Example 1

Technical Method

Taxable Income	(46,650)
+ Exemptions	8,000
+ Non-business deductions in excess of non-business income	11,650
= NOL	(27,000)

Non-business deductions	
Standard deduction	12,600
Non-business income	
Interest	(600)
Dividends	(350)
Excess	11,650

NOL Calculation Example 1

Simplified Method

Wages (Spouse)	25,000
Schedule F (Taxpayer)	(50,000)
Schedule C (Spouse)	(2,000)
NOL	(27,000)

NOL Calculation Example 2

Wages (Spouse)	25,000
Interest	600
Dividends	350
Schedule F (Taxpayer)	(50,000)
Schedule C (Spouse)	(30,000)
AGI	(54,050)
Exemptions	(8,000)
Standard Deduction	(12,600)
Taxable Income	(74,650)

What is the NOL?

What is the farm NOL?

NOL Calculation Example 2

NOL

Taxable Income	(74,650)
+ Exemptions	8,000
+ Non-business deductions in excess of non-business income	11,650
NOL	(55,000)

Farm NOL?

Smaller of:	
NOL or	(55,000)
NOL from farming operation	(50,000)

Farm NOL = 50,000

NOL Calculation Example 2

- Total NOL = 55,000
- Farm NOL = 50,000
 - Default Carryback?
 - 5 years
- Spouse's NOL = 5,000
 - Default Carryback?
 - 2 years

NOL Consumption

- ⦿ NOL consumed in a year is the smaller of NOL or Modified Taxable Income (MTI)

$$\begin{aligned} \text{MTI} = & \text{Taxable income} \\ & + \text{Other NOLs} \\ & + \text{DPAD} \\ & + \text{Exemptions} \\ & + \text{Capital loss deduction} \\ & + \text{Adjustments to IRA, taxable SS, tuition ded., etc} \end{aligned}$$

NOL Consumption

- ⦿ NOL consumed does not always equal income that is offset
- ⦿ If an NOL creates “negative” taxable income in the carried year
 - More NOL is consumed than income is offset
 - Amount of “negative” income is lost
 - Negative taxable income usually displayed as 0 on 1040
 - Some NOL is wasted in each carried year unless the NOL is consumed in the first carried year

NOL Consumption Example

- 2015
 - NOL = 50,000
- 2016
 - AGI before NOL = 60,000
 - MFJ + 2 kids
 - Standard deduction
 - DPAD = 1,000

Avoid NOLs

- Why? For each year an NOL is carried to:
 - Loss of exemptions
 - Loss of standard/itemized deduction in excess of non-business income (interest, dividends)
 - Loss of non-business capital losses (for that year)
 - Loss of other NOLs

Avoid NOLs – Increase Income

- ⦿ If you can plan ahead:
 - Sell inventory
 - Sell appreciated or low basis assets
 - Sell assets outright rather than trade
 - CCC loans treated as income
 - Convert Traditional IRA to Roth IRA
 - Distribute S-corp assets
 - Distribution of S-corp earnings & profit from C-corp years

CCC Loans

- ⦿ With a CCC loan, farmers have the option of treating the loan proceeds as a partial sale of the crop
- ⦿ Elect to treat loan proceeds as income by reporting on Schedule F Line 5a and attaching a statement with details of the loan
 - Election must be made by filing deadline (with extension) or by filing amended return within 6 mo (*excluding* extension)
 - “Filed pursuant to section 301.91002”

CCC Loans

- ⦿ Once the election is made, all CCC loans in that year and future year must be treated as income
 - Application for Change in Accounting Method (3115) required to treat loans as loans in the future
- ⦿ If a loan is treated as income, the grain has basis equal to amount reported as income
 - Don't forget to account for this when the grain is sold!
- ⦿ Sale proceeds may never go through the checking account
 - Taxable income may not be recognized

Avoid NOLs – Increase Income

- ⦿ If you can't plan ahead:
 - Elect out of installment treatment on deferred sales contracts
 - For grain and livestock sales, tax proceeds in the year of sale rather than the year received
 - Election made at tax prep time
 - Deemed dividend from S-corp with E&P
 - Board minutes required?

Avoid NOLs – Decrease Expenses

- If you can plan ahead:
 - Delay purchases or prepaids
- If you can't:
 - Capitalize certain fertilizer expenses
 - Slow down depreciation
 - Elect to depreciate assets using straight-line (SL)
 - Elect to depreciate assets using SL method and ADS
 - Capitalize long life repairs
 - Depreciate rather than deduct

OTHER ISSUES

Prepaid Farm Expenses

- ⦿ Typical business can only deduct expenses consumed during the year
- ⦿ Exception allows *cash basis* farmers to deduct prepaid expenses in the year paid
- ⦿ Prepay must be for specific product (cost & quantity)

Prepaid Farm Expenses

- ⦿ Prepays limited to 50% of all other Schedule F expenses
 - 1/3 of all Schedule F expenses
- ⦿ Deduct excess (above 50%) in year consumed
- ⦿ 50% limit does not apply if:
 - Prepays > 50% because of a change in business operations
 - Prepays in prior 3 years < 50% in those years

Optional Method of SE Tax Calculation

- Allows farmers to use an inflation adjusted plug amount for self-employment tax calculation
 - Substitute negative F with ≈\$5,457 (2016)
 - Equates to \$5,040 of SE income (4 SS credits for disability)
 - Adds \$771 of SE tax
- Use negative F amount in determining taxable income
- May allow partial deduction of SE health insurance or small SEP, SIMPLE, or 401(k) contributions
- May increase earned income credit

Optional Method of SE Tax Calculation

Part II Optional Methods To Figure Net Earnings (see instructions)		
Farm Optional Method. You may use this method only if (a) your gross farm income ¹ was not more than \$7,320, or (b) your net farm profits ² were less than \$5,284.		
14	Maximum income for optional methods	4,880 00
15	Enter the smaller of: two-thirds (2/3) of gross farm income ¹ (not less than zero) or \$4,880. Also include this amount on line 4b above	
Nonfarm Optional Method. You may use this method only if (a) your net nonfarm profits ³ were less than \$5,284 and also less than 72.189% of your gross nonfarm income, ⁴ and (b) you had net earnings from self-employment of at least \$400 in 2 of the prior 3 years. Caution. You may use this method no more than five times.		
16	Subtract line 15 from line 14	
17	Enter the smaller of: two-thirds (2/3) of gross nonfarm income ⁴ (not less than zero) or the amount on line 16. Also include this amount on line 4b above	
<small> ¹ From Sch. F, line 9, and Sch. K-1 (Form 1065), box 14, code B. ² From Sch. F, line 34, and Sch. K-1 (Form 1065), box 14, code A—minus the amount you would have entered on line 1b had you not used the optional method. ³ From Sch. C, line 31; Sch. C-EZ, line 3; Sch. K-1 (Form 1065), box 14, code A; and Sch. K-1 (Form 1065-B), box 9, code J1. ⁴ From Sch. C, line 7; Sch. C-EZ, line 1; Sch. K-1 (Form 1065), box 14, code C; and Sch. K-1 (Form 1065-B), box 9, code J2. </small>		
Schedule SE (Form 1040) 2015		

Retirement Savings Contribution Credit

- ⦿ Credit equals 10-50% of IRA (Traditional & Roth), SEP, SIMPLE, and 401(k) contribution
 - Limited to contribution of \$2,000 for taxpayer and spouse
- ⦿ Applies if AGI < \$61,500 MFJ (\$30,750 single)
- ⦿ Why not let the government fund a part of your retirement?
- ⦿ Need to have cash available to make contribution by return due date

Farm Losses and Applicable Subsidies

- ⦿ Excess farm losses are not deductible if certain applicable subsidies are received
- ⦿ Excess losses are losses greater than the larger of:
 - \$300,000 MFJ
 - Total NFI in prior 5 years
- ⦿ Applicable subsidies:
 - CCC loan
 - Direct or counter-cyclical payment or payment in lieu of either
- ⦿ Does not apply to C-Corps

Farm Losses and Applicable Subsidies

33	Total expenses. Add lines 10 through 32f. If line 32f is negative, see instructions ▶	33		
34	Net farm profit or (loss). Subtract line 33 from line 9	34		
If a profit, stop here and see instructions for where to report. If a loss, complete lines 35 and 36.				
35	Did you receive an applicable subsidy in 2015? (see instructions)		<input type="checkbox"/> Yes	<input type="checkbox"/> No
36	Check the box that describes your investment in this activity and see instructions for where to report your loss.			
a	<input type="checkbox"/> All investment is at risk.	b	<input type="checkbox"/> Some investment is not at risk.	
For Paperwork Reduction Act Notice, see the separate instructions.		Cat. No. 11346H		Schedule F (Form 1040) 2015

Hobby Loss Rules

- Facts and circumstances tests to determine if a farm is a hobby (and not a business)
- If determined to be a hobby:
 - Income reported as Other Income (1040 line 21)
 - Expenses reported as Misc Itemized deduction subject to 2% of AGI floor
 - Expenses exceeding income cannot be reported so losses cannot be deducted
- Presumed to be a for-profit business if profit reported in 3 of last 5 years (2 of 7 for horse farms)

Equipment Leases

- ⦿ Leases are either *capital* or *operating*
- ⦿ Why lease?
 - Effect on balance sheet and financial ratios
 - Desire to fully deduct payments compared to a loan payment
 - “Deduct” a purchase faster than normal depreciation allows
 - Equipment dealers & certain lenders encourage leases
- ⦿ IRS says capital vs operating depends on the intent of the parties in addition to facts and circumstances
 - No single test determines the nature of a lease
 - Capital lease = conditional sales contract

Equipment Leases

- ⦿ IRS says an agreement that contains any of the following may be considered a conditional sales contract (capital lease):
 - A portion of each payment is allocated to equity
 - Title is transferred after a certain number of payments
 - Amount paid over the entire lease is a large portion of the purchase price
 - Lessee has option at the end to buy at a price lower than FMV
 - Lessee has option at the end to buy at a low price when compared to total amount paid during lease
 - A portion of each payment is designated as interest

Equipment Leases

- ⦿ In the accounting world, a capital lease contains any one of the following features:
 - Ownership of the asset is transferred by the end of the lease
 - The lessee has the option to buy the asset at the end of the lease for less than FMV
 - The lease term is at least 75% of useful life
 - NPV of lease payments is at least 90% of FMV

Equipment Leases - Capital

- ⦿ Capital leases should be treated like a debt financed purchase
- ⦿ The interest portion of a payment is deductible, remainder is not
- ⦿ Purchase of asset is deducted using depreciation
- ⦿ Trade in is treated as a like-kind exchange rather than a sale

Equipment Leases - Operating

- ⦿ Operating leases are *not* a debt financed purchase
- ⦿ The entire payment is deductible
- ⦿ Neither asset or debt is listed on balance sheet
- ⦿ Asset is *not* depreciated
- ⦿ If a trade is involved, the traded asset is treated as sold with the sale proceeds applied towards prepayment of the lease
 - Prepaid lease payments are not deductible up front, they are spread out over the life of the lease
 - There may be significant tax consequences!

QUESTIONS?