

Income Tax Management

Kansas Farm Management Association
Kansas State University



Tax Planning is Critical

- Planning in low income years is just as important as in high income years
- Don't leave anything on the table
 - Avoid Net Operating Losses (NOLs)
 - Maximize credits when available
 - Avoid potential tax traps



TAX UPDATES



Federal Tax Updates

- FAFSA (student loan application) no longer looks at current year tax return, no need to file early
- New filing deadlines:
 - 1099s and W2s moved from 3/31 to 1/31
 - Form 1065 (partnerships) moved from 4/15 to 3/15
 - Form 1041 (estates and trusts) moved from 4/15 to 3/15
 - Form 1120S (S-corps) remains 3/15
 - Form 1120 (C-corps) moved from 3/15 to 4/15



Federal Tax Updates

	2016	2017
Standard Deduction (MFJ)	12,600	12,700
Personal Exemption	4,050	4,050
§179 Deduction	500,000	510,000
Bonus Depreciation	50%	50%
MFJ Bracket		
10%	0-18,550	0-18,650
15%	18,550-75,300	18,650-75,900
25%	75,300-151,900	75,900-153,100
28%	151,900-231,450	153,100-233,350
33%	231,450-413,350	233,350-416,700
35%	413,350-466,950	416,700-470,700
39.6%	>466,950	>470,700



Kansas Tax Updates

- Refund of sales tax paid on fire damaged agricultural fence available (application required)
- Kansas return filing deadlines did not change with federal changes
- Tax brackets, standard deduction, exemptions unchanged
 - 2.7% & 4.6% marginal rates
- Low income exclusion
 - No tax if taxable income <12,500 (MFJ)



NET OPERATING LOSSES



Net Operating Loss (NOL)

- NOL is a loss created when deductions exceed income
- NOLs *always* result in unused deductions
- NOL is 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)



Farm Net Operating Loss

- *Only* created when taxable income is negative
- *Not always* created when taxable income is negative
- *Only* created when *farm* income is negative
- By default, farm NOL is carried back 5 years
- NOL is consumed as it offsets income in 5th year back, then 4th year, etc
- If not fully consumed in carryback period, it is carried forward 20 years
- No longer available after 20 years



Farm Net Operating Loss

- Farmers can elect to waive 5-year carryback and carry back 2 years instead
- Or elect to waive carryback completely and only carry the NOL forward



Recalculate Years Affected by Carried NOL

- Reduces adjusted gross income (AGI) as well as taxable income in an affected year
- Reduced AGI may affect other calculations
 - Taxable portion of Social Security
 - Passive loss limit from rentals (25,000 loss limit)
- Reduced taxable income results in a refund of tax liability



NOL Consumption

- Amount of NOL consumed does not always equal taxable income reduction
- If taxable income in carried year is *greater than* NOL
 - NOL is fully consumed
- If taxable income in carried year is *less than* NOL
 - More NOL is consumed than income is offset
 - Exemptions are lost for that year
- Some NOL is wasted for every year it is carried to
- **Avoid NOLs!**
 - Target zero taxable income (or zero plus LT capital gain) at a minimum



Avoid NOLs – Increase Income

- If you can plan ahead:
 - Sell inventory
 - Sell appreciated or low basis assets (either farm or non-farm)
 - Sell equipment 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



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



Avoid NOLs – Decrease Expenses

- If you can plan ahead:
 - Delay purchases or prepays
- 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



NOL Take Aways

- Avoid NOLs!
- If unavoidable, carry to the fewest years possible



OPTIONAL METHOD OF SE TAX CALCULATION



Optional Method of SE Tax Calculation

- Allows farmers to use an inflation adjusted plug amount for self-employment tax calculation
 - Substitute negative F with \approx \$5,457 (2016)
 - Equates to \$5,040 of SE income (4 SS credits for disability)
 - Adds \$771 of SE tax
- No impact on taxable income
- May allow partial deduction of SE health insurance or small SEP, SIMPLE, or 401(k) contributions
- May increase credits available, sometimes significantly!



TAX CREDITS



Earned Income Credit

- Credit for low income earners
- Not available if investment income >\$3,400
- Credit available in an income range depending on filing status with maximum credit somewhere in the middle
- 2016 EIC: MFJ with 2 dependents, no other income
 - Income range: \$0 - 50,198
 - Maximum credit: \$5,572
- In low income years, income can be manipulated (up or down) to optimize credit



Credit for Child and Dependent Care Expenses

- Credit equals 20-35% of smallest of:
 - \$3,000 (\$6,000 if two or more qualifying individuals)
 - Total qualified dependent care expenses
 - Taxpayer's earned income
 - Spouse's earned income
- Credit percentage decreases as AGI increases
 - AGI above \$43,000, credit fixed at 20%



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



Premium Tax Credit

- Credit for enrolling in a qualified plan through the Health Insurance Marketplace
- Advance Premium Tax Credit paid to insurance provider
 - Based on estimates of income at sign-up
 - If income is higher than estimated, some advanced payments may need to be repaid (on 1040)
 - If APTC is greater than PTC, tax owed on the return increases
 - Use caution if estimates are based on a low income year



FARM LOSSES & HOBBY LOSSES RULES



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 (\$150,000 if MFS)
 - Total NFI in prior 5 years
- Applicable subsidies:
 - CCC loan
 - Direct or counter-cyclical payment (would appear to not include ARC/PLC)
- Does not apply to C-Corporations



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 Miscellaneous Itemized Deduction
 - Subject to 2% of AGI floor
 - Expenses exceeding income cannot be reported
 - 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)



KANSAS ISSUES



Kansas Issues

- Kansas doesn't tax farm income and ignores NOLs
- Kansas subtraction modification to exclude a portion of net gain from breeding livestock sales (shown on Form 4797) if Schedule F is negative
 - Exclusion amount is smaller of gain or the loss on Schedule F



LEASES



Equipment Leases

- Why lease?
 - Effect on balance sheet and financial ratios
 - “Deduct” a purchase faster than normal depreciation allows
 - Equipment dealers & certain lenders encourage leases
- Leases are either *capital* or *operating*
 - Depends on the intent of the parties in addition to facts and circumstances
 - Capital lease = conditional sales contract
 - Treated like a financed purchase for income tax purposes



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 - Capital

- Capital leases are a debt financed purchase
 - Interest portion of a payment is deductible, remainder is non-deductible principal
 - Asset is depreciated
 - Asset and liability included on balance sheet
 - Trade in is treated as like-kind exchange



Equipment Leases - Operating

- Operating leases are *not* a debt financed purchase
 - The entire payment is deductible
 - Asset is *not* depreciated
 - Neither asset or debt is listed on balance sheet
 - If an owned asset is traded in on an operating lease:
 - The traded asset is treated as sold with sale proceeds applied towards prepayment of lease
 - Lease prepayments are not deductible up front, they are spread out over the life of the lease
 - May be significant tax consequences!



CANCELLATION OF DEBT



Cancellation of Debt

- Forgiveness of farm debt is normally taxable and included as income on Schedule F (subject to SE tax)
- Exceptions:
 - Debtor is in bankruptcy
 - Debtor is insolvent, exclude up to the amount that they are insolvent
 - Debtor is solvent and the debt is qualified farm debt
 - May be limited depending on tax attributes
- Canceled debt excluded from income may affect tax attributes
 - May result in reduced NOL carryovers, tax credits, capital loss carryovers, or asset basis



FINANCIAL DISTRESS TRANSACTIONS



Financial Distress Transactions

- Tax avoidance strategies in the past may catch up in times of distress
 - §179 deduction or bonus depreciation on financed equipment creates low or zero basis assets, potentially with debt equal to FMV
 - Little to no cash left after sale to pay tax on recapture
- Property surrendered to lender to satisfy debt
 - Treated as if asset were sold
 - Debt > FMV may be taxable cancellation of debt
 - FMV > basis is taxable depreciation recapture



For More Information

<https://www.agmanager.info/kfma/newsletters/september-2016>

<http://www.agmanager.info/finance-business-planning/financial-management/income-tax-aspects-and-consequences-financial>



QUESTIONS?

