

2016 Risk and Profit Conference Breakout Session Presenters

"Knowledge for Life"

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

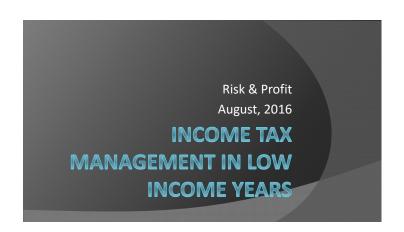
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Abstract/Summary

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.



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

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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

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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?

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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)

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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

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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

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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

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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

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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?

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12

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

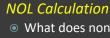
- Carried NOL reduces taxable income
- Reduced taxable income results in lower tax liability
- NOL also changes Adjusted Gross Income (AGI) for that year which may affect:
 - Taxable portion of Social Security
 - Eligibility to make Traditional IRA contributions
 - Tuition deduction
 - Student loan interest 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
 - Add back capital losses in excess of capital gain
 - Add back NOLs from another year



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

Non-business deductions

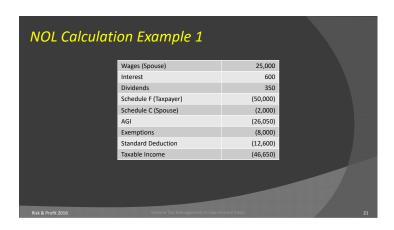
- Standard deduction
- Itemized deductions
- HSA deductions
- IRA contributions
- SEP, SIMPLE, 401(k) deductions
- Student loan interest

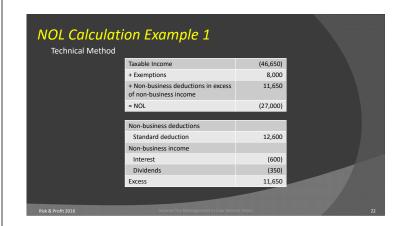
Non-business income

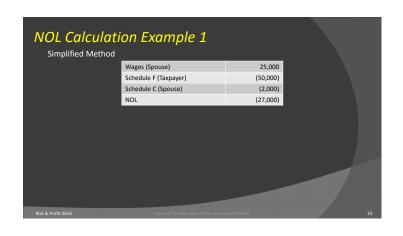
- Interest
- Dividends
- Taxable state tax refunds
- IRA, pension, annuity distributions
- Some Schedule E income
- Taxable social security
- Some Other income

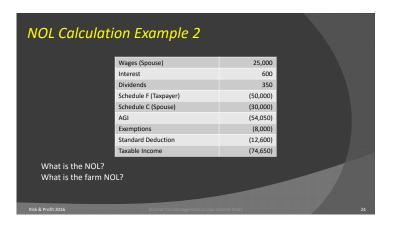
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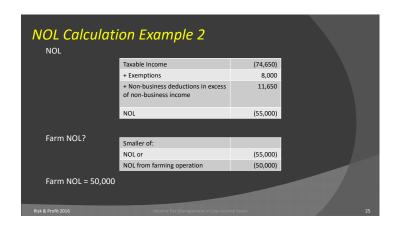
NOL Calculation
Simplified method:
Total all business income
W2 wages, C, F, E page 2, 4797
Subtract all business deductions
½ SE tax deduction, SE health insurance, DPAD

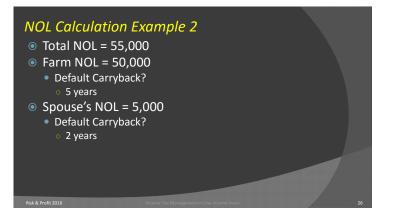












NOL consumed does not always equal income that is

Negative taxable income usually displayed as 0 on 1040

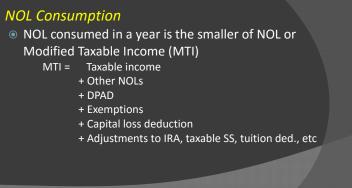
Some NOL is wasted in each carried year unless the NOL

• If an NOL creates "negative" taxable income in the

More NOL is consumed than income is offset

Amount of "negative" income is lost

is consumed in the first carried year



NOL Consumption

carried year

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 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



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)

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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

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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

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Optional Methods of Figure Net Earnings (see Instructions) Farm Optional Methods To Figure Net Earnings (see Instructions) Farm Optional Methods To Figure Net Earnings (see Instructions) Farm Optional Methods To Figure Net Earnings (see Instructions) Farm Optional Methods To Figure Net Earnings (see Instructions) Farm Optional Methods To Figure Net Earnings (see Instructions) 15 Enter the smaller of the orbitics (hij of gross form income* for Its set Shall Net Instructions) Nordern Optional Methods To Instructions (see Instructions) Nordern Optional Method To Instruction (see Instructions) Nordern Optional Method To Instructions (see Instructions) Nordern Optional Method To Instruction (see Instructions) 15 Enter the smaller of the Optional Method (see Instructions) 16 Solderat line 15 from its 4. 17 Enter the smaller of the Optional Method (see Instructions) 18 Firem Start, I, see 34, and Start, in Instruction (see Instructions) 19 Firem Start, I, see 34, and Start, in Instruction (see Instructions) 10 Firem Start, I, see 34, and Start, in Instruction (see Instructions) 10 Firem Start, I, see 34, and Start, in Instruction (see Instructions) 10 Firem Start, I, see 34, and Start, in Instruction (see Instructions) 10 Firem Start, I, see 34, and Start, in Instruction (see Instructions) 11 Firem Start, Instruction (see Instructions) 12 Firem Start, Instruction (see Instructions) 13 Firem Start, Instruction (see Instructions) 14 4, 4,800 Optional Method To Instruction (see Instructions) 15 Enter the smaller of the Start see Instruction (see Instructions) 16 Solderat Instruction (see Instructional Start Sta

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

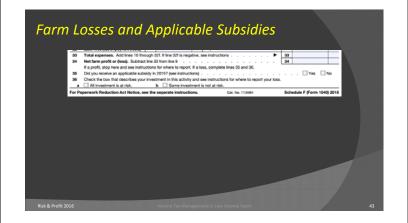
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Farm Losses and Applicable Subsidies

- 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

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42



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)

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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

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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

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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

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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!

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