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Choices for Your Farm Operating Loss*

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Introduction

Many young or beginning farmers may find that their projected farm expenses exceed anticipated farm receipts for the current tax year. These farm losses may be experienced during a start-up period. However other losses may be the result of unexpected events. For some producers, farm losses may generate cash inflows in the form of tax refunds. Tax law allows choices with respect to farm losses. Farm losses realized in one tax year may be carried back 2 years or 5 years1 to obtain refunds of taxes previously paid. If the loss is not carried back, or if the full loss is not used (absorbed) in the carryback years, the loss may be carried forward to offset income and tax liabilities in future years. Therefore, producers with farm losses should analyze their carryback and carryforward alternatives.

A net operating loss (NOL) and a farm loss reported on Schedule F (Form 1040) are often not the same because of differences in income and expense items included. 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 from 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. This article addresses some possible loss situations and general strategies for farmers 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

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1 The five year carryback option is only available for farms. If a farmer has both a farm and a non-farm NOL, he/she may have separate carryback periods.
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.) For the individual owner, these farm losses can create four different situations.

### NOL Offset with Non-Farm Income

First, if the farm family has other income 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. Other income could include gains from the sale of breeding livestock, culled breeding livestock, other business assets or non-business assets. Other income could also include salary and wages from off-farm employment.

### Avoid NOL by Adjusting Farm Receipts and Expenses

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. This would lower the depreciation expense for this year and reserve more of the cost of the asset(s) for depreciation deductions in future years. 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 when the expenses show up on future tax returns.

### Some Benefits Are Removed and NOL Recalculated

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, non-business deductions in excess of non-business income, and capital losses in excess of capital gains are added back, as discussed later. 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 and these deductions are lost forever.

### Recalculated NOL Is Negative

Fourth, if the recomputed taxable income is negative, there is an NOL which can be carried to another tax year. Generally, farmers may carry the NOL back 2 years, elect to carry a farm NOL

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2 Cash basis refers to when revenue and expenses are recognized on a tax return. For cash-basis taxpayers, revenue is recognized on the tax return the year that cash is received and expenses are included the year that they are paid. Most farmers and agricultural producers are cash basis taxpayers.

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back 5 years, or elect to only carry the NOL forward up to 20 years.

If a carryback period is used, the NOL will offset taxable income in the carryback year, generally reducing the tax and creating a refund. If carrying back the NOL will not result in a tax refund, or will result in only a small refund, the farmer can elect to use only the 20-year carryforward period so that 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. There are situations where producers owed self-employment tax on income tax returns, but did not owe any income tax. Since the carryback NOL does not reduce earnings for self-employment tax, there would not be a benefit to the carryback of the NOL.

The best choice with respect to the carryback versus carryforward decision depends on a family’s specific situation. Marginal tax rates and the time value of money are incorporated into the calculation of the net present value of expected tax savings.

**Calculating and Distributing the NOL**

The task of calculating and distributing an NOL is complex and generally involves many computations. Tax professionals rely on computer software to “crunch the numbers,” and often may refer producer clients to tax professionals who specialize in NOLs. The following discussion of NOL computations and distribution is intended to give producers an overview of what is being done.

To determine the NOL deduction and the portion of it that can be deducted in another year, a number of adjustments are necessary. IRS Form 1045, Application for Tentative Refund, is used for calculating the NOL and reporting the adjustments. The 4- and 5-year farm NOL carrybacks may require two Form 1045s to show the effects. An NOL is the net loss from business activities. Business income includes nonfarm wages and gains on disposition of business assets. Business losses include losses on disposition of business assets. The negative taxable income on the tax return is adjusted in two ways to arrive at the net business loss. First, nonbusiness deductions (e.g., standard deduction or nonbusiness itemized deductions) are deductible for computing an NOL only to the extent of nonbusiness income (e.g., interest, dividends, pensions, capital gains from nonbusiness investments). Second, capital losses are deductible for computing the NOL only to the extent of capital gains. Making these adjustments on Schedule A of Form 1045 determines the amount of the NOL to be carried to other tax years.

If the 2-year carryback is used, the current year NOL available for carryback must first offset income recognized two years earlier. If the 5-year farm NOL carryback is elected, the current NOL first offsets 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.” This calculation is made 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 that was not absorbed can be carried forward to the next eligible year (e.g., most recent preceding year for the 2-year carryback and 4 years ago for the 5-year carryback). Similar modifications of the income for that carryback year are necessary to determine the amount of the NOL to be absorbed in that year. Any remaining NOL is carried to the next tax year. When an NOL is carried forward to future years, the income adjustments discussed above are still needed to determine the amount of the NOL absorbed each year.

If a taxpayer wishes to forgo any carryback period and only 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 is made in situations when a carryback of the loss would result in little or no tax refund. If the election to forgo the carryback is not made on the current year’s return, then the individual must carry the NOL back 2 years before any remaining NOL may be carried forward. Tax benefits are 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 base year taxable income if the NOL may provide a tax benefit in another tax year. The IRS’s Schedule J instructions include a worksheet to perform the necessary add back calculations.

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

**Summary**

Taxpayers should 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 relating to use of the NOL and should 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. If possible, 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 are essential to make the most of an operating loss.
IRS Publications

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- IRS Publication 225, Farmer’s Tax Guide.
- IRS Publication 536, Net Operating Losses (NOLs) for Individuals, Estates, and Trusts.

Additional Topics

This fact sheet was written as part of Rural Tax Education a national effort including Cooperative Extension programs at participating land-grant universities to provide income tax education materials to farmers, ranchers, and other agricultural producers. For a list of universities involved, other fact sheets and additional information related to agricultural income tax please see RuralTax.org.

Fact sheets that might be of interest of particular interest include:

- Farm, Farming and Who’s a Farmer for Tax Purposes
- Farm Losses versus Hobby Losses: Farmers Must Plan Ahead to Avoid Adverse Tax Consequences
- Materially Participate in the Business to Avoid the Passive Activity Loss Rules
- How Do the At-Risk Rules Apply to a Farm Business?

This information is intended for educational purposes only. You are encouraged to seek the advice of your tax or legal advisor, or other authoritative sources, regarding the application of these general tax principles to your individual circumstances. Pursuant to Treasury Department (IRS) Circular 230 Regulations, any federal tax advice contained here is not intended or written to be used, and may not be used, for the purpose of avoiding tax-related penalties or promoting, marketing or recommending to another party any tax-related matters addressed herein.

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