



Farm Tax Network™

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Capital Gain and Loss Tax Planning in a Net Operating Loss Year

In a number of sectors of the ag economy today, a net operating loss is a possibility. But if the taxpayer's 1040 also has capital gain and loss transactions, there can be a surprising tax trap. In this release, we explain why analyzing the business and nonbusiness status of capital gains and losses can be important when a net operating loss is in the mix.



Background

Cash method farm taxpayers have tremendous flexibility in planning their taxable income or taxable loss for a particular tax year. In an unprofitable year, a cash method farmer may choose to target a current net operating loss that becomes available for carryback against prior high income tax years. In general, a net operating loss is carried back two years, followed by a carryover period of 20 years [Sec. 172(b)]. However, the portion of the net operating loss (NOL) that is attributable to farming is treated as a separate NOL. A farm NOL is initially carried back five years rather than the general two year carryback [Sec. 172(b)(1)(F) and Sec. 172(h)].

A taxpayer with a farm NOL may irrevocably elect to forego the five year carryback period for a farming loss [Sec. 172(h)(3)]. In this case, the net operating loss is subject to the general two year carryback rule. Further, a taxpayer may elect to relinquish the entire carryback period with respect to a net operating loss for a taxable year, and instead only carry the loss forward [Sec. 172(b)(3)].

Since 2010, there has been a limitation on farm losses of taxpayers who receive any direct or counter-cyclical payments from the USDA or any CCC loan [Sec. 461(j)]. The limitation on the farm loss is the greater of \$300,000 or the total of the net farm income for the previous five years [Sec. 461(j)(4)(B)]. This provision is not applicable to a C corporation. Any loss disallowed under this rule is treated as a deduction attributable to a farming business in the next taxable year [Sec. 461(j)(2)]. The result of this rule is that a taxpayer with a history of farming net income generally will not face a restriction; a farm loss will be currently allowable to the extent available for carryback against prior five year farm net income. But if a taxpayer lacks sufficient farm net income in the prior five years, the current year loss is limited to \$300,000, assuming the taxpayer is receiving USDA subsidies under the 2008 Farm Bill or a CCC loan. Direct or counter-cyclical payments have been eliminated under the 2014 Farm Bill, leaving the receipt of a CCC loan as the only receipt which will trip the excess farm loss provision.

The Net Operating Loss Computation

A net operating loss, of course, is an ordinary loss. In the case of a taxpayer other than a corporation, the NOL computation limits any capital loss to gains from the sales or exchanges of capital assets [Sec. 172(d)(2)]. Nonbusiness deductions are allowed in computing the NOL only to the extent of income that is not derived from a trade or business [Sec. 172(b)(4)]. Thus, when computing a net operating loss, business and nonbusiness items are separated and only the business income, deduction and loss items are taken into account in computing the NOL.

This can lead to surprising results if business and nonbusiness capital gains and losses have been mixed in the current computation of AGI, but are segregated when the NOL computation occurs.

Example 1 - NOL year and a business capital gain

Assume a farm 1040 will report a 2016 farming loss of \$500,000. This amount is targeted because the taxpayer has high bracket taxable income in prior years that can be efficiently offset with an NOL carryback of about \$500,000. However, the taxpayer has also recognized a Sec. 1231 capital gain of \$100,000, taxable at 15% (e.g., sale of a small parcel of farmland; sale of raised breeding stock).

The tax advisor recognizes that \$100,000 of the ordinary business loss will be offsetting a capital gain otherwise taxable at a 15% rate. Accordingly, prior to year-end and upon the advice of the tax preparer, the farmer recognizes a \$90,000 capital loss from nonbusiness sources (security transactions sold at a loss, speculative contracts in a capital loss position at year-end, etc.). The taxpayer's AGI for 2016 is as follows:

Farm business loss	\$ (500,000)
Sec. 1231 capital gain	100,000
Nonbusiness capital loss	<u>(90,000)</u>
AGI	<u>\$ (490,000)</u>

Example 2 - NOL year and nonbusiness capital loss

Assume the same facts as in the prior example, except that the taxpayer, at time of year-end tax planning, has incurred the \$500,000 farm business loss, and also has recognized a nondeductible nonbusiness capital loss (again, from nonbusiness sources such as security sales, futures transactions that are categorized as speculation, an investment in a corporate entity unrelated to the taxpayer's business activity, etc.). Only \$3,000 of the nonbusiness capital loss would currently be deductible. However, recognizing an opportunity, the tax advisor recommends recognition of a Sec. 1231 capital gain of \$100,000 (such as from raised breeding stock sales or a small parcel of land sold to a family member). As noted above in Example 1, the taxpayer's AGI would be in the same position with a \$490,000 loss.

Examples 1 and 2 get to the same AGI, but with different year-end planning actions occurring to net out a capital gain and capital loss. In either case, by appearance there is a \$490,000 negative AGI that should result in a NOL that aligns with the client's objective. But in computing the NOL for carryback or carryforward purposes, nonbusiness deductions in excess of nonbusiness income or gain must be removed. Sec. 172(d)(4) requires, in the above set of numbers, that the nonbusiness capital loss of \$90,000 be removed from the NOL computation. Accordingly, when preparing the Form 1045 NOL carryback, the computation is as follows:

Farm Business Loss	\$ (500,000)
Sec. 1231 business capital gain	<u>100,000</u>
NOL available	<u>\$ (400,000)</u>

The result is that the nonbusiness capital loss of \$90,000 provided no tax benefit to the taxpayer. The capital loss netted against the Sec. 1231 capital gain for current year regular tax purposes, but otherwise it was a wasted transaction as it provided no benefit to the net operating loss computation. The result is the same as if the \$90,000 nonbusiness capital loss had not been recognized.

The Take-aways

Here are a few lessons that can be learned from these examples:

- In general, it is permissible and generally efficient to net business capital gains and losses with nonbusiness capital gains and losses, but this assumes the tax year in question is not generating an NOL.
- In a year in which an NOL is incurred, any planning for capital gain and capital loss netting should be limited to matching business capital gains and losses with other business capital gains and losses, or conversely matching nonbusiness capital gains and losses.
- If the taxpayer has nonbusiness deductions greater than nonbusiness income in a year in which an NOL is incurred, the receipt of additional nonbusiness income is tax free. But incurring additional nonbusiness deductions provides no tax benefit.

As a final suggestion, when tax planning is undertaken for a Form 1040 in a loss year, take the extra step of working ahead to the computation of the NOL carryover. If the transactions are properly coded as business and nonbusiness, your software will be helpful in spotting these risks.