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Farm Losses Demystified

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Farmers are sometimes surprised to find that the full amount of a year's loss from farming isn't the same loss amount that they can claim as a deduction on their tax return for the year. There are several sets of tax rules that must be met in order for a farm loss to be deductible. Farmers without crop insurance to cover losses should be aware of these rules that may limit the amount of deductible losses that can be claimed. The rules to be aware of include:

- The "at-risk" rules[1]
- The excess farm loss rules, and
- The passive income rules.

At Risk Rules

The at-risk rules generally apply to all trade or business activities, including farming. These rules apply to farms that are taxed as S corporations and all farms that are not incorporated.[2] The farmer is considered to be at risk for the following amounts which are adjusted and determined at the end of each tax year:

- The amount of money and the basis in property contributed by the farmer to the farm business, and
- The amount of farm debt for which the farmer is personally liable. Debt for which the farmer pledged property as collateral qualifies as long as the pledged property is not already being used in the farming business as security for the amount borrowed.

The following debts generally do not qualify as debt included in the farmer's at-risk amount:

- Debt borrowed from a relative or another person that has an interest in the farm (other than as a creditor)[3]
- Nonrecourse debt
- Debts with a guarantee or stop-loss arrangement

Nonrecourse debt is generally debt that the farmer is not personally obligated to pay.

The amount of a loss that a farmer can deduct for the year may be limited to the amount the farmer has at risk in the farming business.

Example 1: Fred's full-time job is working on the family farm. He purchased the farm, including buildings and all equipment in 2005 for $1 million. Fred purchased the farm with a down payment of $50,000 and a $950,000 mortgage. Fred lives in Illinois, where state law indicates that the mortgage constitutes recourse debt for which Fred will be personally liable in the event of default. After making monthly mortgage payments, Fred paid down $50,000 of the principal amount of the mortgage. Accordingly, at the end of 2012, the principal amount of Fred's mortgage is reduced to $900,000 and Fred's equity in the farm is $100,000 ($50,000 down payment plus $50,000 reduction of mortgage principal from making mortgage payments). At the end of 2012, Fred has a farming loss in the amount of $360,000. In addition, Fred had the following additional contributions to the farm business:

- An additional $10,000 to provide working capital if needed (which was still in the farm business bank account at the end of the year)
- A tractor with a cost basis of $5,000.

Fred's wife, Carol, works for a medical technology company. Carol received wages in the amount of $200,000 for the year.

A simplified balance sheet at the end of 2012 is as follows.

Balance Sheet
As at December 31, 2012

Cash contributed by Fred	$ 10,000
Farmland	700,000
Buildings	100,000
Farm Equipment	200,000
Tractor contributed by Fred	5,000
Total Assets	$1,015,000
Mortgage loan	$ 900,000
Farm equity	100,000
Equity from cash and tractor contribution	15,000
Total Liabilities and Equity	$1,015,000

Fred would like to claim at least $200,000 of the $360,000 farm loss in 2012 to use against Carol's income on their joint return. However, the amount of deductible loss that Fred can claim for the year might be limited by the at-risk amount he has in the farm business. Fred's at-risk amount for 2012 is calculated at the end of the 2012 tax year[4] as follows.

Item	**At-Risk Amount**
Recourse mortgage	$900,000
Farm equity	100,000
Cash contribution in 2012	10,000
Basis of tractor contributed in 2012	5,000
Total At-Risk amount	$1,015,000

In this case, Fred has an adequate at-risk amount ($1,015,000) to allow his full deduction of the $360,000 loss (as long as no other limits reduce the amount of deductible loss for the 2012 tax year).

Example 2: Use the same facts as the previous example, but Fred during 2012, Fred had to renew his mortgage and the bank required Fred's mother to guarantee the mortgage. Guaranteed debt does not count toward Fred's at-risk amount. Fred's at-risk amount for 2012 is as follows.

Item	At-Risk Amount
Farm equity	100,000
Cash contribution in 2012	10,000
Basis of tractor contributed in 2012	5,000
Total At-Risk amount	$115,000

While Fred has a 2012 farm loss of $360,000, he has only $115,000 at risk in the farm operation after his mother becomes guarantor of the mortgage. Therefore, of the $360,000 farm loss, the at-risk rules limit Fred's deduction to $115,000. This leaves a remaining suspended loss of $245,000 ($360,000 total loss - $115,000 deductible loss) that Fred must carry forward to future tax years until it can be used.

Excess Farm Loss Rules

Starting with the 2010 tax year, the excess farm loss rules pose yet another possible limitation on the amount of loss a farmer can deduct. Farms affected by the excessive farm losses rule are those farms which are not C corporations that have received "applicable subsidies". An applicable subsidy is a direct or counter-cyclical payment received under the 2008 Farm Bill[5] or a payment that the farmer elected to receive instead of this type of payment. Any Commodity Credit Corporation loan is also considered an applicable subsidy. The disallowed excess farm loss is the amount of the year's farm loss in excess of the greater of:

- $300,000 (or $150,000 in the case of a farmer with Married Filing Separately status), or
- Aggregate net farm income over the previous 5 year period.

Example 3: Use the same facts as Example 1. During 2012, Fred received direct subsidy payments in connection with his farm. While the at-risk rules indicate that Fred can deduct the entire loss of $360,000 for 2012, he must also determine if the excess farm loss rules apply. Over the previous five years (2007 through 2011 inclusively), Fred had the following amounts of net farm income.

Tax Year	Net Earnings
2007	$80,000
2008	15,000
2009	95,000
2010	80,000
2011	55,000
Total	$325,000

The excess farm loss rules place a limit on the amount of loss Fred can deduct for 2012. This limit is the greater of $300,000 or the total amount of net farming income Fred had for the previous five years (which is $325,000). Accordingly, Fred can deduct $325,000 of his $360,000 farm loss for 2012. The remaining nondeductible loss of $35,000 ($360,000-$325,000) is a suspended loss and carries forward to 2013. It will continue to carry forward from year to year until used.

Passive Loss Rules

Tax rules require the farmer to classify income and losses into two categories: earned or passive. If the farmer's loss is from a passive farming activity, the use of any resulting farming loss is limited for tax purposes. A passive farming loss can generally only be claimed against other passive income. It cannot be claimed against the farmer's earned (or "active") income from other sources.

The degree of the farmer's participation in the farming activity determines whether the farming activity is active or passive. If the degree of a farmer's activity in the farming operation meets one of the several "material participation" tests under the applicable tax rules, the income or losses from the farming operation will not be categorized as passive.[6] The losses will therefore not be subject to the limitation of being used only against passive income but rather, can be used against active, or earned income.

A farmer having self-employment income from the farm operation, typically reported using Schedule F, will generally be considered to materially participate in that farming activity.[7] While leasing real estate is generally considered a passive activity, special rules exist for farmers that lease land that make it easier for the farmer to meet the material participation requirement. A landlord farmer is considered to be a material participant if that farmer performs any three of the following four activities:

- Pay at least half of the direct costs of producing the crop or livestock using cash or credit
- Providing at least half of the tools, equipment and any livestock used in the production activities
- Advise or consult with tenants
- Periodically inspect the production activities.

Alternatively, if the landlord farmer does not perform three of the above tests, material participation still exists if the farmer does one of the following:

- Regularly and frequently makes (or takes an important part in making) management decisions that substantially contribute to the success of the arrangement
- Works at least 100 hours over a period of 5 weeks or more in activities connected with agricultural production, or
- Performs other activities that show material and significant involvement in the production of the farm commodities.[8]

Using the Farm Loss to Reduce Taxes

Once the farmer has a deductible loss, there might be an "excess" loss that cannot be fully utilized within the year that the loss occurred. Here is where a good farm tax return preparer's advice can provide the farmer with substantial tax savings with some planning and strategy.

The farmer's loss for the year may be used to reduce taxes either retroactively or proactively. A farming loss for the tax year, after some adjustments[9], may result in a farm net operating loss (NOL). Generally, the amount of farm NOL that is not used within the current year to reduce taxable income can either be:

- Carried back 5 years,[10] or
- Carried forward 20 years.

While farmers have a 5 year carryback period, the carryback period for general business NOLs is 2 years[11] which the farmer can elect to have apply instead of the normal farm 5 year carryback period.[12] This election may be important because if the 5 year carryback period is used, the farmer's NOL must first be applied to the 5th preceding tax year. After it is determined how much of the NOL is "absorbed" in the 5th preceding year, any remaining NOL is then applied to the 4th preceding year and so on. If the tax savings from using the 5 year carryback period is minimal, an election to use the usual business-NOL 2 year carryback period may be advantageous because the farm NOL would first be applied to the 2nd preceding tax year, which may provide greater tax savings. Care must be taken when this election is made because once made, it is irrevocable.

In addition, the farmer has the option of waiving the carryback period entirely if it is advantageous to use the farm NOL exclusively in future years.[13] This election is also irrevocable once it has been made. If the election is not made, the NOL amount must be carried back first. Accordingly, it is important for the farmer to obtain proper tax advice that will provide the farmer with the maximum amount of tax savings and tax refunds from the amount of any available NOL. Other considerations include whether the farmer is operating as a sole proprietor, partner, LLC or S-corporation (in which case any loss will pass through to the farmer personally for use on the farmer's personal return) or as a C corporation (in which case the loss remains at the corporate level for use on corporate tax returns).

Notes

[1] IRC §465
[2] Treas. Reg. §1.465-1(d)(1).
[3] There are some exceptions to this rule. See IRC §465(b)(3).
[4] Treas. Reg. §1.465-1(a).
[5] The Food, Conservation and Energy Act of 2008, P.L. 110-234.
[6] These material participation tests are found in Treas. Reg. §1.469-5T.
[7] Tax Reform Act of 1986, H.R. Conf. Rep. No. 99-841.
[8] IRS Publication 225, *Farmer's Tax Guide* (2011), p. 74
[9] See IRS Publication 536 for details on the method used to calculate a net operating loss (NOL).
[10] IRC §172(b)(1)(G).
[11] IRC §172(b)(1)(A).
[12]IRC §172(i)(3).
[13] IRC §172(b)(3).

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