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Robert P. Achenbach, Jr.
Contributing Editor
Dr. Neil E. Harl, Esq.
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Managing Losses in An Economic Downturn

-by Neil E. Harl*

The high level of prosperity in the agricultural sector in recent years has been most unusual, thanks to several factors including increased exports which reflects improving incomes in low income countries, favorable weather condition and increased demand for commodities used in producing biofuels. Typically, commodity prices well above the cost of production lure farmers and ranchers into increasing output and driving commodity prices downward. It is often said that farmers and ranchers are the world's best economic citizens . . . give them half an incentive and they promptly increase production and destroy their own prosperity. Concern about losses tends to fade as commodity prices rise but that concern returns in times of downturns in commodity prices. The decline in commodity prices in 2014 and 2015, which promises to continue well into 2016 at least, is expected to focus renewed interest in managing losses.[1]

This article focuses attention on the losses most likely to be encountered as commodity prices decline.

Net operating losses

The type of loss most likely to be encountered in an economic downturn, by a substantial margin, is the net operating loss.[2] Effective for taxable years beginning after August 5, 1997, the carryback years for net operating losses was reduced to two years but the carry forward period was increased to 20 years.[3]

The three year carryback period was retained for the portion of net operating loss relating to casualty and theft losses of individual taxpayers and to Presidentially declared disasters suffered by taxpayers engaged in farming or by a small business (any trade or business, including one conducted in or through a corporation, partnership or sole proprietorship, with $5 million or less of gross receipts for a three tax-year period).[4]

For a farming loss, the loss is allowed as a net operating loss with a net operating loss carryback to each of the five taxable years preceding the taxable year of loss.[5] That provision is confined to those situations where only the lesser amount of the income and deductions attributable to farming businesses is taken into account or the amount of the net operating loss for the taxable year.[6]

Abandonment and Obsolescence Losses

A deduction is allowed for a loss sustained in abandonment of property used in a trade or business (or a transaction entered into for profit).[7] The abandonment loss is the adjusted income tax basis in the abandoned property less any salvage value, insurance

* Charles F. Curtiss Distinguished Professor in Agriculture and Emeritus Professor of Economics, Iowa State University; member of the Iowa Bar.

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recovery or other compensation received for the loss. Any abandonment loss is an ordinary loss, even though it is a capital asset.[8] Depreciable property is considered abandoned when the taxpayer withdraws the property from use or gives up possession with the intention of ending ownership but without passing the property on to someone else.[9]

Embezzlement losses

Embezzlement losses are deductible in the taxable year in *which the loss is discovered*.[10] IRS had argued that the taxpayer had failed to prove embezzlement in a 1951 case, *Stevenson-Chislett, Inc. v. United States*,[11] but the court stated that it would be unreasonable to require an extensive audit.

No deduction is allowed where income tax had never been paid on the amounts embezzled.[12]

Passive losses

Recently, the controversy has been over whether losses incurred by limited liability companies (LLCs) and other pass-through entities should be treated as limited partnership losses are treated with only three of the seven tests for material participation allowed.[13] Under those three rules, losses attributable to limited partnership interests (and LLCs and other pass-through entities as well) are treated as arising from a passive activity unless a limited partner—(1) participates for more than 500 hours per year,[14] (2) materially participated in five or more of the ten preceding years[15] or (3) the activity was a personal service activity in which the limited partner participated for any three preceding years.

After losing several court decisions,[16] the Department of the Treasury in late 2011 issued proposed regulations stating that the Department of the Treasury was adopting the reasoning of the litigated cases *if all members of pass-through entities had the right to manage the entity at all times during the entity's taxable year*.[17] While this was lauded as a shift in the right direction, it soon became clear that this move was motivated at least in part by making the pass-through entity distributions from entities to members subject to self-employment tax where all members had the right to participate in management of the entity.[18] A Chief Counsel's advice made that relatively clear in a 2014 CCA letter ruling[19] that limited partners involved in management had self-employment tax liability.

In conclusion

Facing operating losses (and other losses) after a string of profitable years calls for a review of the rules governing the handling and reporting of the losses. For some, this will likely commence with the 2015 filing year.

ENDNOTES

[1] The United States Department of Agriculture data indicate that the net farm income nationally was $123.7 billion in 2013, $91.0 billion in 2014 and an estimated $58.3 billion in 2015. See http:/tinyurl.com/q8n4v85.

[2] I.R.C. § 172.

[3] Tax Reform Act of 1997, Pub. L. No. 105-34, § 1082, 111 Stat. 788 (1997), *amending* I.R.C. § 172(b)(1)(A). See Sumrall v. Comm'r, T.C. Memo. 2002-78 (couple failed to claim net operating loss carryback refund); Klyce v. Comm'r, T.C. Memo. 1999-198 (carryforward of net operating losses not allowed because of failure to elect to forego the carryback period); Ltr. Rul. 201017007, Jan. 21, 2010 (C corporation allowed to carryback net operating losses to offset portfolio income, not barred by I.R.C. § 469).

[4] I.R.C. § 172(b)(1)(E).

[5] I.R.C. § 172(b)(1)(F).

[6] I.R.C. § 172(h)(1).

[7] I.R.C. § 167(a).

[8] See IRS Pub. 544.

[9] Treas. Reg. § 1.167(a)-8(a).

[10] I.R.C. § 165(e). See Stevenson-Chislett, Inc. v. United States, 98 F. Supp. 252 (W.D. Pa. 1951), *aff'd,* 344 U.S. 167 (1952).

[11] *Id*.

[12] Stahl Specialty Co. v. United States, 82-2 U.S. Tax Cas. (CCH) ¶ 9666 (W.D. Mo. 1982).

[13] Temp. Treas. Reg. § 1.469-5T(a).

[14] Temp. Treas. Reg. § 1.469-5T(a)(1).

[15] Temp. Treas. § 1.469-5T(a)(5).

[16] E.g., Garnett v. Comm'r, 132 T.C. 368 (2009).

[17] Prop. Treas. Reg. § 1.469-5T(e).

[18] I.R.C. § 1402(a).

[19] CCA 201436049, May 20, 2014.

[20] 1984-1 C.B. 509.