As we move towards warmer temperatures and spring grass growth, we approach the annual calf placement decision for many summer stocker operators. Calf prices have risen considerably in the last couple weeks, which is typical of the spring market. Some operations likely placed calves during the winter, with the intention of purchasing stockers before the typical spring price peak. However, many more will place calves as pastures green up in the coming weeks. It is imperative that stocker operators pay careful attention to the market, their costs, and what can be paid for stocker calves this spring.

The feeder cattle market followed an unusual seasonal pattern during 2014, increasing considerably from spring to fall. Stocker operators who did not utilize price protection, or those who utilized strategies that left some upside price potential, likely enjoyed the highest returns they had ever seen. Much the opposite was seen during the summer of 2012 as a severe summer drought slashed grain yields and drove corn prices skyward. Stocker operators who did not protect sale prices saw their margins dissipate rapidly through summer as feeder cattle prices declined. These two years were excellent examples of how much volatility can be present in feeder cattle markets during the summer. While it is impossible to predict the direction of feeder cattle markets during 2015, producers can use the current CME© feeder cattle futures market as an indication of what can be paid for calves to be placed on grass this spring and sold this fall.

Key assumptions for the stocker analysis are as follows: 1) Graze steers April 1 to October 1 (183 days), 1.5 lb/day gain (no grain feeding), 2% death loss, and 4% interest on calf. Given these assumptions, sale weights would be 775 lbs and 875 lbs for 500 lb and 600 lb purchased calves, respectively. Using a $214 CME© futures contract for October 2015 to estimate sales price, a 775 steer is estimated to sell for $206 and an 875 steer is estimated to sell for $198. This amounts to an $8 per cwt price slide for heavyweight steers. Price slides by weight are likely to remain high given that corn prices are a bit lower and the overall feeder cattle market is much stronger. These sale prices are also based on the assumption that cattle are sold in lots of 40 or more head. Stocker operators who typically sell in smaller lots should adjust their expected sale prices downward accordingly.

Estimated costs for carrying the 500 and 600 lb steers are shown in Table 1. Most of these are self-explanatory except the pasture charge. Stocking rates of 1.0 acre per 500 lb steer and 1.2 acres per 600 lb steer were assumed in arriving at these charges. The pasture charge accounts for variable costs such as bush-hogging, fertilizer, and re-seeding. The last of these pasture costs are on a pro-rated basis and are considered a bare-bones scenario. Sale
expenses (commission) are based on the assumption that cattle will be sold in larger groups and producers will pay the lower corresponding commission rate. However, producers who sell feeders in smaller groups will pay the higher commission rate which will likely be around $50 per head based on the revenue assumptions of this analysis. This continues to be a challenge for small operators in this high priced market. Any of these costs could be much higher in certain situations so producers should adjust accordingly.

### Table 1: Expected Variable Costs 2015

<table>
<thead>
<tr>
<th></th>
<th>500 lb. Steer</th>
<th>600 lb. Steer</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pasture Charge</td>
<td>$30</td>
<td>$36</td>
</tr>
<tr>
<td>Vet</td>
<td>$20</td>
<td>$20</td>
</tr>
<tr>
<td>Interest</td>
<td>$27</td>
<td>$30</td>
</tr>
<tr>
<td>Death Loss</td>
<td>$28</td>
<td>$30</td>
</tr>
<tr>
<td>Sale</td>
<td>$16</td>
<td>$16</td>
</tr>
<tr>
<td>Haul</td>
<td>$15</td>
<td>$18</td>
</tr>
<tr>
<td>Mineral</td>
<td>$10</td>
<td>$12</td>
</tr>
<tr>
<td>Other (water, etc.)</td>
<td>$10</td>
<td>$12</td>
</tr>
<tr>
<td><strong>Total Variable Costs</strong></td>
<td><strong>$156</strong></td>
<td><strong>$174</strong></td>
</tr>
</tbody>
</table>
|*Note: Interest varies slightly by purchase price.*

Target purchase prices were estimated for both sizes of steers and adjusted so that gross returns over variable costs ranged from $50-150 per head. This gives a reasonable range of possible purchase prices for each sized animal this spring. Results are shown in Table 2. For 500 lb steers, target purchase prices ranged from $2.58 to $2.77 per lb. For 600 lb steers, target purchase prices ranged from $2.35 to $2.51 per lb. When targeting a $100 per head gross profit, break-even purchase prices were $2.68/lb for 500 lb steers and $2.43/lb for 600 lb steers.

### Table 2: Target Purchase Prices For Various Gross Profits 2015

<table>
<thead>
<tr>
<th>Gross Profit</th>
<th>500 lb Steer</th>
<th>600 lb Steer</th>
</tr>
</thead>
<tbody>
<tr>
<td>$50</td>
<td>$2.77</td>
<td>$2.51</td>
</tr>
<tr>
<td>$75</td>
<td>$2.73</td>
<td>$2.47</td>
</tr>
<tr>
<td>$100</td>
<td>$2.68</td>
<td>$2.43</td>
</tr>
<tr>
<td>$125</td>
<td>$2.63</td>
<td>$2.39</td>
</tr>
<tr>
<td>$150</td>
<td>$2.58</td>
<td>$2.35</td>
</tr>
</tbody>
</table>

*Notes: Based on costs in Table 1 and sales price of $206 & $198 for 775 lb & 875 lb sales weight respectively for 500 lb & 600 lb purchased steers.*

Of course, it is highly likely that your cost structure will be different than that presented in Table 1. If this is the case, simply shift the targeted gross profit up or down to account for this. If your costs are $25 higher per calf, then you would shift each targeted profit down by one row: For example, you would use the $125 gross profit to estimate a $100 gross profit. Another way to evaluate this is that a $1 increase in costs would decrease the targeted purchase price by $.20 per cwt for 500 lb steers and $.17 per cwt for 600 lb steers.

It is important to note that the gross profits in Table 2 do not account for labor or investments in land, equipment, fencing, and other facilities (fixed costs). Thus, in the long-run, these target profits need to be high enough to justify labor and investment. In many locations, calf markets are already at levels that would place expected returns on the lower end of the range analyzed. This is all the more reason that stocker operators should carefully think through their budgets and make rational purchasing decisions.

With calf prices at such high levels, and with the potential for them to move even higher in the next few weeks, summer grazers will have a lot of money invested in calves that are placed into grazing programs this spring. Furthermore, if we have learned anything over the last few years, it is that feeder cattle markets are highly volatile, especially during the corn growing season. Thus, price risk management will be critical as calves are placed this spring and stocker operators seek to protect downside price risk.

Hedging, through the sale of futures contracts, provides solid downside risk protection, but will subject the producer to margin calls if cattle prices increase. This was a serious challenge for many who employed this strategy during the summer of 2014. Entering a cash forward contract with a feedlot or order buyer, or offering cattle through internet sales with delayed delivery, will reduce or eliminate price uncertainty, but will also limit marketing flexibility should weather conditions necessitate sale at a different time. Finally, strategies such as put options and Livestock Risk Protection (LRP) Insurance offer a less aggressive strategy that provides some downside price protection, but more ability to capitalize on rising prices.

Regardless of what makes the most sense for the individual producer, time spent considering price risk management is likely time well spent in these volatile markets. Links to two publications on using futures markets to manage price risk in feeder cattle and a publication on the use of Livestock Risk Protection (LRP) Insurance, can be found on the livestock page of the UK Agricultural Economics website: [http://www.ca.uky.edu/agecon/index.php?p=41](http://www.ca.uky.edu/agecon/index.php?p=41). The best way to ensure profitability is to budget carefully and to manage downside price risk. It is our opinion that if you are not occasionally leaving some money on the table through your risk management strategy, you are probably taking too much risk in your operation.

~ Greg Halich, greg.halich@uky.edu & Kenny Burdine, kburdine@uky.edu
Trying to Make Sense Out of an Abruptly Changing Burley Tobacco Market

As burley contracts began rolling out over the past two weeks it became obvious that 2015 will be a challenging year for burley tobacco growers. While it appears that contract prices offered by most buyers will be similar to 2014 price schedules (with a few companies reducing prices for mid to lower stalk leaf), U.S. burley contract volume will be reduced significantly. Unlike during the days of the former federal tobacco program when quota changes were uniform across all growers, contract volume changes for 2015 will vary considerably across U.S. burley growers. In reality, 2015 contract volume changes range from small increases for a few growers, to 100% reduction for other growers with differences within a given company generally based on historical “scorecard” variables such as delivery percentages and quality factors. Some companies are extending contracts almost exclusively to their multi-year contract growers, resulting in the elimination or sharp reduction in contract volume for single year contract growers while others did offer “across the board” cuts to all contract growers.

In lieu of these abrupt changes, what will the change in U.S. burley acres be for this year? The USDA Planting Intentions report will be released on March 31st, but keep in mind that these survey results are based on grower expectations as of late February and early March – prior to the roll-out of tobacco contracts. Given that grower expectations for 2015 burley contract volume were likely higher several weeks ago, I anticipate USDA burley planting intentions for 2015 to be inflated relative to actual contract volume and actual plantings. Based on what I am hearing from various individual companies and other buying interests (i.e. cooperatives), I could anticipate the call for a 30 to 40% or greater reduction in 2015 U.S. burley acres.

What can be made of these abrupt changes after the buying sector was so aggressive in purchasing leaf in the 2013 marketing season and relatively strong prices for 2014 contracted tobacco? Perhaps some of the adjustments can be explained by several of the following factors.

- A global surplus of burley has rapidly materialized over the past 18 months as world burley production has increased by more than 30%, while global burley consumption has declined
- Export demand is extremely weak amidst an abundance of cheaper foreign leaf and an increase in the value of the U.S. dollar making U.S. tobacco more expensive in international markets
- Some buyers overcommitted in purchasing the 2014 U.S. burley crop as demand expectations did not materialize and thus will have to make additional adjustments in 2015 to correct for this imbalance
- The loss in Malawian burley production from recent flooding during the growing season was not as devastating as initially reported
- Current and forecast sales of American blended cigarette sales continue to fall globally
- Tobacco companies realize U.S. growers will overproduce above contract volumes which provides an opportunity to purchase lower priced leaf in the U.S. and globally
- Tobacco companies continue to tighten burley inventories amidst a very uncertain domestic and global regulatory environment along with a small, but rapidly emerging non-combustible (i.e., e-cig,vaping) market
- An excess supply situation provides an opportunity for companies to eliminate lower quality growers or those who have not followed through with their previous contract obligations.

The U.S. burley growing industry has experienced drastic volume reductions in the past, followed by some stability and even some periods of growth. Perhaps this will occur in the near future, but no one can make this statement with a lot of confidence in today’s marketing environment. While the market is demanding less burley today, such drastic contraction of the industry within a single year possibly jeopardizes future U.S. burley leaf supply security for buyers if the market eventually rebounds and the overall grass-root political support for the industry.

The remaining growers will need to realize that an excess supply market likely results in more critical grading for the 2015 crop and that non-contract tobacco production will be extremely risky. With anticipated tighter margins, growers will have to place an even greater emphasis on quality, labor efficiency and yield to have a favorable outcome for the 2015 crop.

~ Will Snell, wsnell@uky.edu
New Repair Regulations and Rev. Proc. 2015-20

The IRS recently released new guidelines on reporting repairs versus capital purchase. The issue has been vague guidelines defining when an expense is to be depreciated or reported as a repair or supply expense on Schedule F, Profit or Loss from Farming. See Rev. Proc. 2015-20 released February 13, 2015, for specifics and http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Tangible-Property-Final-Regulations.

The new rules define deductible repairs and supplies as things like lubricants, parts, and materials costing less than $200 that have a useful life of 12 months or less.

So what about tires, sprayer tips, roofing, and other items that cost more than $200 and last more than a year? There are three safe harbors available, and a three-step test for determining repair vs. depreciation. The safe harbors are elections that must be made annually with the tax return to apply. They are not challenged by the IRS. Farmers may also elect to treat repair and maintenance cost as a depreciable expense. Qualified depreciable expenses may be written off under Section 179 expensing.

1) Most farmers will qualify for the $500 de minimis safe harbor, an annual election to treat up to $500 per invoice as a current expense. The amount includes all costs on the invoice, including delivery and setup. Cost of multiple items on an invoice must be allocated by item.

2) The small building safe harbor allows repairs and capital expenses to a farm building to be included in current expense. An election is filed for each building separately. The amount allowed is the smaller of 2% of the unadjusted basis in the building or $10,000. Unadjusted basis is the cost plus improvements without deduction for depreciation.

3) The safe harbor for routine maintenance allows deduction of expenses for recurring activities to keep business property in its “ordinarily efficient operating condition.” Recurring activities can be expected to be performed more than once a) in a 10-year period after placing a building in service or b) during the class life of machinery and equipment. Most farm machinery and equipment have a 10-year class life that begins when the item is placed in service by you. This safe harbor does not apply to Betterments or Restorations.

The three-step test for determining repair vs. depreciation classifies repair expenses as depreciable if they are for Betterment, Restoration, or Adaptation. Expenses are evaluated as a Unit of Property (UoP). For buildings, a UoP would be a key building system, like roof, plumbing, or HVAC. For equipment, a UoP would be “functionally interdependent components” like engine or braking systems.

Betterment could be one of three things:
1) Fixing a condition that existed before the item was acquired, such as rebuilding an engine on a newly-acquired used truck.
2) Adding on, enlarging, expanding, or adding a major component to increase capacity or space.
3) Increasing productivity, efficiency, or quality. In each case, the Unit of Property is improved and the cost must be depreciated.

Restoration means:
1) Replacing a major component of the UoP, like replacing the AC on a tractor.
2) Repairing an item that has deteriorated so it no longer functions as intended, like replacing a roof. But replacing 20% of the roof would not be a significant part of the roof system, so it could be deducted.
3) Repairing an asset after the end of its class life to like-new-condition or full restoration.
4) Certain tax situations your tax preparer will know.

Adaption changes the use of an item, like conversion of a tobacco barn to a cattle barn.

Adopting these new rules is a change in accounting method. Generally, that requires paperwork and making things done in the past conform to the new method. Rev. Proc. 2015-20 waives the requirement for qualified taxpayers. However, some tax payers may benefit from a “partial disposition election” of assets that would not be capitalized under the new tests. Consult with your tax advisor.

~ Jerry Pierce, jerry.pierce@uky.edu
Employee versus Contract Labor

As spring approaches, farmers will begin preparations for the next production season. One such preparation is making sure the farmer has enough (but not too much) labor to get the work done. One of the most common questions asked in regards to hiring is if an individual is an employee or if they are an independent contractor. Obviously one of the benefits to hiring “contact workers” is the simplicity in paying contract workers over employees. However the employer must properly categorize their labor force to avoid potentially costly penalties down the line.

In general, the IRS says an individual is an independent contractor if the employer “has the right to control or direct only the result of the work and not what will be done and how it will get done”. If the employer controls what work is done and how the work is done, that person is an employee. For example, let’s say that Farmer Sarah hires Worker Lee to harvest her tobacco crop. If Sarah tells Lee that she wants her tobacco cut and hanging in the barn by September 20 and leaves it up to him to complete the job, then Lee is most likely a contract worker. Sarah pays Lee gross wages, will send him a 1099 by January 31 of the following year (assuming wages are $600 or higher) and it is up to Lee to pay the self-employment taxes on his earnings.

If Sarah tells Lee when to start and quit each day, tells him when to take breaks, provides the tools for the job and oversees Lee’s work performance, then Lee is an employee. Sarah must have Lee complete an I-9 form, a W-4 form, and a K-4 form (if in Kentucky) within the first 3 days of his employment.

Important message for H-2a employers

More and more farmers are creating separate entities, such as LLCs and Partnerships through which they employ H-2a workers. It is this new entity that applies for the H-2a workers. During the Department of Labor and Homeland Security H-2a certification process, these federal agencies check for tax returns in the name of the applicants (either the farmer or the separate entity whoever is applying for the H-2a workers). These new entities, whether they are a partnership or an LLC MUST file a tax return. Some of these entities are not doing this. If this tax return is not filed, they will very likely be denied their application for H-2a workers. And yes, it is a requirement that Partnership and LLC’s file a tax return. Applications are already being denied because of this issue.

Similarly, some farms are applying for H-2a workers under a “DBA” (or Doing Business As). They are running into the same problem… if there is no tax return filed under the name of the H-2a applicant, then the application will very likely be denied.

We also continue to remind our H-2a employers and employees that H-2a workers MUST get a social security number after they arrive in the U. S. In general, H-2a workers are not subject to federal income tax withholding and are exempt from FICA taxes. However, if the H-2a worker does not get a social security number, then the employer MUST withhold 28% for federal tax withholding from their gross wages. Although H-2a workers are exempt from federal tax withholding, they are not exempt from paying income taxes. They must file tax returns each year. Failure to do so could prevent their future ability to work under the H-2a Visa.

~ Laura Powers, laura.powers@uky.edu
“In recent years, growth in U.S.-China agricultural trade has accelerated. During calendar years 2012-13, U.S. exports of agricultural products to China averaged $25.9 billion per year—a tenfold increase from the late 1990s. Sales to China doubled during 2004-08 and doubled again during 2008-12, while the share of U.S. agricultural exports going to China rose from about 3 percent during the 1990s to 18 percent during 2012-13. China became the largest overseas market for U.S. farm products in 2010. U.S. imports of agricultural products from China rose at a slower pace, reaching $4.4 billion in 2013—agriculture is one of the few sectors where the United States has a trade surplus with China. During 2012-13, the United States accounted for over 24 percent of China’s agricultural imports by value and was its leading supplier of oilseeds, cotton, meat, cereal grains, cattle hides, distillers’ dried grains (mainly used for animal feed), and hay. Soybeans account for more than half of the total value of U.S. agricultural exports to China, averaging $14.1 billion during the 2012-13 calendar years, and are also the largest U.S. export of any type to China, accounting for about 11 percent of the value of total U.S. exports to China.”

Source: Economic Research Service/USDA:

~ USDA, Economic Research Service
Another successful tax seminar season

The 48th year of the UK Income Tax Seminars wrapped up in January. Total registrations for the 2014 season were 1,670, a slight increase from 1,651 in 2013. At least two participants in Lexington have attended all 48 years.

UK Ag Economics partnered with the Kentucky Department of Revenue and the Internal Revenue service to deliver seminars at locations from Paintsville to Paducah. Two teaching teams staffed by an accountant, retired IRS and DOR agents, Kentucky DOR employees, IRS staff, and KFBM area specialists delivered sixteen, two-day seminars between November 5 and January 7.

UK Ag Economics is a member of the Land Grant University Tax Education Foundation, a consortium of 26 universities which produces a 700+ page workbook used in the seminars. Registrants received over 1000 pages of educational materials and updates, a completion certificate, and continuing education credits for their participation.

The targeted audience was accountants/CPAs; certified financial planners; enrolled agents; attorneys; financial, insurance, farm management, and real estate professionals; and registered tax return preparers. The two-day seminars were designed for preparers with at least one year of experience and covered individual taxpayer and small business issues and included one session dedicated to agricultural topics. New legislation, rulings and cases, retirement topics, and ethics were also covered.

The two-day seminars were approved for Continuing Education credit by the IRS, the Kentucky State Board of Accountancy, the Kentucky Department of Insurance, the Certified Financial Planners Board of Standards, the National Association of State Boards of Accountancy and the Kentucky Bar Association.

Planning is underway for the 49th season of tax seminars to be delivered this fall. For additional information contact Kathy Roe, Program Coordinator or see the UK Income Tax Seminar website at www.uky.edu/uktax/.

~ Steve Isaacs, sisaacs@uky.edu