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**KENTUCKY
DAIRY
ENTERPRISE
COSTS
AND RETURNS**



by Darwin Foley and Rush Midkiff

Average net returns for 1997 dairy enterprises summarized by the Kentucky Farm Business Management Program were negative for the third straight year, following three years of positive returns. Although the enterprise showed improvement in both 1996 and 1997, net losses, considering all costs (cash and non-cash), averaged \$-85 per cow. In 1997, 29 enterprises were evaluated. They averaged 129 cows, and ranged in size from 53 to 408 cows. Average milk production per cow was 17,187 pounds, with farm averages ranging from 13,455 pounds to 22,319 pounds.

Total returns averaged \$2,672 per cow. Milk prices averaged \$14.44 per cwt., a decrease of \$1.09 from 1996. Beef prices increased in 1997 but returns from cull cow sales, bull calf sales and inventory values still made up only 7% of the total enterprise returns. Average milk production per cow increased 1,318 pounds in 1997. This increase in production more than offset the decrease in milk price, and led to an increase in returns of \$58 per cow over 1996. Total costs per

cow increased for the fifth consecutive year. Non-feed costs increased \$51 per cow, but feed costs decreased \$33 per cow.

Dairy enterprises varied greatly in levels of production efficiency, cost, and net returns. Net returns represent the financial reward attributable to management of the dairy enterprise. Although average net returns were negative, 11 of the 29 herds (38%) had positive net returns. The high-return farms (top 1/3 of herds, based on net returns per cow) averaged \$230 net returns per cow, or \$1.35 per cwt. of milk produced. The low-return farms (bottom 1/3 of herds) averaged \$-357 per cow net loss, or \$-2.15 per cwt. of milk produced.

From 1987 to 1992, changes in net returns were driven mostly by changing milk prices and increases in production per cow, but from 1993 through 1997 increases in cost of production had a larger impact on net returns than did production level or milk price. In 1997 milk prices were moderately lower but feed prices also declined. Milk prices over the period 1989 to 1997 have been volatile. Monthly price charts for the past few years show that production driven seasonal milk price patterns have given way to price patterns determined by what Jeffrey Sims calls the "invisible hand of supply and demand". The demand for cheese, and the price for cheese that results from this demand, has had more to do with milk prices than any other single factor.

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1998 and 1999

In 1998, dairy has been a bright spot in the farm economy. The basic formula price continues to increase, pulled by a strong demand for cheese and butter. Cheese prices are up and butter prices have skyrocketed. The hot summer kept milk production per cow down and the heat also depressed butterfat production. Third quarter milk production was down 0.3% from third quarter a year ago, although September milk production was up 0.4% over September a year ago. Supply seems to be responding to lower grain prices and higher milk prices because milk per cow and cow numbers were both up in September. National supply has been expanding at a 1-2% annual growth rate, but has been basically flat in 1998.

Since the price that farmers receive for milk is based on the basic formula price from two months earlier, farm prices will continue to increase throughout the year, but don't look for high prices to last forever. With the removal of price supports in recent years, milk prices have been on a roller coaster ride. Look for increasing supplies of milk next spring and rebuilding of cheese inventories to push prices below current levels, but cheap feed should keep the average producer profitable in 1999. USDA is forecasting overall lower prices for the next 12 months. On November 10, Chicago Board of Trade basic formula futures prices for March through September of 1999 averaged about 12.50, therefore, Kentucky pay prices are expected to average about \$14.50 through November of next year.

PORK PRICES IN THE CELLAR



by Rick Costin

Hog prices continue to be pummeled by massive pork production. For several weeks hog slaughter has been over 2 million head per week. Pork supplies far in excess of demand keep pushing down live prices. Despite a strong economy that is propping up overall demand, consumer response to large pork supplies is limited. Retailers have lowered pork prices moderately while still maximizing profits. But with other competitive meats realizing large supplies, the consumer has many choices in spending their inelastic meat dollar.

The high teens per cwt. for market hogs offered the past couple of weeks is the lowest price level since 1972. Before some hog producers conclude the world is coming to an end, it hasn't been too long ago that hog prices dipped into the \$20's for four weeks. That was in November and December of 1994 when hog runs exceeded slaughter capacity as is the scenario producers are facing currently.

Lincoln Trail hog producers will average prices around the middle \$30's for the 1998 year. Through October, 1998, prices were averaging about \$39 per cwt. for market hogs in the area.

The September "Hogs and Pigs" report confirms expectations that expansion of the breeding herd has ceased. Although, all indications are that pork production will still be large through much of 1999. In fact, most forecasters are predicting a lower average price in 1999, somewhere around \$34 per cwt.

Hog producers are ending a year with record low prices and an unpredictable upcoming year. It is extremely important that producers use their Farm Business Management records and consult with their specialists about their individual situations.

A BIG SURPRISE MAY BE IN STORE FOR FARMERS WHEN THEIR INCOME TAX RETURNS ARE PREPARED



by Craig D. Gibson and David L. Heisterberg

As human beings, we tend to have short memories. All of the attention that is focused on the potential for lower farm earnings leaves a feeling that income tax management is not of concern for 1998. For many farmers, this is far from being true. Several developments have occurred during 1998 that set the stage for a substantial 1998 taxable income. These developments will require income tax management to be of utmost importance. Farmers must save any dollars possible to efficiently operate during 1999.

For the many farmers that "carried" large inventories of grain and livestock into 1998, gross incomes are probably larger than current thinking. "Selling patterns" for 1998 have been influenced by loan deficiency payments (LDP's). If collected, LDP's could materially increase taxable farm incomes for 1998 in contrast to 1999 taxable farm incomes. The one-time farm financial

aid payments, equal to approximately half of the 1998 agricultural marketing transition payments and to be distributed before the 1998 year ends, will increase taxable income for 1998. In addition, the decision to collect the 1999 installment of the market transition payments during 1998 could further exacerbate the potential for a large 1998 taxable income. Both LDP's and the advanced market transition payments are in fact a "shift" of 1999 incomes into the 1998 tax year.

Regardless of decisions made to this point in time, farmers should begin to review where their 1998 taxable income stands. It is also helpful to project net income and "cash flows" for 1999. Projections provide some guidance under "cash basis" accounting to determine how taxable incomes may be "adjusted" through tax saving strategies for income tax planning purposes. Projections may also provide a dual purpose by creating an opportunity to review business plans for 1999 such that *smart* decisions will be made to insure a profitable 1999.

Utilization of tax planning strategies based on 1997 and 1998 tax legislation are important. Although most tax payers heavily rely on their income tax return preparers for tax planning, it still is imperative that some basic understanding of new tax legislation and the relative impacts are understood. The remaining portion of this article will highlight some of the basic changes in tax law that have been implemented since filing last year's income tax return.

Income Averaging

Income averaging has been made a permanent provision available to farmers. However, it will only be of benefit to taxpayers whose taxable income has moved into a higher

marginal bracket than taxable income from the prior three years. The exact amount of benefit will depend on how much income will "fit into" the lower brackets of the three preceding years. From a planning standpoint, this should not be relied upon for managing your taxable income. The income will still be taxed, although some may possibly be at a lower rate. Also the income will still be subject to self-employment taxes at the current year's rates.

Section 179 Deduction

For 1998, taxpayers are allowed to "write-off" up to \$18,500 of the cost of certain depreciable assets placed in service during 1998. (Note: A lower limit applies to business vehicles.) However, astute business managers know that any end of the year depreciable asset purchases should be made based on "need" . . . not "want" as related to this income tax benefit.

Capital Gains Holding Period

For 1998, new legislation provides that the "holding period" to qualify for the lower long-term capital gains tax rate on the sale of certain types of capital assets is reduced to one year from 18 months. This change was made retroactive to January 1, 1998. For capital gains income that would regularly be taxed at the 15% rate, the capital gains rate will be 10%. For all other capital gains, the rate will be 20%.

In planning, it may be helpful to realize that for sales made after December 31, 2000, certain capital assets held for more than five years may qualify for even lower capital gains tax rates. The rate will be 8% for taxpayers with a 15% marginal tax rate and will include holding periods beginning before January 1, 2001. For taxpayers with higher marginal tax rates, assets must

generally be acquired after December 31, 2000, and held for more than five years to qualify for the capital gains tax rate of 18%.

Retirement Planning

Participation in one or more of the many types of retirement plans can reduce income tax. Care must be taken if participation is made in more than one type of plan due to certain rules. Earnings on money in a retirement account "grow" at a faster pace than assets that are not tax-deferred and thereby enhance the opportunity for greater retirement benefits.

Traditional IRAs

Whether an IRA contribution qualifies as fully deductible on the income tax return is influenced by the modified adjusted gross income level, whether there is active participation in an employer-sponsored retirement plan, and whether both spouses are employed (or have earned income.) Where neither spouse is covered under an employer-sponsored plan and earned income is at least \$4,000, each spouse may contribute \$2,000 to his or her plan and receive a full deduction.

Roth IRAs

Although not deductible as the traditional IRA contribution, Roth IRAs allow the opportunity for "tax free" growth of investments. Participation in Roth IRAs is subject to income limits as measured by the modified adjusted gross income. Also, in order to receive the tax-free advantages, a five-year holding period must be satisfied as well as certain rules related to distributions.

Rollovers from Traditional IRAs to Roths

Individuals may want to consider a rollover from a traditional IRA to a Roth IRA. The rollover is a “taxable event” and penalties are applied if certain requirements are not met. If the rollover is completed before January 1, 1999, an election is available to include the taxable amount of the rollover in your income over a four-year period. For rollovers in later years, the taxable amount of the rollover is included in income for the year the rollover took place.

Shifting Income to Your Kids

A popular strategy to reduce income tax among taxpayers with high income tax rates is to shift income to their kids. This may be achieved by paying wages to children that provide labor in conducting business activity. It may also include making gifts to children, by which earnings from the gifts are taxed at a likely lower marginal tax rate. Care must be made as there is a “kiddie tax” for children under the age of 14 which potentially increases the marginal tax rate on any investment income. Regardless, planning strategies will allow the potential to accumulate capital for future needs.

Education Tax Credits and Deductions

The HOPE scholarship credit allows a maximum tax credit of \$1,500 per student, determined by tuition expenses paid after December 31, 1997, for the first two years of post secondary education. The life time learning credit allows taxpayers a maximum credit equal to 20 percent of the first \$5,000 of tuition (\$10,000 for tax years beginning in the year 2003) incurred during the tax year for qualified tuition for eligible students of post secondary education. The

lifetime learning credit applies to expenses paid after June 30, 1998, and paid for education furnished in academic periods beginning after that date.

Education IRAs were also created in the 1997 tax legislation to allow lower and middle income taxpayers to save for qualified educational expenses. Care must be taken when distributions from Education IRAs are made. Any excess distributions are subject to a 10 percent additional tax.

Qualified education loan interest paid after December 31, 1997, becomes a tax deduction for up to \$1,000 of paid interest for 1998. The maximum deduction increases to \$1,500 in 1999. Interest deductions are allowed only for the first 60 months that interest payments are required and are also limited for taxpayers with modified adjusted gross incomes greater than \$40,000, if single, and \$60,000, if married. For taxpayers with modified adjusted gross incomes greater than \$55,000, if single, and \$75,000, if married, the deduction is not allowed.

Other Tax Law Provisions That May Benefit Farmers

Self-employed individuals may currently deduct 45% of their health care insurance premium cost. Provisions have been made to increase this percentage to 60% in 1999, 70% in 2002, and 100% in 2003.

Net operating losses from farming may be “carried back” up to five years instead of two, as provided in previous tax legislation. Only the part of the NOL that is attributable to farming is allowed the five year carry back. As with previous law, an election may be made to forgo the carry back, and carry all the loss forwards.

For farmers that use “cash basis accounting,” an election may be filed with the income tax return that postpones the reporting of income one year for proceeds resulting from crop insurance and disaster payments. This election is available if it can be shown that you would have reported income from damaged crops in any tax year following the tax year of the destruction or damage, and the payment is received during the year of the destruction or damage.

Conclusion

Many taxpayers have the flexibility to plan for income tax. Year-end strategies are available that result in income tax savings . . . if time and energy is spent. After the end of the tax year is not the proper time to implement income tax saving strategies, although a very limited number of strategies are still available. For farmers, 1998 tax returns may paint a different picture than popular thinking suggests, given the currently depressed commodity prices. Prudent managers will plan and investigate strategies to minimize income tax. The rest may be in store for a big surprise!

KFBM BOARD MEETING

The next scheduled board meeting for KFBM is Tuesday, December 1, in Elizabethtown. If you have any concerns, comments or questions, you’re encouraged to contact your board representative or area specialist.

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