
KENTUCKY FARM BUSINESS MANAGEMENT PROGRAM STATE NEWSLETTER

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Bluegrass Area Update

David L. Heisterberg

The Bluegrass Area Farm Management Specialist position is now vacant. Effective December 1, 2004, Colby Blair resigned to assume a position with Farm Credit Services. We would all like to wish Colby the best as he undertakes his new job. We are very sad as we never like to lose a good specialist, and also do not like to have specialist turnover within an association. However, change is often inevitable and so we move on. Upon learning of Colby's planned departure, Dr. Robbins immediately circulated the position opening, and applications closed November 29. The search committee, including Dr. Carl Dillion and myself as well as the Bluegrass Area board of directors, is in the process of evaluating submitted applications. We hope to interview three applicants before Christmas.

A transition plan was also immediately put in place. In order to continue the service to the Bluegrass Area cooperators and ensure their needs are met, Jennifer Rogers and myself will cover this vacancy. Jennifer is the Area Specialist in the Purchase Area. Colby was able to make most of the fall visits before he left, and generally the work is current. There are several members that need a tax estimate and we will be doing that in the next week or two.

Being optimistic, I would hope to have someone hired by the end of the year, and possibly on the job by early January. This would be an ideal situation, as the new specialist could observe the year-end processing and get to know the cooperators, while Jennifer and I assume most of the responsibility for processing the records. This could be very beneficial to the new specialist, while still maintaining good service to the Bluegrass members.

Tobacco Buyout – Tax Implications

David L. Heisterberg

Now that the tobacco buyout is actually accomplished, many are now turning to the tax and management aspects of how to receive the payments, what taxes there will be, and whether to raise tobacco in the future. While everyone is eager to know what the future brings, I need to put a disclaimer on this information. What is presented here is our best interpretation of what we believe will be the tax implications and how certain procedures will work. However, all of the regulations have not been written, and there is much that could still change. We will attempt to keep you updated as new and final IRS regulations become available. Also, the following Ag Econ web site will have much information and decision aids to assist you in making decisions for your farm: <http://www.uky.edu/Ag/TobaccoEcon/>

As most of you know by now, the buyout will pay quota owners a total of \$7 per pound over the next ten years. This is based on the 2002 basic quota and will be paid to quota owners of record on October 22, 2004. Grower payments of \$3 per pound will be paid to growers who grew tobacco in 2002, 2003, and 2004. If a grower did not grow all three years, the payment will be prorated based upon the number of years tobacco was actually grown. This will also be based upon the 2002 quota. Provisions are in place to convert dark tobacco acreage allotments to pounds.

We believe that the **quota payments** will qualify for capital gains treatment, and if held for more than one year, will be subject to the long term capital gains rate of either 5% or 15% tax rate. Quota owners will be able to subtract their basis in the quota they own arriving at the amount of gain to be taxed. For quota that was purchased in the last few years, that should be a fairly easy number to look up and substantiate. For quota that was purchased several years ago before quota could be separated from the land, and for inherited quota, this could be much more difficult. Quota that was purchased with a farm should have been allocated from the total purchase price. Quota that was inherited with a farm after March of 1976 would have received a “stepped up” basis and also should have been allocated from the farm. If this was not done, it is still possible to go back and make this allocation. However, it will be much more difficult to do now, and great care should be taken to arrive at an accurate and reasonable basis allocation. To help in determining how much quota there would have

been at some past date, there will be an Excel spreadsheet on the web site listed above, that will help you to determine what the quota would have been in the year in which it was acquired, based upon the amount of quota in 2002. The quota payments will not qualify for farm income averaging.

We also believe that the quota payments will qualify for a Code Section 1031 tax-free exchange. However, complying with all of the rules of the 1031 exchange and making the mechanics of the payments work out, may prove very difficult. Also remember that this is merely postponing the tax until such time as you sell the replacement property. The 1031 exchange is something that will require competent professional assistance.

Grower payments on the other hand will probably be taxed as ordinary income and will be subject to self-employment tax, if the farmer was materially participating in the growing of the tobacco. For the share rent landlord, the payment will still be ordinary income, but will not be subject to self-employment tax. Also, there is no basis to subtract in determining the taxable amount of income to be reported. These payments should qualify for farm income averaging.

Another option that will be available to recipients of both the quota and grower payments will be a **lump sum payment**. This will be handled by a financial institution and will result in the payments that would have been received over the next ten years being assigned to the financial institution. The financial institution will in turn give the grower or quota owner something less than the face value of the payments in a lump sum. The amount of discount on the income stream along with the tax implications will determine whether this option is one that should be chosen. At this time we have heard of discount rates from 4% to 10%. Obviously this is a great difference from best to worst and growers and quota owners should shop around to find the best offer. We believe at this time that the election to receive the lump sum payment would be considered an election out of the contract method of reporting the income, and result in paying tax on the lump sum in the year received.

Please consult with your tax professional before making a final decision on whether to take the lump sum payment or taking the income over ten years. Also please get a copy of the contract when you sign up, so that your tax professional can make a proper allocation between the grower payments and the quota payments.

Income Tax Planning

Colby A. Blair

This message is very similar to the one in last year's newsletter, but bears repeating again and again and ...! Money and time spent on tax planning, before the end of your tax year, can be a rewarding endeavor. Many farmers realized an outstanding year in 2003, and deferred much of the income until 2004, which is also turning out to be a very good year, given outstanding yields and also very good livestock prices. These additional gross revenues may pose income tax consequences on the proprietor that can be less than ideal. However, the farm business owner is given many opportunities through the use of pre-paid expenses, accelerated depreciation, income averaging, etc. that, when used effectively, can create a much more manageable income tax liability over time.

There are numerous factors to consider when implementing an income tax management strategy. The key should be to eliminate the enormous swings in tax liability each year. A "bad" year followed by a "good" year often causes a farm business owner to go from owing no taxes to owing substantial taxes. Farmers should exert caution and pay close attention to their position in their respective tax bracket. By participating in tax planning, they can become aware of the potential of surging into higher tax brackets, or being caught in the "phase outs" of certain exemptions and tax credits.

As always, consult your tax advisor and/or your KFBM Specialist before making any decisions relative to income tax. Make sure that the decision is one that will make the farm more profitable in the long run, not just a decision that will lessen your tax liability in the short run.

Income Tax Law Changes / Reminders

David L. Heisterberg

It seems that every year we get more tax laws, many of them in the name of tax simplification. There are no less than nine tax bills that have provisions either beginning or ending in 2004! Two of those bills were passed in October of 2004. The last bill was supposed to be mainly a corporate tax bill, but ended up containing the tobacco buyout discussed earlier along with several provisions that affect individual taxpayers. It is the intent of this article to review and

highlight some of the more important changes. Also, bear in mind that there will probably be more legislation in the upcoming years. President Bush wants to make all of the tax cuts from the 2002 and 2003 tax bills permanent. Whether you agree or disagree with the administration's taxation philosophy, it would be very helpful to not have all the different starting and ending dates to remember. Also remember that all tax strategies should satisfy good management practices for your farming operation. It is not wise to abandon good marketing practices or good production practices simply to achieve some tax savings. You will probably achieve the tax savings you desire, but it will be from truly lowering the income of your farm because of poor management decisions.

Child Tax Credit. This credit allows individual taxpayers to claim a credit for each child under the age of 17 and for whom the taxpayer claims a dependency exemption. This credit is now \$1000 per child and is available until 2010. The refundable portion has also been increased to 15% of earned income up to \$10,750.

Standard Deduction and Tax Brackets. The 2003 Act eliminated most of the "marriage penalty" in the lower tax brackets and the standard deduction for couples filing jointly versus single taxpayers. The standard deduction and the ten and fifteen percent tax brackets are now twice the amount available to the single taxpayer. These provisions have also been extended to 2010. The 10% tax bracket has also been expanded. For single taxpayers, that bracket includes the first \$7,150 of taxable income, and for married filing joint, the first \$14,300 of taxable income. These brackets will be indexed for inflation each year until 2010.

The standard deduction for 2004 by taxpayer category:

| | |
|---------------------------|---------|
| Single | \$4,850 |
| Married filing jointly | 9,700 |
| Married filing separately | 4,850 |
| Head of household | 7,150 |

Individual Capital Gains Rates and Tax on Dividends. Capital gains tax rates are now 5% for those taxpayers who have taxable income within the 10 or 15 percent brackets, and 15% for those who are in a regular tax bracket above 15 percent. These rates have also been extended through 2009. Remember in 2008, the capital gains rate for those in the 10 or 15

percent bracket is scheduled to be zero. Also the tax on most dividend income is now done at capital gains rates.

Alternative Minimum Tax (AMT). The alternative minimum tax was designed to prevent taxpayers from eliminating their tax because of excess tax preferences or use of accelerated deductions. However, in recent years this tax also caught many taxpayers for whom it was not intended because it was not indexed for inflation. Also, new tax reduction provisions were enacted that added to the AMT problem. To soften the likelihood of paying AMT, the 2003 Act increased the income exemption from \$40,000 to \$58,000 and that has been extended until 2010. Also, a provision that trapped many farmers was the use of income averaging. This trap has been eliminated with the 2004 Act, so farmers will now get the full benefit of income averaging that was intended without paying AMT.

Accelerated Depreciation Methods. Since 09-11-2001, we have had two different methods of greatly accelerating depreciation deductions. The Section 179 or “first year write off” has been increased to \$102,000 for 2004 and will be indexed for inflation in 2005, 2006 and 2007. After 2007, it is scheduled to revert back to \$25,000. The 30% or 50% “bonus depreciation” on **new** capital purchases is scheduled to end this year. To qualify, the asset must be placed in service before 01-01-2005. This does not mean that you should run out and buy something before the end of the year. First, there must be a justifiable business reason for the purchase. If it’s not purchased this year, it only means the depreciation write off may be a little slower, but you will still get the depreciation for whatever amount of money you spend.

There is tremendous flexibility in the amount of expense one can generate with these depreciation rules. However, there are some pitfalls that can catch us if we don’t fully understand the rules of these laws. Consult with your tax advisor to do a detailed estimate, particularly if you have a large amount of capital purchases.

Employee Benefits. This subject has as many management implications as it does income tax, but is one that many farmers overlook because of some of the complications it may cause. There are many benefits that could be considered including health insurance, medical reimbursement plans or flex spending accounts, health savings accounts,

retirement plans, housing, meals, uniforms and more. It is important from a management perspective to start with a total compensation package (i.e., what am I going to pay my employee.) Then determine how it’s going to be paid – cash and benefits. This also should be a mutual determination, with the employee having input. There is also a very great need for the employer and the employee to understand the tax savings of these benefit plans. Most of these items are totally deductible to the employer and are not taxable as income to the employee. That’s what you call a win – win situation. When that understanding is present, the desirability of these plans will increase greatly. As we cover these different items in the next few paragraphs, try to envision how they might apply, to both you as the business owner and also to the employee, as part of a benefits package.

Health Insurance. If the health insurance for the farmer and the family is paid by the farm business, it may be deducted on the Form 1040 in total. The self-employed health insurance deduction is currently 100% of the premium. However, this method of deducting health insurance does not save any self-employment tax. Any health insurance paid for an employee is deductible on the Schedule F and will save self-employment taxes. For certain farm operations, it may be possible to employ the spouse, and give the spouse a benefit of health insurance coverage for the employee/spouse and their dependents. This then covers the employer as a dependent of the spouse and puts the full deduction on the Schedule F. There are no discrimination rules with health insurance, meaning that you do not have to cover all employees.

Medical Re-imbursement Plans. With this plan, you are extending what we discussed with the spouse as an employee and covering the spouse’s dependents, to also reimburse the spouse for all out-of-pocket medical expenses for the couple and their dependents, again covering the employer as a dependent. This benefit is more complex in that there are discrimination rules requiring you to cover all employees that meet certain requirements. You also must have a written plan that is administered by a third party. This will mean an administrative fee will be charged, although they are usually not substantial.

Health Savings Accounts. New for 2004 is a plan utilizing high deductible health insurance plans coupled with a health savings account. The basic rules are that your health insurance must have at least

a \$1,000 deductible for single policies and \$2,000 for a family plan. You may then contribute either the \$1,000 or \$2,000 to a health savings account. This contribution is tax deductible on the Form 1040. Any withdrawal to pay qualified medical expenses that are not covered by your health insurance, are tax-free. Any year you do not need the money in your health savings account it may accumulate until needed during a year of high medical expenses. If the money is never needed for medical expenses, it may be withdrawn when your estate is settled. This is a very basic explanation and a full study of your medical history, along with an examination of health insurance plans available, should be done. This also can be used as part of an employee benefit package, and the employer and the employee may both contribute to the health saving account. Any employer contribution would be deducted on the Schedule F and would not be taxable to the employee.

Retirement Accounts. There has been very little changed in 2004 in regard to retirement account rules other than the increase in limits that was scheduled. Most self-employed taxpayers will be using either regular IRA's, Roth IRA's, Simple Plans, or SEPs. The contribution limits for regular and Roth IRA's are the same as last year. For taxpayers under age 50, the limit is \$3,000 and for those over age 50, \$3,500. This is scheduled to increase to \$4,000 and \$4,500, respectively, in 2005. Remember contributions made to a Roth IRA are not tax deductible when made, but if done correctly, all withdrawals including earnings are tax-free. Also, be aware that if you or your spouse are covered by another qualified retirement plan, you may be limited on your regular IRA contribution. With the higher incomes we are experiencing this year, this may catch some taxpayers not normally affected by this provision.

For Simple Plans, the limit for 2004 is \$9,000 of elective contributions for taxpayers under age 50, and \$10,500 for those over age 50. Those limits are also scheduled to increase by \$1,000 for each age group in 2005. For SEP plans, the contribution limits are much higher. For 2004, 25% of net income as defined, up to a maximum contribution of \$41,000 may be made, along with a catch up contribution of \$3,000 for those over age 50.

Both Simple Plans and SEPs require coverage of all employees that meet certain requirements. These basically apply to employees with more than three years of employment and are not part time

employees. Simple Plans require an employer match of 3% if the employee contributes 3%. The employee and also the self-employed farmer may then also make additional elective contributions until they reach the maximum, with no match required of the employer. SEP plans require the employer to fund 100% of the employee contribution and use the same percentage that they contribute to their plan. For most farmers, the Simple Plan will be the plan that is least costly for covering employees, and at the same time let them contribute a higher amount than an IRA to their account.

One recommendation that I now would suggest is not to make a retirement plan contribution until your tax return is nearly finished. At that time, your tax preparer can discuss with you any limitations or other considerations, and together you can arrive at the level of contribution that would be best for your tax situation.

Other Employee Benefits. The other employee benefits mentioned at the beginning of this section have to be tailored to your individual situation. Some of them may work and others may not. Discuss them with you KFBM specialist or tax advisor. Remember that if there is proper communication with your employees, employee benefits can be that win-win situation for tax savings and a happier employee.

Prepaid Expenses. Farmers are allowed to deduct the cost of supplies and other inputs even if the supplies are used in the following tax year. However, there are some rules that must be followed. First, the prepayment must be for a specific quantity of a specific item. It cannot be merely a deposit or payment on account to be used later. The payment must be for a business purpose. Generally, the amount of prepayment cannot exceed 50% of deductible expenses other than the prepayment amounts. Again, consider the management implications when prepaying and remember that you are only deferring the taxes, not eliminating them. The expense you prepay this December will not be in your 2005 expenses for tax purposes. What will the interest cost be for buying supplies now that you may not use for several months? Also how secure is the dealer you are prepaying?

Another item to consider when prepaying is the method of financing these payments. Generally, the financing cannot be provided by the supplier or a lending subsidiary of the supplier. Also the loans secured from the third party must not be a recourse

loan. In other words, if you don't pay the loan, does the third party lender have recourse back to the supplier for payment? If they do, then it is a recourse loan and a deduction is not allowed for tax until the loan is paid. Special care should be used with some of these new financing options to ensure that we know the type of loan. Often times the supplier may not know what type it is. They only know it is a way to finance your purchase. You may need to call the lending agency and ask them if it is a recourse or non-recourse loan.

The last item to avoid when prepaying is to not use a "cold" or "float check" thereby giving you a negative bank balance on December 31. Often times farmers have given a check for prepay and ask the supplier not to deposit the check until January 2 when they can sell some grain and cover the check. Unless you have a line of credit in place that would cover that check, Internal Revenue would disallow that deduction.

Although we have barely touched many of these income tax topics, we hope to have created an awareness of the issues so that you can then discuss them with you KFBM specialist or tax advisor. Please feel free to contact any of the KFBM specialists with questions about this newsletter or other farm management issues that relate to the management of your farm business.

Coordinator Summary

This completes a little over a year since I became the KFBM program coordinator. It has been different being in this role instead of serving directly with a group of cooperators as I had for so many years. However, as the "vacancy guy", I have had the opportunity to continue to work with some of my former cooperators as well as meet and work with many producers in the Purchase Area and now upcoming in the Bluegrass Area. While I enjoy working with each and every one of you, I also hope the number of vacancies will be zero for the next couple of years. There are many other items that I would like to work on to enhance the information available to the KFBM cooperators and also to all producers in the Commonwealth. All together it has been a good year and I look forward to next year.

I hope this has also been a good year for you. Generally we have had another good crop production year and livestock prices have been better than average. While the weather has not been totally

cooperative with fall harvest, I hope we can all say we have been blessed in many ways.

May each of you have a very Blessed and Merry Christmas and a Happy and Productive New Year.



Craig D. Gibson & Brian D. Lacefield, Editors
Extension Farm Management Specialists

