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# KENTUCKY FARM BUSINESS MANAGEMENT PROGRAM STATE NEWSLETTER

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**Farmers Should be Prepared for Tax  
Time**

*Rush Midkiff and Suzy Martin*

The Holidays are upon us. Farmers have a lot to be thankful for in 2005. In the Western part of the state crops were generally better than expected. Farmers have received tobacco buyout payments, lawsuit settlement money, and phase II payments. Income from the Farm Service Agency, particularly LDP's, has run higher than most producers expected. Many producers carried over an excellent 2004 crop to sell in 2005. Why is all this information important? Many producers could be looking at hefty income tax bills if they fail to plan accordingly.

Some producers are unaware of the tax burden they have created. Many have made wise decisions to use the extra money to pay down debt or make additional investments in their operations. However, not all investments are tax deductible and paying off principle on loans is never deductible on your income taxes.

As producers, you still have time to meet with your tax advisors and do sound tax planning with them. Some of the deductions available to our producers have expired like the special 50% and 30% new equipment depreciation deduction. However, the Section 179 deduction on new and used purchases is still available. The maximum amount, for federal purposes, is at \$105,000 for 2005.

The purpose of this article is to encourage producers to think about tax planning. Is it a sound management decision to pay for some of the 2006 inputs in the 2005 tax year? Is it a good choice to carry over some of the crop to sell after the first of the year? Please do some tax planning prior to the New Year to prevent you from sending money to Uncle Sam that could be used for the higher input costs that are expected in 2006.

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## 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, and 2005 was no exception. Many of the provisions of this year's tax legislation and also those from 2004 legislation that take effect this year are targeted to certain individuals or to stimulate particular industries. Also, bear in mind that there will probably be more legislation in the upcoming years. Good long term tax strategies should be adopted. With the current federal and state budget problems, it is likely that tax legislation will be passed to generate more tax revenue. What groups or industries are targeted here remains to be seen. 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. In much of the discussion to follow, we will not cover all the details of how the tax provision might work, but enough to make you aware of implications it has or the benefits it might offer.

**Tobacco Buyout:** Because we have covered in detail in previous newsletters the tax implications of the buyout, we will only summarize the main points here. Previous newsletters can be found on the KFBM website and also there is much information on the tobacco economics website. Those addresses are: [www.uky.edu/Ag/KFBM](http://www.uky.edu/Ag/KFBM) and the management and budgeting link, [www.uky.edu/Ag/TobaccoEcon](http://www.uky.edu/Ag/TobaccoEcon)

- **Grower Payments:**
  - Ordinary income reported on Sch F
  - Subject to ordinary tax rates from 10% to 35%
  - Subject to self-employment tax of 15.3% if materially participating
  - Not subject to self-employment tax if share landlord
  - Eligible for farm income averaging
  - Taxed over 10 years as received or in year lump sum payout is received
  
- **Quota Payments**
  - Capital asset eligible for capital gains tax rates of 5% or 15%
  - Not subject to self-employment tax
  - Not eligible for farm income averaging
  - Will be taxed as installment sale unless elected out or take lump sum payout.
  - Will have a tax basis that needs to be determined
  - Part of payment will be allocated to interest and taxed as ordinary income

We can not stress too much that proper tax planning relative to the tobacco buyout payments is very necessary. Particularly those who have take or are considering the lump sum payment. Timing of the lump sum may be a strategic part of this. Also, determining basis in the quota may be difficult and time consuming, and this needs to be done NOW.

**Domestic Production Receipts Deduction.** There is a new deduction starting in 2005 for businesses that have income attributable to domestic production and have employees that they pay qualifying wages that are reported on a Form W-2. The deduction is the lesser of 3% of your Qualified Production Activity Income, 3% of your adjusted gross income, or 50% of wages paid in your business and reported on Form W-2 that were subject to withholding. Qualified Production Activity Income for most farmers is Schedule F income subject to some adjustment, and raised breeding livestock sales. This deduction will be an adjustment to income on the front of your tax return and reduce adjusted gross income.

**Energy Credits.** There is a new non-refundable tax credit for costs incurred to improve the energy efficiency of a taxpayer's main home. Eligible expenditures must be made after December 31, 2005 and before January 1, 2008. The lifetime maximum credit per taxpayer is \$500, with lower limits applied to specific items. The credit is based on 10% of the

cost of qualified energy efficient improvements and 100% of the cost of qualified energy property. The taxpayer's basis in the property is reduced by the amount of the credit. These credits are for such items as insulation materials, exterior windows and doors, and certain roofing materials. It also includes energy-efficient property such as geothermal heat pumps, highly efficient central air, and natural gas, propane or oil water heater. However, all these items must meet energy efficiency standards specified in Internal Revenue Code Section 25C. A reputable seller of these items should be able to help you with the qualifications of various items. There are also credits still available for the purchase of certain vehicles that exceed certain standards for fuel economy and clean-air standards. Again, the auto dealer should be knowledgeable of the credit available for each auto.

**Kentucky Tax Modernization.** The Kentucky legislature passed major legislation this past year with most of the changes applying to limited liability companies, limited partnerships, and Sub-S corporations. All of these companies will be taxed as a corporation and pay the tax as calculated. The shareholders will then have a tax credit for their pro-rata share of the tax paid. For many, this may not change much the total tax the family and the business pay, but for others where other businesses have an effect on total income, these changes could result in substantially more tax being paid to Kentucky. There is a minimum \$175 tax for each of these entities that will not pass as a credit to the partner or shareholder. If you have one of these types of business, please discuss the tax implications with your tax preparer. The only break some will get is the corporation license tax, which has been eliminated for Sub C and Sub S corporations.

**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 \$7,300 of taxable income, and for married filing joint, the first \$14,600 of taxable income. These brackets will be indexed for inflation each year until 2010.

The standard deduction for 2005 by taxpayer category:

Single	\$ 5,000
Married filing jointly	10,000
Married filing separately	5,000
Head of household	7,300

**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.

**Accelerated Depreciation Methods.** The so called "bonus depreciation that has been in effect since 09-11-2001 has ended and is **not effective for the 2005 tax year**. The Section 179 or "first year write off" has been increased to \$105,000 for 2005 and will be indexed for inflation in 2006 and 2007. After 2007, it is scheduled to revert back to \$25,000. The first year write-off is reduced for anyone buying more than \$420,000 of qualifying property.

Even though the bonus depreciation has ended, there is still 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 these laws. Consult with your tax advisor to do a detailed estimate, particularly if you have a large amount of capital purchases. Also remember that depreciation is an expense and will reduce the profits of your business. Make sure that the purchase is justified from an overall management perspective before you buy just to save taxes.

**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 Reimbursement 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 in 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 is 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 change in 2005 in regard to retirement account rules other than the increase in limits that was scheduled. Most self-employed taxpayers will be using regular IRA's, Roth IRA's, Simple Plans, or SEP's. The contribution limits for regular and Roth IRA's are the same as last year. For taxpayers under age 50, the limit is \$4,000 and for those over age 50, \$4,500. 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 2005 is \$10,000 of elective contributions for taxpayers under age 50, and \$12,000 for those over age 50. For SEP plans, the contribution limits are much higher. For 2005, 25% of net income as defined, up to a maximum contribution of \$42,000 may be made, along with a catch up contribution of \$4,000 for those over age 50.

Both Simple Plans and SEP's 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 is to not 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 2006 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.

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## **Farm Family Living Costs**

*Suzy Martin and Jennifer Rogers*

It is estimated that production costs will be considerably higher for the 2006 crop year. Farmers should be aware of this and make plans to budget accordingly. However, in addition to increased production expenses, farm families should also budget for increasing family living costs. Kentucky Farm Business Management (KFBM) actual farm data show that sole proprietorships in the state have increased their family living costs every year since 1998. Family living costs for these data include expendables, life insurance, medical, contributions, and capital spending. In 1998 family living costs were \$41,309 while in 2004 they were \$53,675. That is roughly a 4.2% increase per year. It's not just the state of Kentucky; data from other states suggest this increase in farm family living is pretty standard. Illinois Farm Management Program data show a 3% increase from 1998 to 2003, while North Dakota data suggest a 4.9% increase from 1998 to 2004.

It is important to note that these data indicate that even in years where farm income has been lower than average, family living expenses have remained the same or increased. Family living expenses do not typically decrease with lower farm income levels.

While family living costs have increased, the amount of income from non-farm sources has also increased. According to KFBM data, non-farm income in 1998 averaged \$21,796 and in 2004 it was \$36,213. Although non-farm income varies from farm to farm, the impact can be quite large. Those with income from non-farm sources had lower medical costs as the family's health insurance was sometimes subsidized under employer-provided plans. Medical costs during that timeframe have increased by a staggering 9.2%. This can largely be attributed to the sharp increase in self-employed health insurance costs. Additional data from the KFBM Program, Ohio Valley Farm Analysis Group show that a married sole proprietor with no outside employment spent \$7,555 on medical insurance while sole proprietorships with at least one spouse with outside employment spent \$4,413.

In what range should family living costs be for an average farming operation? There are several ways to determine this. One standard suggests that family living costs should be somewhere between 10% and 15% of the business's gross revenue. Thus, an operation with \$500,000 in gross income can use \$50,000 to \$75,000 for family living costs. David Kohl with Virginia Tech suggests another way to see if an operation's costs are in line. Multiply the farm's revenue by 5% and add \$12,500 per operator/manager. So, if you had a farm generating \$500,000 of revenue each year and two operators that lived off the operation, the family living costs should be \$50,000  $\{(500,000 \cdot .05) + 12,500 + 12,500 = 50,000\}$ . Kohl also suggests that if an operation's debt to asset ratio is greater than 50 percent, then the percent of revenue that an operation can use for family living should not be any larger than 10%.

Farmers should seriously analyze their costs for the upcoming year. Not only do they need to manage their production costs, but also the amount of farm earnings that are leaving the operation to fund family living. Keep in mind that higher energy

costs are not only going to affect the farm budget, but will increase transportation and heating costs for the family as well.

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## Coordinator Comments for 2005

*David L. Heisterberg*

One of the recommendations that came from our program review in 2003 was to do an external review of the KFBM program in 2006. We have that process well underway, with the review team members being selected and background documents being prepared for the team members to study prior to coming to Kentucky May 30 to June 2, 2006. Prior to them arriving, you will be sent a survey to complete and return for their use, and you will also be invited to personally meet with the review team if you desire. Agriculture is changing, cooperative extension is changing, and so must the KFBM team change to stay abreast of current technology, etc. That's not to say we won't stay the same in areas that are working and are our strong points. But hopefully this review from people outside the state will let us see how we need to adapt for the future.

We know that one of our major problems right now is keeping qualified specialists employed. While sometimes it has taken awhile, we have been able to hire good specialists. Keeping them has been another matter. In the last year we have experience two unplanned resignations. Fortunately we have been able to hire two new specialists to replace them, and I believe we have hired two very excellent specialists that will, in time, be considered great specialists (if we can keep them)! R. W. Eldridge started work in the Bluegrass in July. R.W. received his BS and MS from the University of Kentucky and is a Franklin County native. Jody Welsh will start in the Pennyroyal in mid-December. Jody received her BS from Virginia Tech and her MS from Purdue. We welcome both of them to our ranks.