



KANSAS FARM MANAGEMENT ASSOCIATION

Your Farm - Your Information - Your Decision

N E W S L E T T E R

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IRAS: TAX DEDUCTIONS THAT MAY APPRECIATE

Some of you will be looking at a marginal Federal and State Income Tax rate of 31% or higher this year. No doubt you will have farm operating and capital expenses that will help manage your overall tax bill. However, choosing to invest in your retirement could also be a good option. This type of asset is designed to **appreciate** over time instead of **depreciating!**

In addition to enabling tax deductions, retirement plans will also help ensure financial security for you and your family. These investments can help diversify your retirement assets. Most producers invest a large portion of their assets back into the farm. This is okay if there is enough cash flow to meet retirement and farm operation needs when the time comes. With the volatility of farm income and expenses, I wouldn't count on the farm cash flow generating enough income for family living expenses during retirement.

There are several types of Individual Retirement Accounts (IRAs) available for this type of investment. The Traditional IRA is tax deductible, but only allows a maximum contribution of \$5,000. The Roth IRA has the same limits as the Traditional, but is **not** tax

deductible. The Coverdell Education Savings Account (CESA) is designed to save for the education expenses of children under age 18. This type of IRA doesn't allow annual contributions to exceed \$2,000.

While there are many more details that explain the Traditional, Roth, and CESA IRAs, I would like to focus on three types of IRAs that would be more likely to fit your needs: the **SIMPLE IRA Plan**, the **Owner-only 401(k) Plan**, and the **Simplified Employee Pension Plan (SEP)**. As you can see in the chart below, each of these plans allows you to invest more than \$5,000 in your retirement account.

As with all financial matters, there is not a blanket strategy that works for every operation. You need to consider your historical tax situation and prospective tax situation before you choose a plan. Then you need to choose asset classes within the plan to offset your investment in your farm operation. You may then have a supplemental source of cash flow when you "retire."

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	SIMPLE	Owner-only 401(k)	SEP
Tax Advantages	- Tax-deductible	- Tax-deductible	- Tax-deductible
	- Tax-deferral on earnings	- Tax-deferral on earnings	- Tax-deferral on earnings
	- Flexible distributions	- Roth 401(k) contributions are after-tax	- Flexible distributions
Features	- \$10,500 maximum yearly deposit, \$13,000 maximum if owner is over 50 years of age	- \$15,500 maximum yearly deposit, \$20,500 maximum if owner is over 50 years of age	- Initial deposit cannot exceed 20% of net income
Advantages	- Low cost, low maintenance	- Flexibility in making contributions	- Flexibility in making contributions
	- No cost to establish (unlike the 401(k) plan)	- Contributions can exceed 25% of compensation	- No cost to establish (unlike the 401(k) plan)
	- Easily reported on Form W-2		

GIFTING COMMODITIES: CHARITABLE AND OTHERWISE

For cash-basis taxpayers, commodities could be a means of conveying a gift with tax savings. By gift, we mean this could be charitable or just to an individual. Whether you are a person that regularly donates to a church, is helping a family member out, or has interest in making a significant community bequest; this article is for you. Do take care to note, there are slight differences with donating to charity versus a non-charitable donee.

Advantage over Giving Cash

The significant advantage of giving a commodity instead of cash is the tax savings. Once the commodity is given away, the gifting taxpayer will not have to claim the income—avoiding income and self-employment tax. A common reaction is that the gifting taxpayer could have taken a charitable deduction anyway. Not necessarily, for individual taxpayers there is the standard deduction to meet before charitable

deductions are utilized. For C-Corporations, there is a charitable deduction limit of 10% of the current year taxable income.

The donor may also be transferring income to a lower bracket taxpayer, such as a child buying their first home or a parent in need of assistance with long term care expense.

Example 1: Joe and Jane Farmer annually donate \$3,000 to their church. They have very few medical expenses, no home mortgage, and always utilize the standard deduction instead of itemizing on their tax return. In 2008, the standard deduction for a married couple is \$10,900. Joe and Jane would have to donate more than the amount of their standard deduction to utilize the charitable deduction.

An alternative would be to donate bushels of grain to the church that might equate to the

\$3,000 cash donation. By donating 300 bushels of a prior year soybean crop still in inventory, Joe and Jane would not have to claim the income those bushels would have sold for. The self-employment tax alone would be a \$423 savings and when combining with income tax, the savings could be \$938—assuming they are in the 15% tax bracket.

Example 2: Joe and Jane Farmer would like to give \$10,000 to their child that is on their own and purchasing their first home. Since Joe and Jane no longer support this child, they don't have to worry about kiddie tax. By giving bushels of last year's crop equating to around \$10,000 to their child; Joe and Jane would avoid claiming the income, but the child would claim the income from the sale. The big difference is that Joe and Jane would have had to pay \$1,413 of self-employment tax on the grain sale as earned income. It would be unearned income treated as a capital gain transaction in the hands of the child, and only subject to normal income tax. Also note that the holding period for the commodity is the planting date of that commodity, so the donee may be eligible for the reduced long-term capital gain rates.

Example 3: A C-Corporation that typically shows \$25,000 of income each year and already donates \$2,500 each year to charity, would like to help sponsor a large community project and donate an extra \$5,000 in the current year. Because C-Corporations can only deduct 10% of their taxable income in the form of charitable deduction, their normal donations would fill that deduction. The extra donation would have to be carried forward to future tax returns.

An alternative would be to assign the number of bushels equating to the extra donation wish to the charity. The charity could then sell the bushels and the C-Corporation would not claim the income.

Who Can and Cannot Benefit

Any cash-basis farmer or rancher who actively

raises a commodity could benefit from gifting commodities. In contrast, crop-share landlords and accrual basis farmers and ranchers do not reap a tax benefit from gifting commodities.

Mechanics of How to Make a Gift

There are two steps that must happen to ensure transfer of ownership before the grain is sold. The **first step** is to gift the commodity with evidence that the **title of the commodity was transferred**. The **second step** involves the **donee selling the commodity**. The donating taxpayer should have no involvement in the sale of the commodity or direction of the income once the ownership has been transferred. If the commodity is transferred and sold on the same day, it increases the likelihood IRS will call it a sham transaction, because it is the same as giving cash. It is suggested that the donee hold the commodity for at least 10 days after the transfer.

For entities making charitable gifts and individuals making non-charitable gifts, the commodity should be sourced from a **prior year crop**, in which all expenses against it have been deducted. For charitable gifts from sole-proprietor agriculture producers, the commodity can be of current year crop and expenses against the crop can be deducted as normal on Schedule F according to Reg. 1.170A-4(c)(4).

For individuals making a non-charitable gift of more than the annual gift exclusion, currently \$12,000 per donee, a *U.S. Gift Tax Return* should be filed by the donor.

Why Grain is better than Livestock

Gifting raised grain is much cleaner than raised livestock. Once ownership is transferred, grain does not require the maintenance that livestock does. The donee receiving the livestock should pay for any post-gift maintenance expenses for the livestock. But, there is a risk that this could be considered material participation in caring for the animals, creating a circumstance that the sale of the animal would be subject to self-employment tax for the non-charitable donee.

How Kiddie Tax may Impact the Donee

Any child who is under the age of 19 or a full-time student between the ages of 19 and 23 is subject to kiddie tax when they have more than \$1,700 of unearned income. An exception applies when they provide more than half of their own support with earned income. Kiddie tax charges the parent’s highest marginal tax rate on the unearned income. So the key here would be any commodity gift combined with any other unearned income to someone in this age range should not be worth more than \$1,700.

Key Take-Homes

In conclusion, keep in mind the following bullets when gifting commodities.

- Should be a cash-basis agriculture producer
- Non-charitable gifts should be commodities raised in the prior tax year

- Ensure that ownership is transferred to the donee prior to sale
- Ensure that the donee controls how and when commodity is sold
- Crop-share landlords should not gift commodity sourced from rental activities
- Grain contributions are much easier to perfect than livestock
- Watch out for Kiddie Tax rules when gifting to children
- Could be beneficial to all entity types, not just individuals

As always, be sure to double check that this article is applicable to your situation with your tax preparer or KFMA economist.

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CREDIT QUALITY OF KANSAS FARMS

This article discusses trends in credit quality and the current distribution of credit quality ratings for farms participating in the Kansas Farm Management Association program. Using financial ratios briefly described below, the probability of default for each farm from 1973 to 2007 was computed and summarized.

In modeling credit risk, financial institutions rely on many measures, including liquidity ratios, profitability ratios, repayment capacity, firm size, and other business performance measures, along with non-economic measures such as character. Typically, a financial institution will give ratings to firms similar to that of a bond index such as the Standard and Poor’s (S&P) which, from best to worst, is AAA, AA, A, BBB, BB, B, and CCC.

Using previous research, the probability of default for this study was computed using the

following equations:

$$(1) dv = -2.3643 - 0.00135 CDRC - 0.0217 OE - 0.00399 WC$$

$$(2) \text{probability of default} = \frac{\exp(dv)}{1 + \exp(dv)} * 100$$

where *dv* is the dependent variable for the credit scoring regression, *CDRC* represents capital debt repayment capacity, *OE* represents owner equity percentage, and *WC* represents working capital percentage. The capital debt repayment capacity (*CDRC*) variable was computed using information on repayment capacity, estimated principal and interest payments on term loans, working capital, and capital asset replacement. The working capital percentage (*WC*) variable was computed by dividing working capital by gross farm income. The relatively large absolute value on the coefficient for *OE* in equation (1) suggests that this variable is an important determinant of the probability of default.

Average ratio values can be used to illustrate how the probability of default was computed. The average values for CDRC, OE, and WC in 2007 were 126%, 71%, and 34%, respectively. Substituting these values into the equations above would result in a probability of default of 1.46%. Because the distribution of ratings is skewed, the probability of default using the average ratio values is lower than the average rating per farm in 2007 (2.03%).

Table 1 provides credit quality mapping information. This mapping is used to examine the trends in credit quality and the current distribution of credit quality among farms below.

Figure 1 presents the probability of default for Kansas farms. The graph also illustrates the range of ratings for the B, B+, BB-, and BB rating categories. In 1973, the average rating was BB. From 1974 to 1979, the average rating was a BB-. For most of the next three decades, the average rating was B+. However, the average rating from 1984 to 1986 and for 2002 was a B. It is important to note that the probability of default in 2007 was the lowest it has been since 1979. Also, it is important to note that the probability of default can change rapidly. For instance, the probability of default went from a BB- rating in 1979 to a relatively low B+ rating in 1981.

The current distribution of credit quality for Kansas farms is presented in Table 2. A majority of the farms are rated BB-, BB, or BB+. However, approximately 9.5% of the farms are rated BBB- or higher. The remaining farms are rated "B" or "CCC". Firms with a "B" rating are typically assumed to have the capacity to meet credit obligations. However, adverse conditions could impair their ability to meet credit obligations. Firms with a "CCC"

rating are vulnerable to nonpayment. Ability to meet credit obligations for these farms depends heavily on business and economic conditions.

Credit ratings, such as those presented in this article, are important for a couple of reasons. First, it is useful to track a credit rating for an individual firm or group of firms over time to ascertain their ability to handle adverse conditions. Second, interest rates can vary substantially depending on a firm's credit rating. For example, using the bond market, the estimated difference in 30-year interest rates for a firm with a B and BB rating is 1.7%. Specifically, the firm with a B rating would have an estimated interest rate that is 1.7% higher than that of the firm with a BB rating. It is important to note that this difference in interest rates may not apply to production agriculture. However, at least some difference in interest rates would be expected for farms with these ratings.

As mentioned in previous newsletters (e.g., February 2008 newsletter article on benchmarking), profitability, measured using the net farm income ratio, profit margin, or similar measures, can vary significantly among farms. Individual farms are encouraged to benchmark their profitability measures with other producers in their association. Financial performance and credit ratings can also vary by farm size and type. A future newsletter article will document differences in financial performance and credit ratings by farm size and type.

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Table 1. Credit Quality Mappings.

S&P Rating	Probability of Default Range
AAA	(0.00, 0.02]
AA+	(0.02, 0.03]
AA	(0.03, 0.04]
AA-	(0.04, 0.05]
A+	(0.05, 0.07]
A	(0.07, 0.09]
A-	(0.09, 0.14]
BBB+	(0.14, 0.21]
BBB	(0.21, 0.31]
BBB-	(0.31, 0.52]
BB+	(0.52, 0.86]
BB	(0.86, 1.43]
BB-	(1.43, 2.03]
B+	(2.03, 2.88]
B	(2.88, 4.09]
B-	(4.09, 6.94]
CCC+	(6.94, 11.78]
CCC	(11.78, 14.00]
CCC-	(14.00, 16.70]

Source: Lopez, J.A. "The Empirical Relationship Between Average Asset Correlation, Firm Profitability of Default and Asset Size." Federal Reserve Bank of San Francisco Working Paper, June 2002.

Figure 1. Probability of Default for Kansas Farms

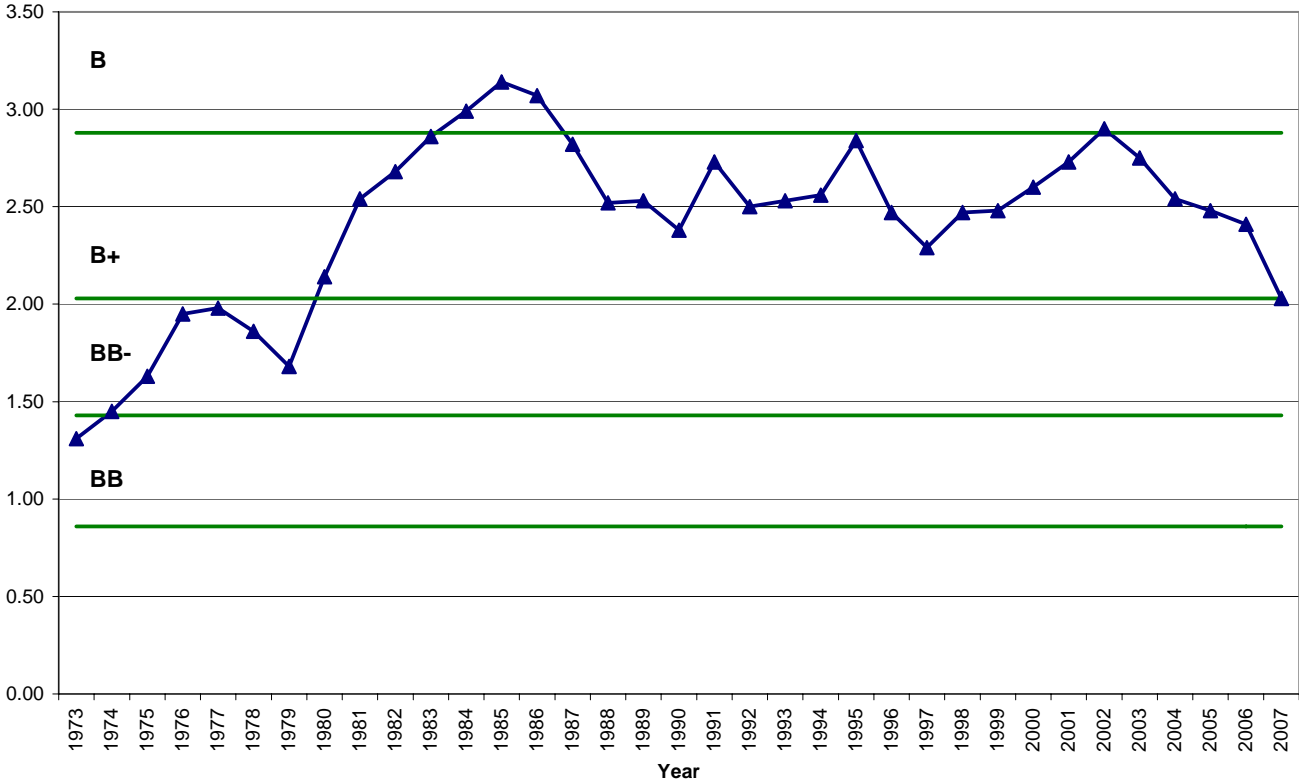


Table 2. Distribution of Credit Quality for Kansas Farms.

S&P Rating	Percentage of Farms
BBB+	0.0%
BBB	0.6%
BBB-	8.9%
BB+	21.1%
BB	20.9%
BB-	14.3%
B+	13.4%
B	9.6%
B-	7.8%
CCC+	3.0%
CCC	0.3%
CCC-	0.1%

The Kansas Farm Management Association (KFMA) Newsletter is distributed monthly to provide farm management information to farm decision makers. Further farm management information can be found on the KFMA program website: www.kmar105.com/kfma; and, on the Extension Agricultural Economics website: www.agmanager.info. The Newsletter is edited by Michael Langemeier, Professor, Department of Agricultural Economics, Kansas State University.



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