



KANSAS FARM MANAGEMENT ASSOCIATION

Your Farm - Your Information - Your Decision

N E W S L E T T E R

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SOCIAL SECURITY REVISITED

In these times of stock market and overall economic turbulence and uncertainty, it is as important as ever that we have a solid understanding of our Social Security program and the potential benefits to be earned through it. Also, it is extremely helpful to have at least a basic knowledge of how Social Security's benefits are calculated. For most retirees Social Security provides a substantial retirement benefit, and potentially survivors' and spousal benefits as well as disability protection.

History

Created in 1935, Social Security was never meant to be a "stand alone" retirement plan. It was to serve as a foundation for a comfortable retirement. In other words, the program was designed to be a base layer of retirement funding, not as the only source. It has undergone much change since 1935, developing into a multi-faceted program. In 1939, survivors' benefits were added, allowing decedents' heirs to receive some assistance as well. The next major change to the program occurred in 1956, when disability protection was added. Later, Medicare was established as a companion program in 1965, supplying medical coverage for those 65 and older. The last major change in either Social Security or

Medicare **was** the creation of Medicare's Part D prescription drug benefit in 2003.

U.S. Demographics Working Against Social Security

A key feature of Social Security is that current workers are paying in tax dollars to provide the benefits for current retirees, survivors, and disabled individuals. Although one's personal employment history provides the values for calculating that same individual's potential retirement, survivor, or disability benefits, a separate and distinct account for each individual is not established. Therefore, the number of current workers per Social Security beneficiary is an important factor in the ability of the program to continue fully paying benefits. In 1960, five workers were paying into the system for every beneficiary drawing out payments. Currently, that ratio has dropped to three workers per beneficiary, and by 2030, only two workers will be providing all the benefits being paid out to each recipient.

Another demographic feature of the United States challenging the solvency of Social Security is an aging population. In 1946 only seven percent of the U.S. population was 65 years or older and therefore in position to receive retirement benefits through Social Security at the program's full retirement age. Currently, 12 percent of the population is at least 65, and by 2030 that number is projected to rise to a full 20 percent. As a matter of fact, men turning 65 this year can expect to live—and therefore draw Social Security benefits—another sixteen years; women another twenty years.

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Changing U.S. demographics have stressed Social Security and have created the need to make changes in the program in order to ensure its long-term success. To that end, the full retirement age was increased to 67 (from 65) and is presently being phased in over several years. However, more changes will be necessary, as the Social Security Trust Fund is projected to be fully depleted by 2041. Obviously, the changes would be either a reduction in one or more of the benefits, an increase in the tax rate, an increase in the income amount on which taxes are collected, or a combination of these.

The fact that Social Security benefits being paid out are funded by current workers means that—even after the Trust Fund is fully depleted—tax dollars will continue to be available for payment of benefits. However, they will not at that time be enough to cover the full program. It is projected that 78 percent of benefits will be able to be funded after 2041. In other words, even if no changes are made to the program, Social Security benefits could still be paid out at a 78 percent level. Given that, you can be rest assured that Social Security—or something similar—will be there for you when you reach retirement age. The benefit may just be 20 – 30 percent lower than today’s levels unless changes are made before then.

Values Used in Calculating Your Retirement Benefit

As mentioned earlier, wages earned over your lifetime form the basis for calculating your Social Security retirement benefit. However, the method for calculating the benefit is often misunderstood. Your lifetime wages are first adjusted for changes in average national wage levels (i.e. wage inflation). After this, the **highest 35 years** are utilized in arriving at your retirement benefit. The important thing to note here is that the timing of your high earning years does not matter. Many people believe that paying more Social Security taxes later in life carries more weight than doing so when they were younger. This is not so. After accounting

for wage inflation, every year carries the same weight regardless of when it occurred and your 35 highest earning years are used.

Disability Insurance

Social Security also provides disability benefits for those qualified who suffer a disabling injury that either prevents them from working for at least a year or is expected to result in death. Make note that the disability must prevent work for an entire year, not just six months, as many private disability insurance policies require. To qualify for Social Security’s disability protection, one must have paid Social Security taxes that have earned at least 20 “credits” in the last 10 years. The amount of wages or self-employed income necessary to earn a “credit” is indexed for inflation annually, and in 2008 is \$1,050. The maximum number of “credits” that can be earned per year is four. This would occur in 2008 if you have at least \$4,200 in wages or self-employed income (or a combination thereof).

It is extremely important that self-employed farmers understand this provision. As net farm income is volatile by nature, some years result in a net loss on Schedule F of the farmer’s tax return. Without any extra attention to this issue, no Social Security tax will be paid and therefore no “credits” will be earned. While this may sometimes be part of the tax management plan in a low income year, a determination of eligibility for Social Security disability should be completed by you and your income tax preparer. In a loss (or very low profit) year, a self-employed farmer can elect to use an optional method for calculating self-employment (i.e. Social Security and Medicare) tax. This results in a small amount of Social Security tax to be paid. The main reason for doing so would be to maintain (or gain) eligibility for disability protection. A point of caution bears mentioning here. In recent years, using the optional method to calculate self-employment tax would only have earned the taxpayer one single “credit.” Again, you need at least 20 “credits” earned over the prior ten years

for disability protection. A provision to change the optional method for calculating self-employment tax was included in this year's Farm Bill. It allows for the earning of four full "credits" each year this optional method is elected. Also, thankfully, it is now indexed for inflation, so the taxpayer electing this method in the future will continue to earn four "credits" as well. If you have a loss on Schedule F, make certain you communicate with your tax preparer regarding this provision and ascertain your eligibility for Social Security disability protection.

The Online Retirement Estimator

The Social Security Administration (SSA) currently sends a summary of Social Security and Medicare taxes paid, lifetime earnings, and projected benefits a couple months prior to your birthday. Examine this document, checking for errors and taking note of your potential benefits. Recently, SSA began allowing individuals to go to SSA's website (www.socialsecurity.gov) and generate this same information at any time. All you need is your name, date and place of birth, Social Security number, mother's maiden name, and last year's earnings that were subject to

Social Security tax. This section of the website, called "The Online Retirement Estimator," presents your projected retirement benefits at age 62, at your full retirement age, and at age 70. You can also adjust the age at which you will stop working as well as your future earnings levels and view the corresponding results.

Summary

A financially safe, secure retirement requires significant resources and Social Security can provide a good portion of that for you, while also supplying some disability insurance along the way. It is extremely valuable to be knowledgeable about Social Security and be aware of the amount it can provide you in retirement or in the event of your disability. By being proactive and understanding the basics of Social Security and how your benefits are calculated, you will be able to make some well-informed decisions regarding retirement, taxes, and disability insurance.

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IS YOUR PRE-PAID EXPENSE REALLY PRE-PAID, AND MORE IMPORTANTLY, DEDUCTIBLE?

As volatile as this year has been, many farmers are doing things a little differently this fall. Pre-paying expenses for the following year's crop before the current crop is out of the field is becoming more common. Price discounts and reasonable interest rates make pre-paid expenses more of a financial decision than just a tax planning strategy. But, if you do plan on deducting a pre-pay expense for next year's crop on your current tax return, be sure that it is paid for properly.

If an expense is financed through a promissory note with the supplier, it is not deductible until the note is paid, per Rev. Rul. 77-257. What is not clear is if one finances the purchase through a lender owned by the supplier whether or not it qualifies as a pre-paid expense. Some could argue that they are separate entities, but others could counter that ownership is the same for both entities and not separate. See table 1 for different pre-payment options and tax deductibility.

Table 1: Pre-Paid Expense payment options

Payment Option	Tax Deductible as Pre-Paid Expense?
Cash	Yes
Financed through 3 rd party lender	Yes
Financed through supplier's wholly-owned subsidiary	?? - No No definite IRS ruling
Financed directly with supplier	No

Some classic examples of pre-paid expenses that are commonly financed with suppliers are:

- Seed
- Commercial feedlot bills

- Feed supplement

Basically, if you are planning on deducting a pre-paid expense for the current year, make sure it is paid for with cash or financed through a third party lender that is distinct from the vendor.

For a further refresher on pre-paid expenses check out the December 2007 KFMA newsletter.

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PURCHASING EQUIPMENT FOR TAX SAVINGS – DOES IT MAKE SENSE?

During November and December, most of your Economist's time is spent with year end tax planning for members. It is one of the most valuable services provided to our members and for me it is one of the aspects of the job that I really enjoy.

In 2007, net farm incomes were relatively high, and in many parts of the state, there is the potential for high net farm incomes this year due to the relatively high crop prices experienced earlier in the year. One common comment from my producers that are facing higher than expected incomes is, "I owe that much in taxes? I need to go buy a tractor." My typical response is, "Do you need a tractor?" With the section 179 deduction that allows for the expensing of most farm equipment in the current tax year, there is a large incentive to buy equipment to reduce a producer's tax liability. However, if you are buying a piece of farm equipment that you really don't need, then it just might be cheaper to pay the taxes.

Table 1 illustrates two taxpayers, one with income in the upper end of the 15% federal

income tax bracket and the other with income in the upper end of the 25% federal income tax bracket. The left side of the table illustrates the total federal and state income tax liability for both taxpayers, including federal self employment tax, before the purchase of a \$50,000 piece of farm equipment. The right side shows the total federal and state tax liability following the purchase of \$50,000 in farm equipment. The entire purchase price was expensed using the section 179 deduction instead of being depreciated over seven years.

The 15% taxpayer had a savings of \$16,847 in total tax liability, while the 25% taxpayer saved \$17,187. In both of these cases, the difference in tax liability was substantially less than the \$50,000 purchase price of the equipment. In other words, the government takes some of your profits, but they don't take all of them.

But this is not the end of the cost you incur when purchasing equipment to lower the tax bill. Many producers would borrow the money to purchase the equipment. Assuming a 20% down payment and 8% interest, the producer

would be borrowing \$40,000 for five years. Figuring simple interest, the first year cost of borrowing the money would be \$3,200.

Purchasing unnecessary equipment also increases you're per acre equipment cost, making you less competitive with neighboring operations. For example, if you farmed 1,000 acres, assuming a seven year life in the equipment, you're per acre machinery and equipment cost would increase by \$7.14 per acre using straight line depreciation. Thus, buying equipment just to save on taxes could put you at a competitive disadvantage when trying to purchase or rent new ground, as other operators with lower per acre costs could afford to pay more for the same land.

There is also an opportunity cost associated with asset purchases. Once you spend \$50,000 on something, it is gone. It could have been used

to pay down debt or to purchase items that were actually needed in the operation.

The purpose of this discussion is not to convince you not to purchase equipment. If equipment needs to be replaced, or would otherwise make the operation more efficient, then by all means purchase it, and you and your Economist can use the purchases to your advantage from a tax standpoint. However, purchasing equipment just to decrease your tax liability does not make economic sense, as it is cheaper to pay the taxes, particularly given that the other costs associated with the purchase may make you less competitive. And as always, these examples are to illustrate principles, be sure and consult your Economist or tax advisor when exploring the tax ramifications of any purchase.

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Table 1. Comparison of Tax Liability Before and After \$50,000 Equipment Purchase

	Before \$50,000 Equipment Purchase		After \$50,000 Equipment Purchase	
	15 % Taxpayer	25% Taxpayer	15 % Taxpayer	25% Taxpayer
Net Farm Income	\$89,000	\$157,000	\$39,000	\$107,000
Adjusted Gross Income	82,712	148,574	36,245	99,441
Federal Taxable Income	64,812	130,674	18,345	81,541
Federal Tax Liability	21,495	42,209	7,460	28,191
State Tax Liability	3,713	7,961	901	4,792
Total Tax Liability	25,208	50,170	8,361	32,983
15% Taxpayer Savings	\$16,847			
25% Taxpayer Savings	\$17,187			
Purchased Equipment Cost	\$50,000			

KFMA PAYROLL MANUAL

For those of you hiring employees for the first time or even long-term employers looking for a refresher, the Kansas Farm Management Association now has a payroll manual. The manual is entitled *We are Hiring an Employee, Now What? A Guide to Agricultural Payroll in Kansas* and is available upon request from your Farm Management Economist. The manual

includes how to calculate a paycheck, payroll associated forms, payroll depositing, and a brief section on employee benefits. To receive a copy, ask your local Farm Management Economist for a PDF or printed copy.

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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.agmanager.info/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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