KENTUCKY FARM BUSINESS MANAGEMENT PROGRAM

STATE NEWSLETTER

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Inside:

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Farm Asset Depreciation Changes for 2018

Rush Midkiff

The Tax Cuts and Jobs Act of 2017 (TCJA) has changed how farm producers depreciate assets. Under the old law, new (brand new, never been used) farm equipment was classified as 7-year property. Now, new farm equipment is classified as 5-year MACRS property. Used farm equipment is still classified as 7-year property.

Under the old law 3, 5, 7, and 10 year farm property was depreciated at 150 % declining balance. Now, under TCJA 3, 5, 7 and 10-year farm property will be depreciated at 200 % declining balance. This allows the farm producer to get depreciation at a faster rate. Farm assets in the 15 and 20-year MACRS recovery classes remain at 150 % declining balance method.

The TCJA has increased Section 179 deduction to $1,000,000 in 2018 for qualified property. Section 179 expense deduction is reduced dollar for dollar if the cost of qualifying Section 179 property placed in service in 2018 is over $2,500,000. If qualifying Section 179 property is greater than $3,500,000 farm producers cannot take Section 179 expense deduction.

The total amount of Section 179 deduction farm producers can take on sports utility vehicle (SUV) placed in service in 2018 is $25,000. Vehicles must be rated at more than 6,000 pounds gross vehicle weight but not more than 14,000 pounds gross vehicle weight. This is for SUVs used for farm business purposes.

Special Depreciation Allowance (Bonus Depreciation) for farm assets placed in service in 2018 are eligible for a 100% depreciation allowance. This rate will stay in effect thru 2023. In the past only new (brand new, never been used) items were eligible for Special Depreciation Allowance.

Now, both new and used assets are eligible. Special Depreciation Allowance is not an election. If you do not plan to use Special Depreciation Allowance you must elect out of it on a class by class basis.

The tax changes that have been enacted in the Tax Cuts and Jobs Act of 2017 are some of the biggest changes to our tax code since 1986. Farm producers should consult with their tax advisors to see how the law will affect them and their farming operations.

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Tax Law Changes for Traded Items

Suzy Martin

In the past, personal property that was used as a trade-in on a purchased item was treated as a "like kind" exchange. The Tax Cuts and Jobs Act changed the wording to accommodate only real property as eligible for like kind exchanges. Starting in 2018, personal property (i.e., equipment and livestock) will be treated as being sold when a trade occurs. This could potentially have both good and bad consequences.

For example, let's say you have Tractor A that you plan on purchasing. The full cost of Tractor A is $150,000. You are going to trade Tractor Z in and the trade allowance is $70,000. Under the old law you would not report the sale of Tractor Z, it would continue to depreciate out and be marked as a traded item on your asset schedule. Meanwhile, Tractor A would be put on your depreciation schedule with a cost (basis) of $80,000 ($150,000-70,000.)

Under the new law, Tractor Z will be sold for $70,000. If there is any cost left to depreciate then that will reduce the amount of gain or recapture on Tractor Z. Tractor A will be put on the depreciation schedule at $150,000 cost (basis.)

The sale of equipment and livestock is reported on a Form 4797 on the income tax return. The sale generally results in gain being reported as recaptured depreciation (taxed at ordinary income tax rates) or capital gain (taxed at capital gain rates.) Neither of which are subject to self-employment tax. Let's assume that Tractor Z was depreciated out, the entire sales price of $70,000 would be income reported on the Form 4797, under the new law.

The entire cost of $150,000 of Tractor A is available for depreciation on your Schedule F (farm income and expenses.) Most likely some combination of depreciation allowances like Section 179 and/or Bonus Depreciation will be used to get the Schedule F to the net amount preferred.

Keep in mind that the goal of tax planning is not to avoid taxes but rather to be consistent in the income tax brackets and avoid large swings in income levels from one year to the next. Continuing the example above, let's assume the taxpayer has no other means of income and generally keeps the amount of adjusted gross income in the area of $75,000. The gain on the sale of the tractor was $70,000 on the Form 4797. Ideally, the taxpayer would then have a Schedule F net income of $5,000 to be consistent on the overall amount of adjusted gross income. Remember, self-employment tax is only on earned income such as the schedule F and not Form 4797.

On the positive side, taxpayers could pay less in self-employment tax than they have in previous years. In the example, the taxpayer is paying self-employment tax on $5,000 rather than $75,000. The flip side of that argument is that taxpayers need to keep in mind that paying less (or zero) amounts of self-employment tax could have a negative impact of future retirement earnings or even qualified quarters for disability payments.

Another factor to consider is the difference between federal and state depreciation laws. Kentucky has limited the Section 179 deduction to $25,000 and the deduction gets phased out if the equipment purchases are greater than $225,000. Kentucky also does not allow for bonus depreciation. This means that there will likely be substantial differences in gain between the Kentucky and federal income tax returns.

Taxpayers will need to let their tax preparers know when items have been traded and how much was allowed on the trade in. As always, taxpayers need to plan ahead and visit with their tax preparers before the end of the year to avoid any surprises when they file their returns.

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Ag Trade Update

Will Snell, Kenny Burdine, Todd Davis

Trade continues to be a hot political (and economic) topic for U.S./Kentucky agriculture during fall harvest and the upcoming mid-term elections. Despite all the trade rhetoric this past year, coupled with a strengthening U.S. dollar, USDA is projecting U.S. agricultural export value to increase 3% in FY 2018 (+ $4.3 billion to $144.5 billion) on the heels of strong corn (+14%), and meat exports (beef +16%, poultry +8%, dairy +5%) and pork (+3%) exports, offsetting lower soybeans exports (-7%). Trade accounts for approximately 1/3 of the value of U.S/Kentucky agricultural production so trade tensions/losses are a real concern, especially in a depressed farm income/price environment.

What about the U.S. Mexico, Canada Trade Agreement (USMCA)?

U.S. agriculture welcomed the news of the recent trade agreement between the United States, Mexico, and Canada. Mexico and Canada have consistently been among the top three foreign markets for U.S. agriculture. Under NAFTA, tariffs for most agricultural commodities/products were reduced to zero, which propelled U.S. ag exports to our southern and northern neighbors to increase from less than $9 billion prior to NAFTA's passage in 1993 to nearly $40 billion in recent years. Collectively, Mexico and Canada represent the largest export market for U.S. corn, wheat, beef, poultry, and pork and accounts for nearly 30% of total U.S. agricultural exports.

In reality, the USMCA (if ratified) will not likely result in a significant boost in U.S/Kentucky ag exports to Mexico and Canada in the short-term, but the agreement may offset the fears of these neighboring markets seeking alternative suppliers amidst the trade dispute, and thus prevented an erosion of exports to this important trading region if the trade tensions had lingered. Under USMCA, most agricultural tariffs established under NAFTA will remain at zero, but the retaliatory Canadian tariffs placed on some U.S. beef products and the Mexican tariffs placed on U.S. pork (among other ag products) remain in effect. The latter is pretty significant as nearly one-third of US pork exports go to Mexico. Still USMCA may be a step towards removing these retaliatory tariffs on U.S. meats and other U.S. ag products. In general, pork markets are more heavily impacted by trade barriers as a much larger share of our domestic pork production is exported than our domestic beef production. In 2017, 22% of U.S. pork production was exported, while around 11% of U.S. beef production was exported.

The United States will see some additional access to Canadian dairy markets under USMCA, but Canada's dairy supply management system largely remains. In addition to dairy, the USMCA will bring about additional access for U.S. poultry/eggs, and wines entering Canada. The USMCA should preserve important grain and oilseed markets. USDA-FAS data ranks Mexico and Canada as the first and third largest importer of U.S. grains and feedstuffs, respectively. Similarly, Mexico and Canada are the second and third largest importer of oilseeds. The agreement should open the Canadian wheat market to the U.S. as the Canadian system graded U.S. milling quality wheat as feed grade in Canada. The agreement also provides science-based sanitary and phytosanitary (SPS) measures to address agricultural biotechnology and gene editing to reduce SPS imposed trade barriers, which U.S. trade officials hope is a model for future trade agreements.

U.S. agriculture now awaits how retaliatory tariffs recently applied to U.S. ag goods in these markets will be handled, as well as the legislative approval of the agreement among the three nations. Presently, it appears the U.S. Congress will not vote upon USMCA until early 2019.

What about China and other Trading Regions?

The trade relationship with China remains tense with the United States currently applying tariffs on $250 billion of goods entering from China, roughly half the value of all Chinese goods sold to the United States last year. China has countered with tariffs on over $100 billion of U.S. goods (mainly ag products). Just two years ago, China had overtaken Canada and Mexico as the number one destination for U.S. ag exports, but will likely slip to fifth position in 2018, behind Canada, Mexico, Japan, and the European Union. Through August, U.S. ag exports to China were 21% lower compared to a year ago, primarily due to soybean exports being off 34% from 2017 levels. The White House indicates that President Trump will meet with Chinese President Xi next month at the G-20 summit in Buenos Aires, Argentina to discuss their trade differences.

In other trade news, it appears that the U.S. will be pursuing trade discussions with the EU, Japan, Philippines, and the United Kingdom. Improved access to the Japanese market was one of the biggest opportunities for U.S. agriculture lauded in the Trans Pacific Partnership (TPP), prior to the U.S. pulling out of the TPP in the early days of the Trump administration. Earlier this month, the Trump administration officially informed Congress that it intends to begin negotiations with Japan on a bilateral free trade agreement, which could be a boost for U.S. meat, dairy, and grain exports. Japan has historically been a top five export market for U.S. agriculture. Despite relatively high tariffs, Japan is the largest export market for U.S. beef. Under TPP, tariffs on U.S. beef would have been reduced to 9% over time compared to the current level of 38.5%. Current tariff levels provide a competitive advantage for Australian beef, which under a recent free trade agreement enjoys a much lower tariff structure entering Japan than U.S. beef.

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The New Qualified Business Deduction

Laura Powers

The Tax Cuts and Jobs Act of 2017 introduced a new deduction for most businesses, beginning with the 2018 Tax Year. This deduction applies to sole proprietorships, partnerships, and S corporations. It does not apply to C-corporations. Simply stated, this Qualified Business Income (QBI) deduction allows for these types of businesses to deduct up to 20% of net business income (with caveats) from their taxable income. While the concept of this deduction is simple, there are many conditions and thresholds that the taxpayer must consider, especially for tax planning purposes.

The taxpayer must first determine what income qualifies for the deduction. As the title indicates, the income must be considered by the IRS to be that from a "trade or business". Not all income is derived from a trade or business. For example, capital gains (and losses), wages, salaries, guaranteed payments for services, and non-business interest income are excluded from QBI. Recaptured depreciation of farming equipment is included in QBI. Rental income must be evaluated more closely to determine its status as QBI. In order for income of farm rental activities to be considered QBI, it must be conducted regularly and with a profit motive, from the IRS's point of view. Cash rental arrangements will likely not be considered QBI. Crop-share arrangements are more likely to be considered QBI if the landowner shares in the cost of inputs and has some involvement with the management of the farming activities.

The QBI deduction calculation varies depending on the total taxable income of the taxpayer. If the taxpayer's income is less than $315,000 (Married Filing Jointly) or $157,500 (Single), then their QBI deduction is simply the lessor of 20% of their QBI or 20% of their net taxable income. There is an upper taxable income threshold ($415,000 MFJ and $207,000 Single) at which the deduction is limited based on W-2 wages paid and unadjusted basis of qualifying property. If taxable income is between the lower and upper thresholds, the W-2 wage and property limitations are phased-in. So if a farmer has taxable income of $415,000 or higher, has no employees and has no qualifying property, they will have no QBI deduction (unless

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Upcoming Events

Ohio Valley Analysis Annual Meeting	Nov 20
Purchase Farm Analysis Annual Meeting	Nov 26
Pennyroyal Farm Analysis Annual Meeting	Nov 26
KFBM Winter Board Meeting	Dec 6
Henderson Lender's Conference	Dec 12 (PM)
Mayfield Lender's Conference	Dec 13 (AM)
Hopkinsville Lender's Conference	Dec 13 (PM)
Lexington Lender's Conference	Jan 31

they sell grain to a cooperative that distributes their share of QBI). Additionally, if income is derived from a Specified Service Trade or Business (e.g. law, accounting, financial services) and taxable income is above the higher threshold, then there is no QBI deduction for that type of income.

Special QBI rules apply if a farmer sells grain to a cooperative. As it is likely that the cooperative will distribute their QBI deduction on to their patrons, the farmer reduces their QBI deduction by the lessor of 9% of their co-op related net business income or 50% of their W-2 wages related to their co-op business income. Keep in mind that while the farmer is reducing their QBI because of their business with a cooperative, they may also receive an additional deduction to add to the farmer's share of QBI deduction, similar to the old DPAD deduction.

There are many steps, thresholds, and limitations that must be considered when determining the QBI deduction for the taxpayer. For more information, please meet with you Farm Business Management Specialist or tax advisor.