

Is It Time to Start Thinking About Long-Term Marketing Contracts?

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With the painfully low hog prices experienced so far this year, it may be more than you can handle to read about long-term marketing contracts. Coupled with the closing of Thorn Apple Valley's kill floor in July 1998, producer concerns regarding market access and price are being elevated to increased levels of awareness. But awareness can also be viewed as opportunity -- in fact, in Chinese, the words for crisis and opportunity are the same. Therefore, while concentrating on cash flow and production measures over the next year will be critical to your operation, thinking today about your desired marketing strategy may help position your operation for the future, also.

Consider the trend in long-term marketing contracts (Figure 1). In 1993, long-term marketing contracts accounted for 11 percent of the hogs supplied to packers. In 1995, nearly 40 percent of the U.S. hogs were marketed this way. Last year, approximately 57 percent of the 1997 U.S. market hog production was sold under some form a marketing agreement, including futures contracts and long-term packer marketing contracts. Estimates place the 1998 figure at more than 60% -- this implies that less than 40% of all market hogs will be sold as spot market purchases. But just looking at the aggregate data may be somewhat misleading. To truly understand what is going on with marketing contracts, we need to take a look at the types of contracts used and who is using them.

At a very basic level, a marketing contract simply specifies that a producer agrees to sell a specified number of animals or percentage of production to a buyer for a predetermined price at some point in the future. For instance, a CME lean hog futures contract is a marketing contract. It may even be considered as a long-term contract since delivery can be determined approximately 18 months in advance. However, most of the current discussions involving long-term marketing contracts involve agreements between a producer and a known buyer, the packer.

The most common situation is for the producer to commit 100% of his or her production for future delivery to the packer. In addition, the life of the contract is typically four to seven years. Of course, there are exceptions to every rule and contracts will be as varied as the number of producers and packers out there. That said, still we can talk about three dominant types of contracts that have emerged in the industry: formula

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price agreements, price window contracts and contracts based on cost of production. Each of these packer marketing contracts differs by the method used to calculate the "base price."

The first type of marketing agreement, the *formula price*, is the one most often used by the very large producers marketing more than 500,000 head annually. In fact, more than 75% of all hogs marketed by this category of producer are sold under a formula price contract. With this type of forward agreement, the base price is tied by a predetermined formula to a publicly quoted price such as the Iowa/So. Minnesota market price. By tying price to a publicly quoted market outside of the region of those involved in the contract, regional variation in price should not influence the formula price. In addition to the base price determined by the formula, discounts and premiums are applied based on carcass quality.

This particular contract does little in the way of risk sharing, although producers are assured the "market price." Rather, its primary purpose from the producer's perspective is to gain market access ("shackle space") with an additional benefit of reduced transaction costs. If your production schedule leaves a narrow window for marketing hogs, this type of contract may

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well be suited to your marketing strategy. From the packer's perspective, the primary advantages of long-term marketing contracts are improved hog quality, increased consistency of supply, and increased volume of hogs (Hayenga, et al.).

The second contract, a *price window* contract, greatly improves upon the risk sharing features of the formula contract. One of the advantages of the price window contract is its ability to reduce the producer's exposure to price risk and in effect, provide a degree of income smoothing. With a price window agreement, the contract price received by the producer, plus or minus premiums or discounts, follows the market price as long as the market price is between a predetermined minimum and a maximum price, i.e., the "price window." When the market price is above the window, the producer receives either the maximum price or the maximum plus a share of the difference between the maximum price and the market price. For instance, consider a contract with a price window of \$35-\$45/ cwt. in liveweight terms. Given a market price of \$50 and a packer:producer share arrangement of 60:40, the producer would receive $\$45 + .4(\$50 - \$45) = \47 . Alternatively, if the market price dropped to \$30, the producer would receive $\$35 - .4(\$35 - \$45) = \33 . Clearly, one advantage to the producer of this contract type is the dampening of downside price shocks. Likewise, the drawback is the reduction in upside price swings and not being able to shop around for the best price.

You can think of a price window contract as a type of cash flow assistance program. This is demonstrated in a variation of this contract in which the packer maintains a ledger account for the producer. In periods when the market price is below the contract price minimum, the packer pays the producer the minimum price, but also reduces the balance of the producer's ledger account by the difference between the minimum and the actual market price. Likewise, the producer's ledger account is credited when the market price is above the maximum price. Upon contract expiration, the account is settled by the parties. With ledger accounts, however, one needs to proceed with caution. With \$30 hogs, a producer's deficit can quickly build up -- what risks are involved? How will your banker treat this intermediate liability? Is interest charged on the deficit? Is there an alternative way to smooth cash flow that better fits your business objectives?

In terms of reducing price risk and smoothing income, the third type of contract tends to be the most attractive to producers. The *cost-plus* contract bases payment to the producer on his estimated costs of production plus a profit margin. A third-party source is used for calculating costs of production. In the Midwest, common sources are the Iowa State University estimates for cost of production or the calculations published by the University of Missouri for farrow-to-finish farms. A more common alternative to calculate production costs is for the contract to break costs down into feed cost and non-feed cost allowances. Feed costs are then determined by formula, typically using a rolling average of published corn and soybean meal prices. The non-feed costs and the profit margin are fixed in the terms of the contract. Typical profit

margins are \$2-\$5/cwt, but vary considerably based on other terms in the contract.

A unique feature of the cost-plus contract relative to the formula price or price window contract is that it is not based on the market price of hogs. Because it is tied to cost of production, producers who are able to perform better than the estimates used in calculating cost of production are able to retain additional profit. An obvious drawback is that producers will not be able to capture the profits derived from high hog prices resulting from impacts other than increases in input prices. In addition, since non-feed costs are usually fixed in the contract, changes in the cost of non-feed inputs over the length of the contract will not likely be reflected in cost of production.

THE BOTTOM LINE ON PACKER MARKETING CONTRACTS

Significant patterns exist in the pork industry as to what type of producers are more likely to market hogs by means of a long-term marketing contract. Figure 2 demonstrates nearly 92% of the hogs marketed by producers selling more than 500,000 head annually are sold under some type of marketing contract. The most common type of contract for this group is the formula contract accounting for more than 75% of all hogs marketed. Futures, window and cost-plus contracts each contributed small percentages.

Growers marketing between 50,000 and 500,000 head use some type of marketing contracts for approximately 82% of the hogs. Within this size category, formula contracts are again the most popular (57%), followed by window contracts (13%) with cost-plus and futures contracts accounting for a small percentage each.

Producers marketing less than 50,000 head a year are less likely to use marketing contracts than their larger counterparts. Still, nearly 40% of the hogs marketed by this category of producer are sold under some type of marketing agreement. While formula contracts again account for the largest share of hogs marketed under a procurement contract by this size producer, in contrast to the pattern set by larger producers, cost-plus contracts account for a greater share than the window or futures contracts. For producers who sell less than 50,000 head a year, nearly 7% of their hogs are marketed under a cost-plus agreement.

The bottom line on marketing contracts is still evolving. For the very large producers, formula contracts will no doubt continue to dominate the packer-producer relationship. A key for this group will be price discovery as smaller volumes are moved through traditional markets. For producers marketing less than 50,000 head, formula, window and cost-plus packer contracts have increasing appeal as a means to assure market access and reduce price risk.

Today, however, most packers are currently not offering new marketing contracts to producers. There appears to be two reasons for this. First, there is a very steep learning curve in the industry as prices are discovered, windows determined, and costs estimated. For example, price windows five years

ago tended to be in \$42-\$52 range, but some today are in the \$34-\$44 range. Clearly, the window is a moving target as producers and packers work out how much risk they are willing to bear and how ledger accounts affect cash flow for both parties. Likewise, obtaining a third-party cost of production can be difficult, especially when feed prices are volatile.

The second reason most packers are not offering new con-

tracts is that they seem to have already achieved their publicly stated target percentage of hogs procured under marketing contracts. For most packers, this has tended to be 35-50 percent of procurement. However, be prepared for a new round of marketing contracts to emerge as the hog cycle bottoms out and new players enter and exit the industry. Depending upon your marketing strategy, long-term packer marketing contracts may meet your objectives. 🐷

Fig. 1: Percentage of U.S. Hog Production Sold Under Some Form of a Marketing Contract

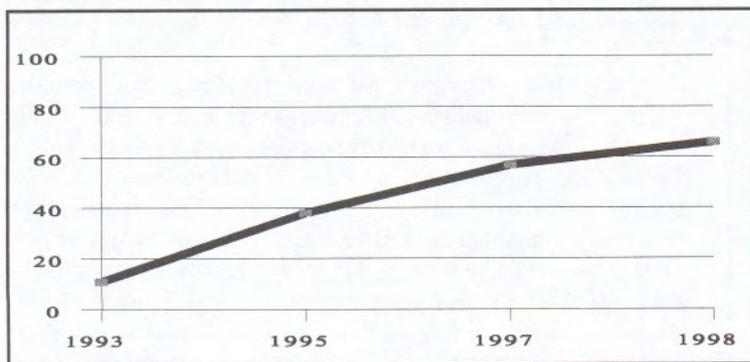
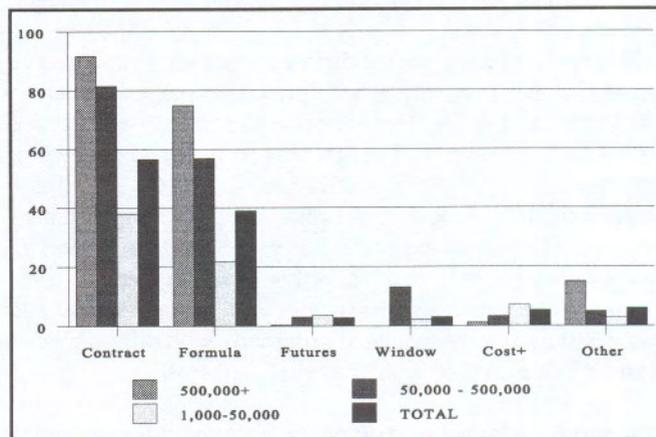


Figure 2: Percentage of Hogs Under Procurement Contract



Telfarm Courtesy Fees for New Microtel Clients

This year, due to low commodity prices and poor growing conditions in many areas of Michigan, producers may want to explore their financial options in greater depth than they have previously. This type of analysis begins with complete, accurate farm business financial records.

To encourage and assist you in this area, Michigan State University Extension is offering reduced costs as a courtesy for new Cooperators to Telfarm's Microtel System. MSUE will pay for *one half the cost* of software, set-up, and enrollment to **NEW** Telfarm participants who are **RECOMMENDED** by their Local/Area Agricultural Agent or District Farm Management Agent.

As a New Cooperator, you will receive all the same advantages and opportunities as current Telfarmers:

- a personal on-farm visit to set up the program
- reports and schedules generated at the Telfarm data processing center
- Telfarm staff available by phone to answer questions, and
- meetings with agents throughout the year.

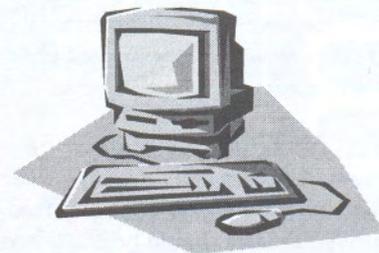
Agent meetings include a local Check-In meeting in late Fall (usually at your local extension office) consisting of a 1-2 hour session to assist producers with tax consequence consid-

erations and end-of-year planning. In late Winter or early Spring, you will have the opportunity to meet with an Agent to prepare an annual Business Analysis for your farm. Other options include Microtel Workshops, individual meetings with extension staff for long-range planning or budgeting, and workshops to increase your accounting/bookkeeping skills.

Typical costs for the first year of the Accounting software program, set-up, and enrollment in Telfarm are \$545. With this special offer, cost to a **NEW** Cooperator would be only **\$272.50**, a **50% savings**. For the Accounting, Payroll, and Checkwriter software programs, set-up, and enrollment would normally be \$990. In this case, the cost to a **NEW** Cooperator would only be **\$495**.

For more details on the Telfarm program and Microtel software for your farm business recordkeeping, contact your County Extension Office, your District Farm Management Agent, or the Telfarm office (517-355-4700).

You may also e-mail the Telfarm Center at microtel@msue.msu.edu. We look forward to the opportunity to assist you with your farm business records. 🐷



Can You Cut Genetic Costs?

By: Ronald O. Bates,
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The dramatic drop in pig prices this fall has caused pork producers to examine all cash expenses. One expense category is genetic costs. Genetic costs are those that occur within the breeding program and include; 1). Gilt genetic premiums, 2). Boar premiums, 3) semen expenses. We will examine these in relation to short and long term impact.

Gilt genetic premium is the difference between gilt cost and market value. Typically genetic premiums range between \$90-\$150 for parent gilts. There are two possible ways to reduce gilt genetic premiums. The first is short term and calls for using terminal cross gilts from finishing to be used as replacement gilts. In examining this option there are several items that must be part of the evaluation process. These market gilts are sired by boars from a line or lines that have not been selected for maternal performance. If used as replacement gilts they will need to be managed differently with different expectations of their subsequent maternal performance.

Since these gilts are of terminal background it is expected that their age at puberty would be older and their conception rates lower. More gilts than normal would have to be kept for replacements and they may conceive at an older age than their maternal counterparts.

At farrowing, these females should farrow smaller litters, potentially .5 to 1.0 pigs/litter. Also their litter weights should be somewhat lighter and survival rate to weaning may be poorer by as much as 3-5%. After weaning, rebreeding performance may be poorer as well.

It would be assumed that these terminal gilts would be mated to boars of similar breeding, as was their sire. Subsequent progeny would not benefit from full heterosis. That would influence their subsequent performance and survival rate. It would be expected that growth rate and feed efficiency would be poorer. It is likely that days to market could increase by 3-6 days and feed efficiency could be .02 to .04 lbs feed/lb gain poorer. Since pigs from terminal cross gilts would have contemporaries from maternal females, within a all-in/all-out group, growth performance within the group may be more variable which may make finisher barn close-outs more difficult. However, pigs from terminal cross females with terminal cross sires would be expected to be leaner and heavier muscled.

These factors; 1) Older age at puberty, 2) Poorer conception rates, 3) Lower litter size, 4) Lower litter weight, 5) Poorer progeny growth rate 6) Poorer feed efficiency and 7) Improved backfat should be considered before deciding to use market gilts as replacements. It should be also noted that this strategy will reduce cash income since gilts that would have been sold as market pigs are retained as replacements.

The second strategy to reduce gilt genetic premiums would be to temporarily change the breeding system to a rotaterminal. It must be understood that this is a long-term strategy since matings made today would not yield gilts to use as replacements for at least 10 months. Choosing this strategy would imply that this the present market doldrums would continue through the year 2000.

To change to a rotaterminal program, 10-15% of sows would be mated to maternal sires different in breeding from their sire. For example a female that was sired by a Yorkshire or Large White sire would be mated to a Landrace boar or semen. Sires chosen should be high ranking for maternal characteristics (e.g. number born alive and litter weight) while at least at breed or line average for growth and backfat. If this option is chosen, then producers must be more familiar with genetic evaluation information to choose potential sires for replacement gilt production.

The second item to reduce genetic costs, reducing boar expenses, can be accomplished several ways. The first is to delay new boar purchases. This will only delay the inevitable expense and does increase risk since older boars will be genetically inferior and more prone to a reduction in libido or death, which can cause an increase in open sows. A second suggestion would be to reduce price paid for boars either through dropping terminal boar classification or through negotiation. The drop in genetic merit should be considered. A third consideration would be collecting boars presently owned and extending their semen in an AI program. Terms of purchase would have to be reviewed before implementing this suggestion.

The third item to reduce genetic costs would be reducing semen purchase costs. Many farms do purchase a large amount of semen from commercial vendors. Reducing semen costs can be done through volume purchasing of pooled semen or through semen contacts. This must be done with an understanding of how resulting progeny could differ from progeny produced from the present semen purchase program. These are a few suggestions that could lower genetic costs.

Each farm's production capacity and financial resources are different. Thus each of these possible strategies should be worked through thoroughly in relation to the production facilities and the financial status of the farm. This will allow farm management to understand how pig performance and farm management could change and if farm financial status will be improve. 

STAGES UPDATED

By: Ronald O. Bates,
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Since its inception, the goal of the STAGES has been to aid seedstock producers in the improvement of pure breeds of swine (Figure 1). Over the past two years the STAGES program has been evaluated, updated and revised. These updates and changes were incorporated into the daily across-herd Estimated Progeny Differences (EPD) provides to members this fall. Now as before, it offers to National Swine Registry member's modern technology in EPD estimation and ranking of prospective herd replacements.

STAGES is a performance testing program for seedstock producers. Upon submission of performance information, EPDs, calculated using Best Linear Unbiased Prediction (BLUP) equations, are returned to seedstock producers. These EPDs are used in bio-economic indexes to rank prospective replacement boars and gilts. These bio-economic indexes take into account current economic constraints within commercial pork production and rank animals on the economic potential for different purposes. For instance the Maternal Line Index (MLI) uses EPDs for number born alive, litter 21 day weight, days to 250 lbs and backfat to rank animals for both maternal and postweaning traits. On the other hand, the Terminal Sire Index (TSI) ranks animals exclusively for postweaning traits.

Updates and Changes Several updates are easily noticeable. The most obvious change is the adjustment of growth and backfat from 230 to 250 lbs. The difference from days to 230 to days to 250 lbs is about 10. In other words if a boar had an adjusted days to 230 lbs of 150 then his corresponding adjusted days to 250 lbs should be 160. For backfat, the change in adjustment is approximately 0.05. Thus if a boar has an adjusted backfat at 230 lbs of .50 in. then his adjusted backfat at 250 lbs should be close to .55 in. However, the adjustments are breed specific and therefore there will be small differences from breed to breed.

In fact all adjustments, equations and calculation components are now breed specific. Including adjustments for number born alive and litter 21 day weight. This will further improve the accuracy of the EPD estimates.

A new EPD has been added to the report. It is an EPD for pounds of lean. This is calculated from the the EPDs for backfat and loin muscle area. A difference between two boars or gilts for this EPD suggests that the one with the higher EPD will have progeny with more pounds of lean in an 185 lb carcass. For example if Boar 62-4 had an EPD for pounds of lean of 3.0 and Boar 40-1 had an EPD of 1.0, if mated to average mates, progeny from Boar 62-4 should have 2 lbs more lean in an 185 lb carcass.

Index calculations have also been updated. Previous indexes used a linear approach in their construction. This causes each

new incremental change for a particular trait to have the same influence on the index as the previous change of the same amount. For instance, if the backfat EPDs between two animals were -0.01 and -0.03 in., the index value would change the same amount if the same two animals had backfat EPDs of -0.11 and -0.13 in., if all other traits were held constant. However the new indexes do not take this approach. This is true for both the TSI and the MLI. Yet this will be most noticeable within the MLI.

There are two reasons to change indexing strategy. The first is that very lean animals tend to reach sexual maturity at an older age and can have poorer reproductive potential. The second is that as pigs have become leaner and heavier muscled it has become apparent that the packing industry does not want carcasses with very low backfat. In fact, several packers have changed their buying programs. Among carcasses with approximately .6 in. of backfat or less little or no difference in carcass merit value will be paid as backfat differs among these carcasses.

Therefore indexes were changed to better balance genetic change and improve overall profitability. As boars and gilts have more total lean, economic importance will shift from lean to other traits within the index. Therefore with an index like MLI, animals that have very high EPDs for pounds of lean more emphasis will be placed on number born alive, litter 21 day weight and days to 250 lbs. This is evident in Figure 2. Under the old MLI as the pounds of lean EPD increased the MLI increased linearly. However, with the new MLI as pounds of lean increased the MLI tapers off and other traits in the index will have relatively more economic weight. This will cause lean content to remain constant or increase slowly as other traits improve more rapidly.

The last noticeable change is the size of EPDs themselves. Over that past six years the evaluation system has used 1992 as the genetic base year. Therefore the genetic merit of each pig born after 1992 has been adjusted for the genetic merit of pigs born in 1992. The steady genetic progress has made the average value of the EPDs larger than if a more recent year was used as the base year. Thus the genetic base was changed to a moving genetic base to better reflect present genetic merit of newly tested boars and gilts. The new genetic base year is four years from the present year. Thus the base year for pigs born in 1998 is 1994 and consequently the base year for pigs born in 1999 is 1995. The advantage for using a sliding base year is to regularly account for the improvement in genetic merit that is on-going. While using a base year that is four years prior allows for accurate evaluation among progeny for a given sire, especially for number born alive and litter 21 day weight. Another feature of this moving genetic base is that it changes every day, so to more accurately evaluate the genetic merit of newly tested pigs and sows.

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This change in magnitude of the EPDs and indexes is only a correction for genetic change over time and has nothing to do with the relative merit between two animals. In fact, if after changing the genetic base the EPDs had not changed this would have indicated that genetic progress was not occurring.

The STAGES program provides seedstock producers modern genetic evaluation technology. Use of these EPDs and indexes will improve genetic merit within seedstock herds as well as commercial producers who utilize high ranking animals from these within their breeding programs. 🐾

TAX MANAGEMENT TIPS FOR FARMERS

By: M.P. Kelsey
Michigan State University

1998 - End-of-Year Tax Planning

1. The basic management guideline is to avoid wide fluctuations in taxable income because a relatively uniform income from year-to-year results in the lowest income tax and largest Homestead and farmland preservation credits over time. However, even in a low income year, plan to utilize personal exemptions and the standard deduction.
2. Significant tax changes from 1996, 1997 and 1998 tax legislation, which are now applicable, include:
 - (a) New capital gains rates for sale of long-term capital assets held for 12 months or longer (24 months for breeding cattle and horses). Tax rate is 20% if taxable income is in the 28% bracket or higher and 10% for that portion of capital gain between taxable income and the top of the 15% bracket (\$25,350 single and \$42,350 married). To the extent of depreciation on depreciable real estate, it will be recaptured like 1245 property (i.e., farm personal property such as machinery), but at a maximum rate of 25%.
 - (b) The self-employed health insurance deduction is 45% in 1998 and increases to 60% for 1999-2001, 70% for 2002, and 100% for 2003.
 - (c) The sale of principal residence after May 6, 1997 is tax free on up to \$500,000 of gain for joint return files (\$250,000 single).
 - (d) The alternative minimum tax inclusion of farm property in installment sales in AMT reporting for tax years after December 31, 1987 was repealed.
 - (e) An increase from \$250 to \$2,000 for the annual unemployed spousal IRA contribution.
 - (f) Penalty free IRA distributions may be taken to pay for medical expenses and/or health insurance premiums to the degree expenses exceed 7.5% of adjusted gross income.
 - (g) The section 179 (direct expense) deduction for capital purchases is \$18,500 for 1998, with a gradual annual phase in to \$25,000 in 2003.
 - (h) A new income averaging provision for farm income (Schedule F averaged and Schedule J) which is now permanent.
 - (i) Several special items such as a new work opportunity credit, a deduction for long-term health care, including insurance, but only for itemizers to the degree medical expenses exceed 7.5% of adjusted gross income, and an adoption credit and exclusion.
 - (j) Dependent child credit of \$400 for each child under age 17 (\$500 after 1998).
 - (k) A new 5-year net operating loss carry-back for farm losses.
3. Depending on your tax situation, you may wish to reduce or increase net income for 1998. Following are some of the best income eveners:
 - (a) Buy or delay purchase of supplies such as fertilizer, seed, farm supplies, small tools, and repairs (tax shelters can only deduct items when used). Note: these expenses cannot exceed 50% of your total Schedule F expenses for the year for which economic performance has occurred. In most cases, it will be hard to reach that level of expenditure.
 - (b) Pay in 1998 or delay payment to 1999 on real estate taxes and other annual bills. (Insurance premiums, real estate rental for 1999 and interest cannot be paid in advance to obtain an earlier tax deduction, but 1998 expenses of insurance, rentals and interest can be deferred to 1999 if income is low this year).
 - (c) Watch the timing of sales of livestock and crops ready for market near year-end. Possibly they can be held for sale next year at little cost or sold earlier to even out taxable income.
 - (d) Some expenses are deductible as current year business expenses even though not made every year. These include minor repairs on improvements and machinery, painting of buildings, purchase of small tools and supplies, and within limitations, cost of approved soil and water conservation expenses. Get these jobs done and paid for before year-end if you wish to reduce net income.

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- (e) Where capital purchases have been made, or can be made, study the depreciation alternatives carefully. The direct expense deduction of up to \$18,500 on personal property can be taken on current year capital purchases. Its use, however, cannot reduce your taxable income from farming (plus other earned income) below zero. Taxable income includes net farm profit plus gains on the sale of business assets such as breeding livestock. Where pre-productive expenses are not a consideration, there are four choices for depreciation: Modified Accelerated Cost Recovery System (MACRS) which is 7-year 150% declining balance on machinery; MACRS straight line; the Alternative Depreciation System (ADS), which is 10-year straight line on machinery; and 150% declining balance using the ADS guideline. For the first year the mid year convention is used (1/2 year=s depreciation), unless 40% or more of your capital purchases are made during the last 3 months of the year. In that case, the mid-quarter convention is used (87.5% of a year=s depreciation for purchases made during the first 3 months, 62.5% for purchases in the second quarter, 37.5% for the third quarter, and 12.5% in the final quarter).
 - (f) Pay your children wages for work actually performed for the farm. If the child is under 19 or regularly enrolled in school, they can earn any amount and the parent can still claim an exemption for them if the parents pay over half the child=s support. The parents must use the dependent exemption. The child must file a tax return only if they earn over the standard deduction (\$4,250) unless they have unearned income. In that case, the standard deduction is earned income plus \$250 up to a maximum of \$4,250. A return, usually a 1040A, must be filed by a child under 14 if investment income is greater than \$700. Children under 14 will have unearned income taxed at the parents= rate. Form 8615 is used to calculate the tax. Parents may elect to report the child=s income in their return (Form 8814).
 - (g) For Michigan income tax an individual who is eligible to be claimed as a dependent on someone else=s return and has an adjusted gross income of \$1,500 or less is entitled to a refund of all Michigan tax withheld. If they have an adjusted gross income of more than \$1,500, they are entitled to only a \$1,000 exemption allowance.
 - (h) Frequently unrecorded and forgotten expenses include:
 - (1) Educational expenses that maintain or improve your skills, such as magazine subscriptions, books, fees at extension or other agricultural organization meetings.
 - (2) Travel expenses connected with your business, particularly if it includes meals and lodging.
 - (3) Entertainment expenses when hosting others where the Apredominant purpose@ is the furthering of your farm business operation.
4. Social Security and hospital insurance rates for the self-employed are 12.4% and 2.9% for a total of 15.3% on 0.9235 of net farm profit up to \$68,400 for 1998. One-half of the Social Security tax will be deducted as an adjustment to income. In addition, the 2.9% hospital insurance tax continues on income over \$68,400. For 1999 the base is \$72,600.

Long-Range Tax Planning

1. Maintain a good set of records to insure that all expenses are taken. Small cash purchases are easily forgotten. A good record keeping system is essential for end-of-year tax planning, as well as working with credit agencies.
2. Where income is high enough, plan the purchases of machinery to fully utilize the direct expense deduction.
3. Plan your personal deductions. Many medical expenses and contributions formerly spread over 2 years can be paid in 1 year and itemized as deductions. In the next year, the standard deduction may be taken. Changes in itemized deductions include medical expenses in excess of 7.5% of AGI, no personal interest is deductible, moving expenses are now an itemized deduction and most miscellaneous deductions are deductible only to the degree they exceed 2% of AGI.
4. If your medical insurance and medical expenses are not currently deductible, explore the medical benefit alternatives for the self-employed and choose an alternative that best fits your situation.
5. Investigate a Self-employed Retirement Plan. There are four potential tax deferred retirement plans available. A defined contribution Keogh and Simplified Employee Plan (SEP) require that certain employees also be covered. Tax deferred contribution limits Ato a profit-sharing plan@ are an effective 13.0435% (15% of net income less the contribution). A new simple plan replaces SEPs for 1997. The fourth alternative is an Individual Retirement Account (IRA). Employees do not have to be covered if a self-employed person utilizes an IRA; however, the maximum contribution is \$2,000 per year, with an additional \$2,000 in an unemployed spousal IRA. An IRA deduction cannot be utilized if the contributor is eligible to participate in another retirement plan where the AGI exceeds \$60,000 for a married taxpayer, or \$40,000 for a single taxpayer with reduced contribution limits for AGI down to \$50,000 and \$30,000, respectively. These phase-out levels increase after 1998.
6. Where income is low or negative, consider the transfer of regular IRA balances to a Roth IRA.

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All comments and suggestions should be directed to:

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6. **South West Swine Agent**
Farm Business Mgt.
(616) 657-7745



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7. Your farm business is a built-in deferred compensation and tax loss program. Investments and current expenses are made that substantially improve the value of the business property which can be sold at a later date, frequently at capital gains rates. Establishing a fruit orchard and increasing the size of a breeding livestock herd, for example, fits this situation. ACrops@ that fit this category are Timber, fruit trees, and Christmas trees as well as the build-up in year-end inventories.
8. Use installment sales of capital items to spread income over a number of years. However, with fewer and wider tax brackets and depreciation recapture considerations, an installment sale may not be advantageous.
9. If approaching retirement, keep in mind the new \$500,000 per couple (\$250,000 each) exclusion of gain from tax for that portion of a farm sale attributed to your residence. Also, plan for more of your income from rent, dividends, interest, and pensions rather than ordinary income so that income will not be taxed as self-employment income for Social Security or reduce Social Security benefits. Earned income levels that will decrease Social Security benefits for 1998 are \$9,120 per year for those under age 65 and \$14,500 for persons age 65 to 69. The decreases are \$1 for every \$2 of excess earnings for those under 65 and \$1 for every \$3 excess earnings age 65 through 69. For age 70 and over there is no reduction, but Social Security taxes are still paid on earned income. For 1999 these figures are \$9,600 and \$15,500.
10. Be sure to deduct as large a portion of business-personal expenses as is justified in your situation. Frequently, considerably more than 50% of the electricity and phone costs, can be considered business. Also choose the method for auto deductions which is best for you. The standard mileage rate for 1998 is 32.5 cents per mile for all business mileage. Mileage for charitable purposes can be itemized at 14 cents per mile; for medical purposes, 10 cents per mile.
11. Be aware of the Alternative Minimum Tax in tax planning. Alternative Minimum Taxable Income (AMTI) includes tax preference items such as the difference between MACRS and ADS depreciation, and tax-free interest as well as regular income. There is a single \$45,000 exemption for those filing joint returns (\$33,750 single) and a tax rate of 26% on the first \$175,000 of alternative minimum taxable income and 28% on AMTI in excess of \$175,000. It is paid to the degree the tax exceeds your regular tax, which for farmers is likely to occur when investment tax credit carryover reduces the regular tax, or when MACRS depreciation deductions are very large and taxable income is low. 🐷