

# Farmers Switching to Accrual Accounting

One of the surest ways to clip the wings of the tax-loss farmer is to require farmers to report income by the accrual accounting method.

That's not likely to come to pass in the near future, though there is this possibility: that more and more farmers will switch to accrual of their own accord as the rules for cash accounting become more and more restrictive.

In a new ERS study of cash and accrual accounting, the analyst points out many lawmakers in the past have favored the cash method over accrual. He believes they recognized the accrual method to be an "appropriate means of accurately reporting farm transactions... but that it should not, as yet, be required of all farmers."

This was apparent when the Congress took up tax-loss farming proposals to be incorporated into the Tax Reform Act of 1969. For various reasons legislators did not push for complete withdrawal of the cash accounting option. They did, on the other hand, agree on certain provisions which encourage the use of accrual accounting.

#### Millions Use Cash

Future changes in the cash accounting system would affect millions of farmers. Over 95 percent of them exercise their legal right to report farm income by the cash method rather than the accrual.

As explained in the ERS study, many farmers prefer cash accounting because they don't have to keep complicated records of inventory changes.

Cash accounting also offers a big advantage for the farmer who's expanding his operation yet trying to maintain an adequate income. Since he doesn't have to pay annual taxes on inventory increases, his tax obligations can be postponed, and this frees cash to invest in the farming operation.

Cash accounting compared to accrual also allows greater flexibility in adjusting net income from year to year. Too, sales of raised breeding livestock may sometimes result in lower

taxation than under the accrual system.

The basic difference between cash and accrual accounting has to do with the handling of expenses and receipts from the business.

Suppose a farmer takes delivery of \$500 worth of feed on December 15 and charges the purchase. He's billed for it in January and pays it then.

Under the cash method, the feed outlay is considered a farm expense in January. Under accrual, the \$500 is a cost deduction in December when the farmer incurred the obligation to pay. However, he must report the value of feed on hand on December 31 as part of his ending inventory.

#### Example of handling receipts:

A farmer raises and feeds livestock during the year but doesn't sell any.

Under cash accounting, he has no income until payment for the livestock is actually received. Under accrual, he has income—the increase in the value of livestock and crops on hand at the end of the year compared to the value at the beginning.

#### Farmers Get a Break

Farmers have been privileged to use either method since 1915. The administrative ruling of that year was designed to spare them onerous bookkeeping chores. Most other businessmen were given no choice but to use the accrual system.

What was not anticipated was that some "farmers" would use cash accounting to avoid taxes on their nonfarm income. Year after year they would claim large farm losses which could be legally used to offset other taxable income. Then when they sold out, they benefited again by receiving capital gains treatment on certain items, which are taxed at a lower rate than ordinary income. Under the accrual method, they would have lost some of the favorable treatment otherwise given capital assets.

#### Tighter Rules

Better known as tax-loss farming, this abuse of special tax rules for farmers led to several provisions in the Tax Reform Act

of 1969. One of these requires people with large nonfarm incomes and large farm losses to keep an "excess deductions account," which in essence raises the taxes on the sale of capital assets.

However, the Act says taxpayers can be exempt from keeping the excess deductions account if they report farm income on the accrual basis.

Like cash accounting, accrual accounting offers advantages to some farmers.

For example, farmers who must sell 2 years of production in a single year can, for tax purposes, spread out their income by virtue of the inventory feature.

Other farmers may wish to keep income and taxes on a more current basis than cash accounting allows. This particularly applies in years when deductible expenses exceed the receipts and there is little off-farm income against which this loss can be offset.

Total tax liability may be less than under cash accounting when tax rates or cash income go up, or when inventories decline. This is because property accumulated may have always been reported as income and taxed in prior years as per the inventory feature.

#### Added Benefits

Another advantage is the income and thus qualify for greater Social Security benefits.

To sum up, under certain circumstances some farmers would be better off using the accrual system while others would not.

Those switching to accrual should keep in mind they might have to pay higher taxes for the year the change is made. Under current law, income for that year would include all previously untaxed farm wealth (not including appreciation in real estate). For instance, adjustments would have to be made

likelihood of increased Social Security benefits. Certain capital gains are excluded from self-employment income. Since, under accrual accounting, more of the value of livestock may be treated as ordinary income, accrual farmers may have higher yearly self-employment if a farmer had a beginning inventory of unsold livestock on which he'd already claimed expense deductions. This income and tax obligation, however, may be spread over a 10-year period.

Farmers could also ease the tax burden by changing to accrual in a year when tax rates are low, inventories are low, or tax exemptions are high.

Where a farmer knows in

advance he will sell a large part of his accumulated inventory, he might choose that year for the changeover. His tax liability would be high anyway, but his closing inventory would be low.

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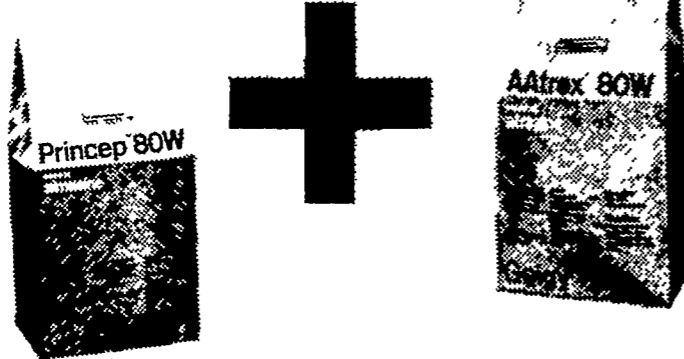
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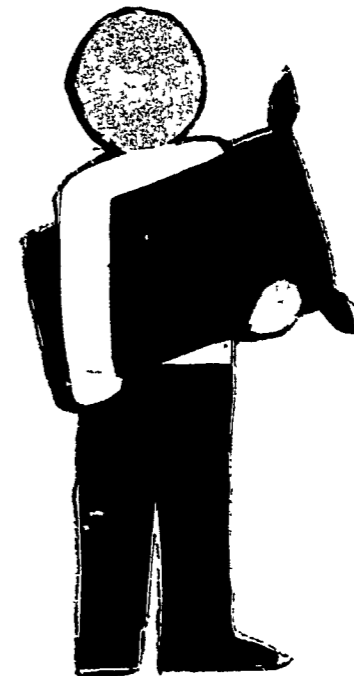


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