Taxes for Agricultural Enterprises

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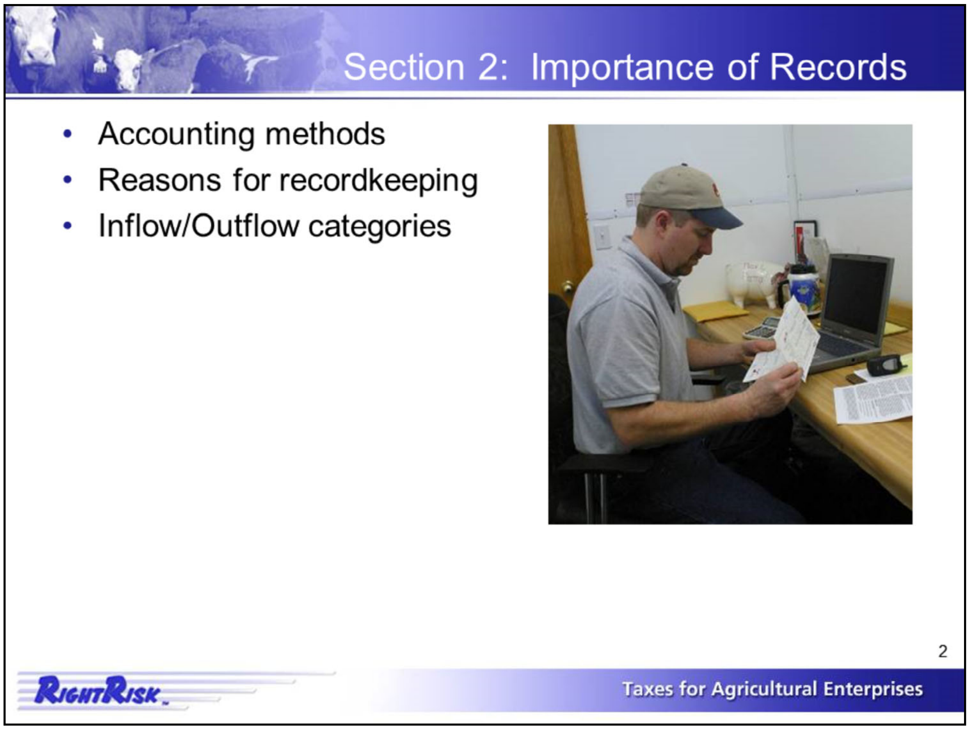
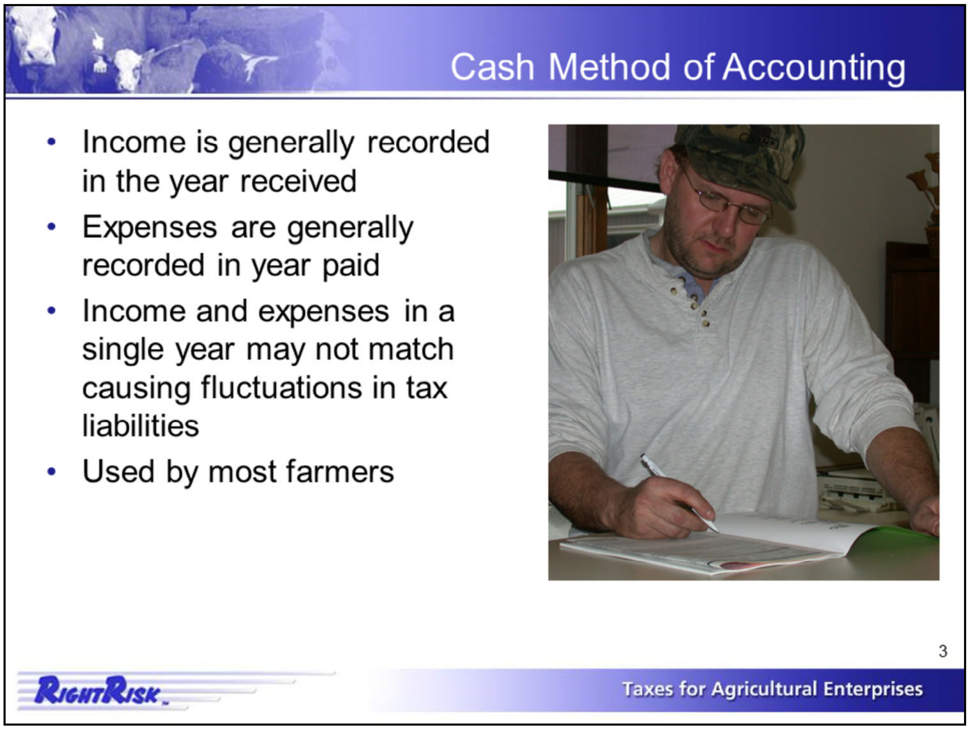
Section 2: Importance of Records



This section provides information on accounting methods, reasons for recordkeeping, and inflow and outflow categories.



There are two basic accounting methods for determining when and how income and expenses are reported: the cash method and the accrual method.

The cash method of accounting works somewhat like a checking or savings account. Generally, income is recorded in the year deposits are made, and expenses are recorded when withdrawals are taken. Certain expenses paid in advance or required to be capitalized are not deductible in the year paid.

This method of accounting does not always match income and expense events. Consequently, there may be higher income in one year and higher expenses in another year. Fluctuations in income and expenses may result in variable profits or losses from one year to the next. Such fluctuations may cause income tax liabilities to change from one year to the net, perhaps unpredictably.

The cash method of accounting is used by most farmers because they find it easier to use and may provide advantages for tax management.

Cash Method of Accounting

Exceptions:

- The purchase costs of items purchased for resale (yearling cattle for example) are carried forward to the year in which the items are sold
- Certain conservation expenses must be capitalized

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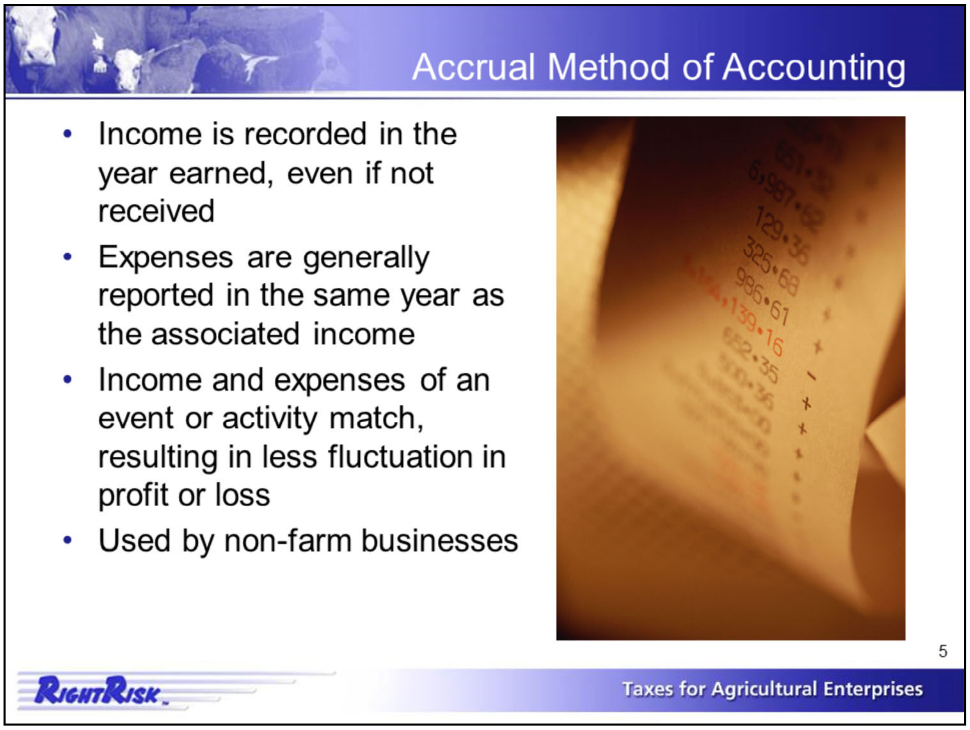
The exceptions include the purchase costs of items purchased for resale (yearling cattle for example) that are carried forward to the year in which the items are sold and certain conservation expenses must be capitalized.



The accrual method of accounting is based on the principle of matching expenses to the income earned. An example might be a crop grown in on the year and sold in the next year. Associated expenses would be deferred and reported in the year the crop is sold.

Use of the accrual method of accounting generally results in a more predicable pattern of profits or losses from one year to the next. Consequently, tax liabilities fluctuate less from one year to the next.

Almost all businesses outside of agriculture use this method of accounting.

Accrual Method of Accounting

Exceptions:

- Certain conservation expenses must be capitalized
- Business expenses and interest owed to a related person who uses the cash method of accounting are not deductible until actual payment is made and the income is included in the related person's gross income

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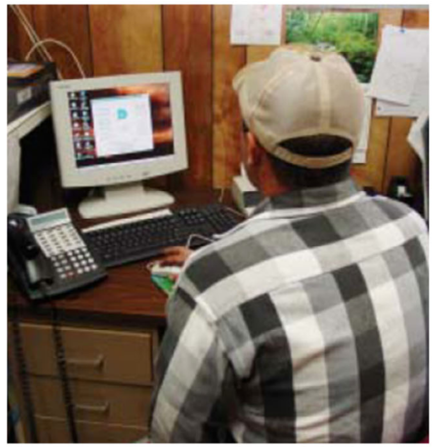
Exceptions to this are that certain conservation expenses must be capitalized, and business expenses and interest owed to a related person who uses the cash method of accounting are not deductible until actual payment is made and the income is included in the related person's gross income.

There are several reasons for keeping records. The main reason for choosing one method over the other is that it meets the needs for information for the individual and business. Some benefits of a good record keeping system include: determining business profits or losses; planning for the future; determining progress made towards goals; communicating financial standing with family members, partners, lenders, and others; and reporting tax liabilities.

Record Keeping Methods

- Hand kept
- Computerized
- Commercial



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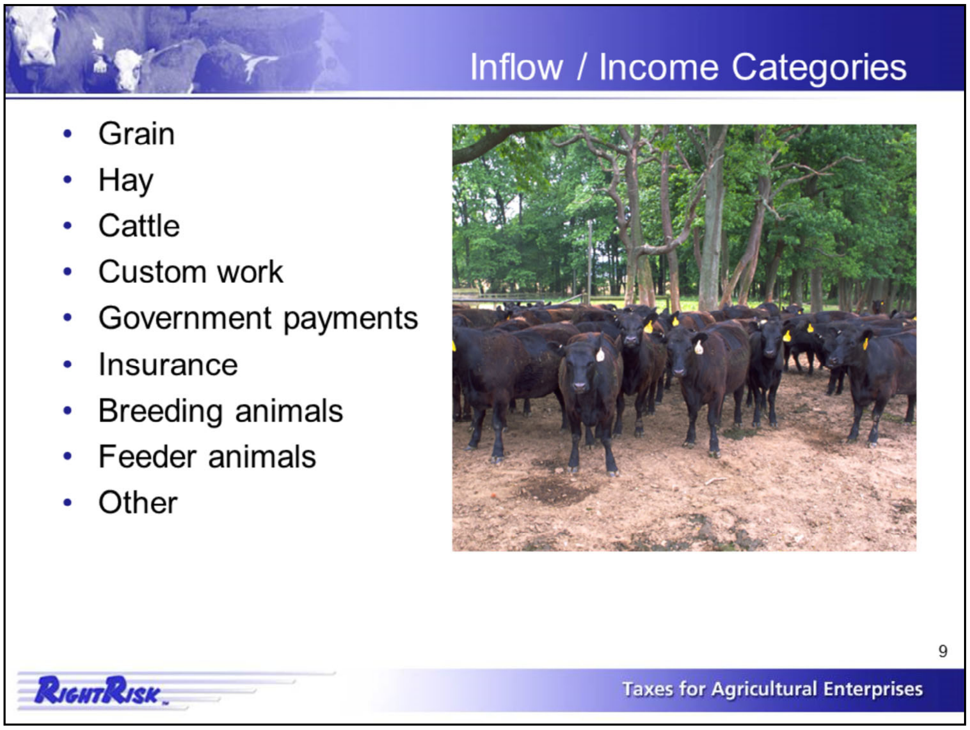
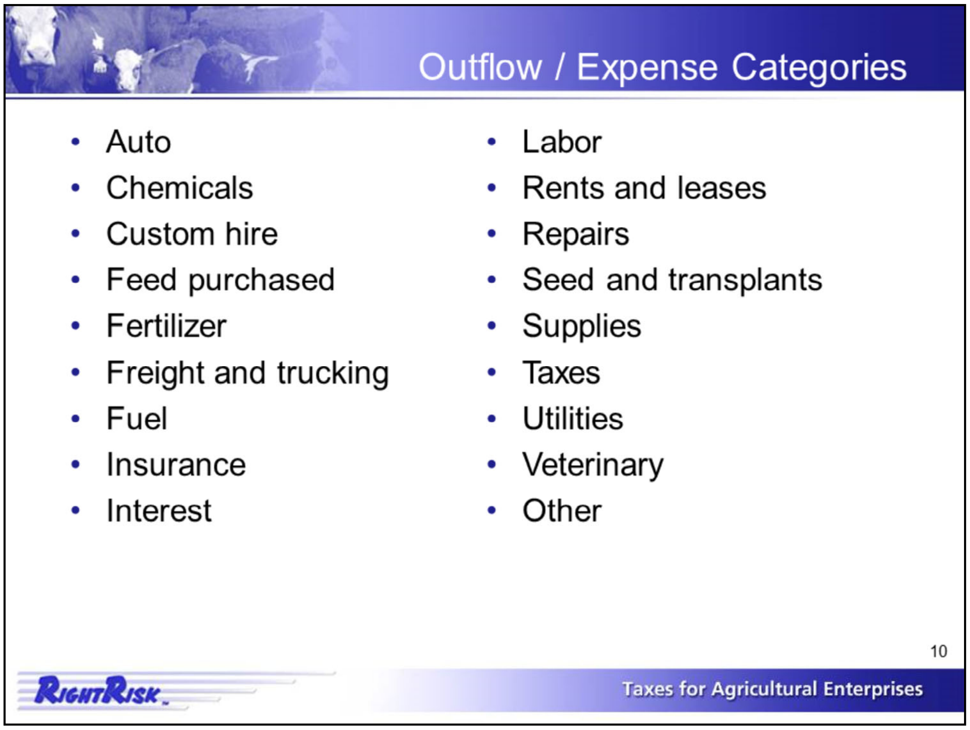
Additionally, three basic methods for keeping financial records are available. Any of the three methods may meet the need for information, but one may work better than another in a specific situation. The three methods are 1) hand-kept in a paper ledger of some type; 2) using one of the many computer programs; and 3) paying someone else to keep your records for you. Each method has its strengths and weaknesses which should be carefully considered when making a choice.



Financial records need cash inflow and cash outflow categories. The inflow or income categories from IRS Form 1040 Schedule F serve as a basic set of cash inflow categories.

Financial records need to account for cash inflows from sales of capital assets – breeding animals, machinery and equipment, land, etc. There should be categories to allow recording of non-farm cash inflows. More detailed records will contain categories for grain, or even for each grain crop, hay cattle, custom work, government payments, insurance proceeds, information pertaining to sales of breeding animals and items purchased for resale.

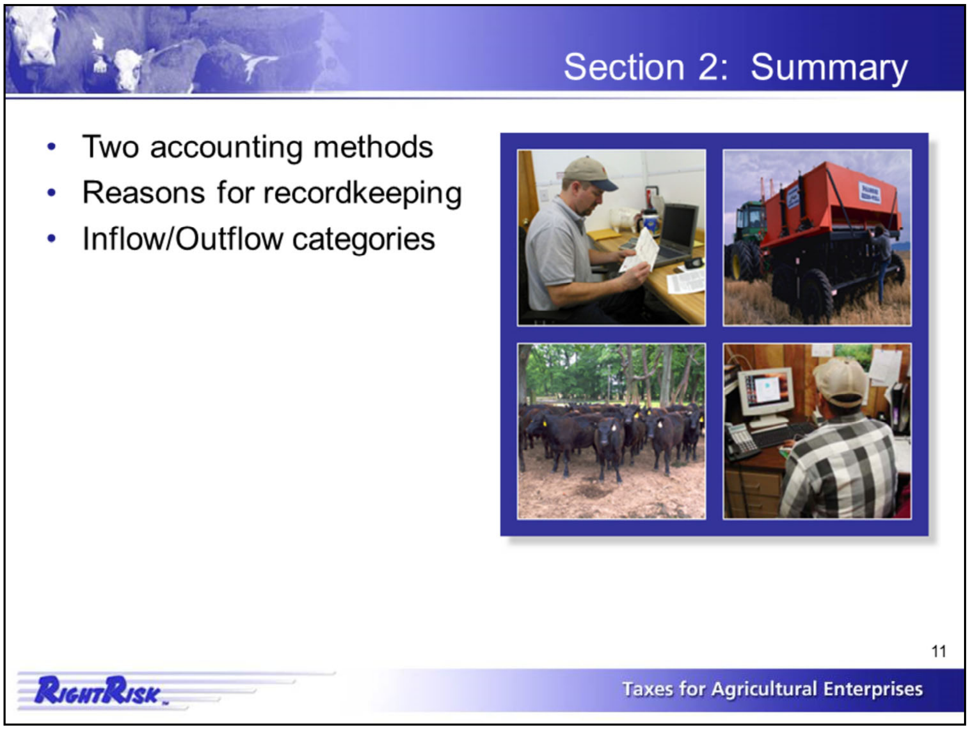
There is always need for flexibility in the records to account for unusual circumstances.



Expense categories on Schedule F are a great source of cash outflow categories to record ordinary farm expenses. Additional categories are needed for purchases of capital assets, items purchased for resale, and family living (non farm) expenses.

Recording the costs of purchasing items for resale, such as feeder cattle, has unique needs. You must be able to carry forward the costs associated with purchasing the items. It may be necessary to even carry purchase information forward to the following year.

More detail, such as repairs for each piece of equipment, may be desired. However, the hassles of keeping such detail may exceed the benefits derived from analyzing the information. One suggestion is to record the repairs into a single expense account and to add detail via the “memo” section.



Summary

•Two methods of accounting – Cash and Accrual

•Good records will meet your needs to make more informed decisions

•Lenders may request certain information, and tax preparers or accountants will need specific information to accomplish their tasks

•Other people using information from the records may be landowners, insurance providers, partners, family members, and ex-family members

•The Internal Revenue Service requires that you keep your records and tax returns for three years after the date on which the tax return was due. The IRS can look at seven years of records in cases of suspected fraud