Current Information Letter

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AGRICULTURAL EXTENSION DIVISION—PAUL E. MILLER, DIRECTOR

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FILE UNDER: AGRICULTURAL ECONOMICS - Income Tax (Note to County Agents: This may be reproduced locally, in whole or part, if desirable.)

SPECIAL INCOME TAX SITUATIONS

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COMPARISON OF THE CASH AND ACCRUAL METHODS

There are two important differences between the cash and accrual methods. (1) When the cash method is used, the receipts and expenses are reported in the year the cash is received or paid, whereas, on the accrual method, the receipts and expenses are reported in the year the transaction occurred whether or not the payment was made. (2) When the cash method is used, the gross farm profit is the cash receipts from products sold for cash or traded for merchandise; while on the accrual method, the gross farm profit is based on the receipts from products sold or traded, with an adjustment for inventory changes. (That is, crops produced in 1942 and sold in 1943 would not be reported as income until 1943 on the cash method; if the accrual method were used, the crops would be reported in inventory and considered as income in 1942 at the December 31, 1942 price.

Advantages of the Cash Method

Farmers using the cash method have two major advantages over those using the accrual. (1) Money is always received in the year for which tax payments are due because payments on the cash method are based on cash receipts less deductions without regard for inventory increases that have not been converted to cash. (2) An advance cash purchase of products, to be used in the next year's production, made near the close of a year when income is unusually large, will reduce the amount of the tax that year. However, if there is no change in the tax rate or the personal exemptions, there may be an increase in the total amount of tax in the following year unless the income in the second year is small.

Advantages of the Accrual Method

There are four major advantages in using the accrual method. (1) Less time is required to prepare the statement when the farmer buys and sells considerable numbers of livestock. Only the total number and value of the beginning inventory, ending inventory, purchase, and sale of each class of livestock need to be reported on the accrual basis. On the cash basis it is necessary to separate the sale of livestock raised from sales of purchased livestock; it is also necessary to separate the sales, depreciation claim, or death loss on purchased livestock for each purchased animal if they were purchased in different years, at different ages, or different costs. (2) Over a period of years the total tax paid by a farmer may be less if his physical inventory of crops, livestock, or products shows considerable fluctuation

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from year to year. This is true if the amount of the change shifts the surtax net income into a taxable bracket or a different surtax bracket, thus increasing or decreasing the tax rate. (3) Installment receipts are reported in the year of the transaction rather than the year the cash is received. By this method the income that may accrue from an installment receipt is more apt to be taxed in the year that claim is made for the expense of producing the product. (4) The accrual method avoids a heavy tax payment when the operator quits farming and sells his personal property. With the cash method, the gross sale value of all livestock, crops, and products produced on the farm is subject to tax in the year of sale; whereas, with the accrual method, only the increase in value from the beginning inventory of the year to time of sale is subject to tax. The larger the volume of business, the more significant is this latter point.

Why the Cash Method Is More Generally Used

(1) Many farmers, when they prepared their first income tax returns, thought the cash method was simpler, because the accrual method involved inventory adjustments. They failed to note the difficulties that are frequently encountered in using the cash method, and did not realize that the cash method may sometimes result in higher tax payments. (2) Having started on the cash method they have not changed to the accrual method because (a) They have not understood the differences and the advantages and disadvantages of each, (b) they have not taken the necessary steps to make the change.

Changing from Cash Method to Accrual Method

To change from one method to the other, it is necessary to request and receive written permission from the Internal Revenue Department to make the change. This request must be made not later than 90 days after the beginning of the taxable year. In the letter asking permission, it is important that a statement be made regarding farm records that are being kept and it is advisable to give the name of the farm record book that is being used. A farmer should have opening and closing inventories and a record of receipts and expenses, not only for the taxable year for which the request is made, but also for the previous year.

For example: Suppose a man had been reporting on the cash basis, with the year beginning January 1, and now at the beginning of 1943, wanted to change to the accrual basis. Assuming he had the necessary records for 1942 and was still keeping such records, he would do these things: (1) Report for 1942 on the cash method. (2) Before April 1, 1943, write a letter to the Collector of Internal Revenue at St. Paul, asking permission to change. (3) After written permission has been received, prepare an Income Tax Return for 1942 made out on the accrual method. (4) Thereafter, keep up the necessary records and continue to report on the accrual method. For additional information see statement under "Accrual Method," page 4 of Form 1040F.

THE VICTORY TAX

The victory tax is an additional tax on income received after January 1, 1943. It does not apply to the 1942 business; therefore, it is disregarded in the preparation of the tax return on 1942 income.

The victory tax as now enacted provides that every person is to pay 5 per cent of the "victory tax net income" on wages and net business profit in excess of his exemptions. The exemption of every taxpayer is $624 per year or $12 per week without regard to his or her marital status. Therefore, the total exemption of a husband and wife having separate incomes may be $1248, providing the income of each one is $624 or more. If the income of one is more and the income of the other is less than $624, then the joint exemption is $624 plus the smaller income. Usually the earnings from the farm cannot be divided into income to the operator and income to his wife; therefore, the exemption allowed most farmers will be $624.

The tax on persons receiving salary or wages will be deducted by the employer on any earnings over $12 per week even though the total for the year is less than $624. The amount so deducted will be sent by the employer to the Bureau of Internal Revenue. The regulations specify that none of the payments to hired labor on a farm or domestic help in a home is to be withheld as a tax by the employer. However, such hired help must file a return and pay a victory tax at the end of the year if the annual income exceeds $624. All individuals who have had a victory tax withheld from their earnings and all other individuals whose income exceeds $624 will prepare a victory tax statement at the close of the year. The victory tax of a farmer is not paid on gross income. It is based on the next farm profit as figured on the income tax form, "Schedule of Farm Income and Expenses."

There are certain credits that may be used to reduce the victory tax payments. There are:

1. Payments during the taxable year on life insurance premiums in force September 1, 1942.

2. Payments on indebtedness. However, this credit is only the amount by which the indebtedness at the end of the year is less than the smallest indebtedness from September 1, 1942, to the beginning of the taxable year.

3. Payments for purchase of U.S. bonds. However, this credit is only the amount by which the total of such bonds owned at the end of the year exceeds the total of such bonds owned at the beginning of the taxable year.

These credits may be applied as follows:

1. For the farmer or other person computing the income tax returns at the close of the year, the credits earned during that taxable year may be used to reduce the victory tax payment or may be applied against other income tax payments of that taxable year.

2. For the person who has paid his victory tax as he went along by having 5 per cent deducted from his salary, the credits may be computed at the end of the year, and applied on other income tax payments for that taxable year.

There is a limit, however, to the amount of these credits which can be applied to the reduction of income tax payments in the manner described. That is, no matter how large the total amount paid during the year on life insurance, debt reduction, and bond purchases, the taxpayer can only claim credits equal to the following amounts: Married person living with spouse, or head of family, 40 per cent of victory tax, with limit of $500 (if a joint return is filed the limit is $1000); single person 25 per cent, with limit of $500; each dependent 2 per cent, with limit of $100.

After the war, the government will credit the taxpayer with any part of the recoverable portion of the victory tax which has not been previously claimed. The fund remaining to the taxpayer's credit will be credited against any income tax payments that the taxpayer may owe at that time and the balance will be refunded to the taxpayer.