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Income and Expense Timing Under the Cash Method*

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Introduction

One important consideration when filing a tax return is determining when and how income and expenses should be reported for tax purposes. The rules that govern the when and how of income and expense reporting are known as a taxpayer's method of accounting. Generally, the two primary methods of accounting used for tax purposes are the cash method and the accrual method.

While the use of either method is permitted, many individuals and small businesses use the cash method of accounting. Additionally, most farmers rely on the cash method as it is simpler, less time-consuming, and generally easier for tracking income and expenses throughout the year. However, certain entities are prohibited from using the cash method, and are instead required to use the accrual method of accounting. For businesses engaged in farming, this includes C corporations with average annual gross receipts exceeding $32 million in 2026 (adjusted annually for inflation), and partnerships with a C corporation as a partner, when that C corporation exceeds the $32 million gross receipts threshold. See Chapter 2 of *IRS Publication 225, Farmer's Tax Guide* for additional information regarding restrictions for using the cash method of accounting. Considering most farming businesses are eligible to use the cash method, and elect to do so, the discussion that follows focuses on the application of that method.

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Cash Method Overview

Under the cash method of accounting, income and expenses are reported in the tax year when payment is received or made. In other words, items of income are included in gross income in the year they are received, and expenses are deducted in the year they are paid.

Income Timing and Constructive Receipt

The cash method extends beyond amounts that are physically received and requires that taxpayers include in their gross income any amounts that are actually or constructively received during the tax year. Items of income that are considered constructively received are those that have not yet been physically received by the taxpayer, but have been made available to the taxpayer without restriction on the taxpayer's ability to control or access them. Due to this rule, income is taxable when it is in the taxpayer's hands or account, and they can use it. This rule is used to prevent taxpayers from delaying the recognition of income by not cashing a check, accepting payment, or depositing money until a later tax year.

Example 1:

Ashlyn uses the cash method of accounting. On December 18, 20X6, she received a $30,000 rent check from a farmer who leases a portion of her land. Ashlyn chose not to deposit the check until January 10, 20X7.

Ashlyn constructively received the rental income in 20X6 because the funds were made available to her without restriction when she received the check. She must include the $30,000 in her gross income for 20X6, even though she did not deposit the check until 20X7.

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Example 2:

Brent uses the cash method of accounting. On December 20, 20X6, he delivers corn to a local cooperative. The cooperative sells the corn before the end of the year. The cooperative issues a check to Brent for the sales proceeds, but Brent asks the cooperative to hold the check until after January 1, 20X7.

Brent constructively received the sales proceeds in 20X6 because he had an unrestricted right to access the funds at any time and there was no forward contract or deferred payment contract (discussed later in the fact sheet) requiring the cooperative to hold the proceeds until 20X7. Brent cannot defer recognition of the income simply by asking the cooperative to hold the check. Brent must include the sales proceeds in his gross income for 20X6, even though he did not receive the check until 20X7.

Expense Timing and Prepaid Expenses

In addition to rules related to income recognition under the cash method of accounting, there are also rules that govern the treatment of expenses. Some of the most important of these involve prepaid expenses. Prepaid expenses are costs for items used in a business that are purchased in a year prior to the year in which they are used. For farming businesses, prepaid expenses commonly include items such as insurance, rent, supplies, feed, fertilizer, and other production inputs. Although business expenses are typically deducted in the year they are paid, special rules apply to prepaid expenses. As a rule, taxpayers are not allowed to deduct prepaid expenses in the year they are paid. Instead, the costs for prepaid expenses must be recorded as an asset and deducted over the period in which the associated benefits from the expenses are received. This general rule applies unless the farmer meets one of the exceptions which are discussed later in this section.

Example 3:

Jed uses the cash method of accounting. On October 1, 20X6, he purchased and paid $7,200 for a 36-month insurance policy covering equipment used in his farming operation.

Although Jed paid the entire $7,200 in 20X6, he cannot deduct the full amount in that year, because the insurance policy provides benefits for more than one tax year. Instead, the prepaid insurance expense must be recorded as an asset and deducted over the period during which the benefit from the insurance coverage is provided. As a result, Jed may deduct $600 in 20X6 (3/36 × $7,200), $2,400 in 20X7 (12/36 × $7,200), $2,400 in 20X8 (12/36 × $7,200), and the remaining $1,800 in 20X9 (9/36 × $7,200).

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The first exception to this general rule for prepaid expenses is referred to as the 12-month rule. Under this exception, a prepaid expense may be deducted entirely in the year that it is paid rather than being recorded as an asset and deducted over time, if the following two requirements are met:

- The benefit associated with the prepaid expense cannot extend beyond 12 months after the date the taxpayer first receives the benefit.

- The benefit must not extend beyond December 31, for calendar year taxpayers, of the tax year following the year in which the payment for the prepaid expense was made.

Example 4:

Kade's business, XYZ, LLC, uses the cash method of accounting. On September 1, 20X6, XYZ paid $10,000 for a 12-month insurance policy that provides coverage beginning September 28, 20X6. The benefit runs through September 27, 20X7.

In this case, the 12-month rule applies. The benefit from the insurance policy does not extend more than 12 months beyond the date the taxpayer first receives the benefit AND does not extend beyond December 31 of 20X7. The $10,000 prepaid insurance expense is fully deductible in 20X6, the year it was paid.

Another exception to this general rule applies specifically to farming businesses. Under this exception, prepaid expenses for farm supplies and livestock feed can be deducted entirely in the year they are paid, rather than the years in which the associated benefits are received. However, the deduction for these prepaid farm supplies in the year they are paid may be limited to 50% of all other deductible farm expenses for that year. See *Prepaid Farm Expenses* on RuralTax.org and Chapter 4 of *IRS Publication 225, Farmer's Tax Guide* for additional information and examples regarding this exception.

Livestock for Resale

In addition to prepaid expenses, another special rule related to deductions for cash method taxpayers applies to livestock purchased for resale. Unlike the general rule that business expenses are deducted when paid, the cost of livestock purchased for resale is generally not deductible when the livestock are purchased. Instead, the purchase cost of the livestock is deducted in the year the livestock are sold.

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Example 5:

Katie uses the cash method of accounting. In 20X6, she purchases 20 feeder calves for $30,000, with the intent of reselling them. In 20X7, she sells the calves for $40,000.

Although Katie paid $30,000 for the calves in 20X6, she cannot deduct that cost in the year of purchase because the calves were purchased for resale. Instead, the $30,000 cost is deducted in 20X7, the year the calves are sold. As a result, Katie recognizes $10,000 of net income from the sale in 20X7 ($40,000 sales proceeds less the $30,000 cost of the calves).

Grain Sales

Considering the rules for both income and expense recognition, as well as constructive receipt, there are specific rules that apply to grain that is raised and harvested in one year, but sold in a later year. Under the cash method, the costs of producing the crop are generally deducted when paid. However, income from the crop is not recognized until the grain is actually sold, and payment is received or constructively received.

Example 6:

Dave uses the cash method of accounting. In 20X6, he incurs $50,000 of costs to plant and raise a wheat crop that is harvested in the fall of 20X6. In February 20X7, he sells the wheat for $80,000 and receives payment at that time.

Dave deducts the $50,000 of crop production costs in 20X6, the year they are paid. However, he does not recognize the income from the wheat until 20X7, when it is sold and payment is received.

There is a special rule that applies to deferred payment contracts for grain sales. This occurs when grain is sold in one year, but payment is intentionally deferred to a later year under a contractual agreement. Taxpayers are generally required to recognize income from a deferred payment contract in the year payment is received. However, if the contract states that the farmer has an unrestricted right to the proceeds after delivery, and the farmer simply chooses to defer payment, the income is taxable in the year the grain is delivered under the constructive receipt doctrine.

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Example 7:

Denise uses the cash method of accounting. In 20X6, she delivers grain to a buyer under a deferred payment contract for $60,000. Under the agreement, she does not have the right to receive payment until January 20X7, and she has no control over when the funds are paid.

Because Denise has a restricted right to the proceeds, the $60,000 is not recognized as income until 20X7, when the payment is received.

If instead the contract allowed Denise to receive the $60,000 in 20X6, but she chose to defer payment until 20X7, the income would be taxable in 20X6 under the constructive receipt doctrine.

Conclusion

Bringing together the rules governing when and how income and expenses are reported for tax purposes, along with specific rules applicable to farming operations, taxpayers have opportunities to engage in tax planning through the timing of transactions. Due to the complexity of these timing rules and individual circumstances, it is advisable to consult with a tax professional before year-end to ensure proper reporting of income and expenses, and to take advantage of available planning opportunities.

IRS Publications

To access IRS forms, schedules, and publications, go to www.irs.gov and type the publication, form or schedule number or title in the search box.

Additional Topics

This fact sheet was written as part of Rural Tax Education, a national effort including Cooperative Extension programs at participating land-grant universities to provide income tax education materials to farmers, ranchers, and other agricultural producers. For a list of universities involved, other fact sheets and additional information related to agricultural income tax please see RuralTax.org.

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