September 26, 2013

The Honorable Dave Camp, Chairman
U.S. House of Representatives
Committee on Ways and Means
Longworth House Office Building, 1102
Washington, DC 20515

Dear Representative Camp:

I am writing to express my firm's significant concerns about the proposal in the Ways and Means Committee small business tax reform discussion draft that would limit the use of the cash basis of accounting for U.S. farmers. This change to the tax code could significantly impact agricultural operations across the United States and would have an especially large impact on feedlots as well as beef, hog, and dairy operations.

Kennedy and Coe, LLC is a Top 100 accounting firm and one of the nation's largest agricultural accounting and consulting firms. We represent a wide diversity of agricultural operations across the country. Many of our clients would be negatively impacted by this proposal.

Background on the Proposed Tax Code Change

On March 12, 2013, the U.S. House of Representatives Committee on Ways and Means issued a discussion draft of provisions to reform the taxation of small businesses. Section 212 of the discussion draft proposed limitations on the use of the cash method of accounting for farmers with gross receipts of more than $10 million. This section would affect farming operations structured as partnerships and as S-corporations. Section 213 of the discussion draft proposes to repeal certain requirements for the use of accrual accounting by C-corporations and to increase the number of family corporations that would be required to use the accrual method of accounting.

Under current law, farmers may use a cash method of accounting unless they are structured as a C-corporation (with gross receipts of more than $1 million) or as a family corporation (with gross receipts of more than $25 million).[1] Under cash accounting, a farmer may recognize items of income when actually received and can recognize items of expense when actually paid.

Expected Impact on U.S. Agriculture

The cash method of accounting presents simpler recordkeeping for most farmers and provides agricultural operators with significant flexibility to manage their farming operations consistent with their cash flow. By contrast, under accrual accounting, a farmer could find that he has incurred a significant tax liability even though he has not yet received payment for a product.

As you know, commodity price volatility may dramatically affect the profitability of farming and other agricultural operations from year to year. Cash accounting methods allow operations to compensate for price volatility and create greater financial stability for their businesses. Because of this, approximately 95% of our dairy and feedlot clients use a cash method of accounting.

[1] Farm operations also must use the accrual basis of accounting if they are a partnership that has a corporation as a partner or if they are defined as a tax shelter.

Under the discussion draft released by the Committee on Ways and Means, farmers (other than sole proprietors) would be *required* to use an accrual method of accounting unless their gross receipts averaged less than $10 million per year. This proposed change would place a significant burden on many mid-sized farmers, feedlots, and hog, cattle, and dairy operations.

We estimate that this tax code change would apply to feed yards that process as few as 8,000 head of cattle per year, cattle feeders that sell more than 6,000 head of cattle per year, and small combined cattle and feeding operations. Any of these smaller companies could trigger the $10 million in gross receipts threshold with current cattle and feed prices. Many of these companies have been operating at significant losses for the past eighteen months due to high commodity prices.

For dairy operations, we estimate that an operation with as few as 1,400 cows could be at risk of losing the cash-basis status. This could affect dairy operations producing nearly one-third of U.S. dairy products and in a period following significant financial stress for many dairy farmers.[2] This would also significantly affect many commercial-scale farms or those selling high-value products.

Many of our clients who would be affected by this change are third-generation farming operations being run by a father and son or by siblings. Many of these family operations support dozens of employees but run at very thin margins and with very low net income.

The combination of historically thin margins, rising costs of production, and price volatility can dramatically impact the gross receipts that an entity engaged in farming may have from year to year and may not reflect the actual income or loss reported by the entity. As a result, an entity may be pushed into the accrual method of accounting because of a year or two of unusually high prices. Note that for an operation such as a feedlot, there is not any correlation between an increase in gross receipts from high corn prices and an increase in profits. To the contrary, in a time of rising commodity prices, an increase in gross receipts could narrow margins and reduce profitability.

Under a cash-basis system, a farmer can sell products or pay for inputs based on the farmer's cash flow. This cash flow is then reflected in the income or loss that they report. Under the accrual method, income or losses are not related to the actual cash flow of the farmer and vary dramatically. If farmers are required to use the accrual method, significantly more time and costs will be expended on record keeping and filing claims to carry operating losses back or forward..

The profit margin in agriculture is not large enough to be subject to a gross receipts test. Where other industries and professional service firms may experience a 40% to 50% gross margin to cover operating costs, agriculture usually has gross profit margins under 20% and, in many operations, typical margins may be just 4% to 5%. As a result, many agricultural operations have significant gross sales to generate a modest profit. In our experience, the profit margin in agriculture is not large enough to be subject to a gross receipts test as low as $10 million.

A final point that should be noted in this discussion is that increasing the use of accrual accounting in agriculture may actually lead to increased tax complexity rather than simplification. Under an accrual method of accounting, farming operations will increasingly be forced to file amended returns to offset gains from prior years with losses incurred in subsequent years. This constant refilling of tax returns is mitigated to a considerable degree by the use of cash accounting. Our firm represents some farming operations that are classified as C-Corporations and are thus currently subject to the $1 million gross receipts test. Such clients often must file amended returns to offset losses. Such filings are much less common among agricultural clients who can rely on the cash method of accounting.

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[2] In its 2012 "Farms, Land in Farms and Livestock Production" report, the USDA calculated that 1730 U.S. dairies have more than 1,000 cattle. Other USDA statistics indicate that in 2006, dairies with >1,000 head accounted for more than 1/3rd of the dairy production in the United States. With increasing concentration in this industry, this change to the tax code could well affect dairies representing nearly 1/3rd of U.S. dairy production.

Conclusion
The proposal in the discussion draft would eliminate long-time revenue recognition rules that currently exist and would make accounting significantly more complex for many agricultural operations. This proposal would limit the ability of producers to compensate for price volatility and extremely narrow margins. It would have an especially adverse impact on feedlots, certain types of cattle, hog and dairy operations, and other high-value producers.

Tax fairness for all individuals, including those in partnerships, should be a cornerstone of tax reform. Under the Ways and Means discussion draft, individuals can continue to use the cash-basis method to calculate and pay their taxes. Noting that a partnership is an aggregation of individuals, those individuals in partnerships should have the same ability to use the cash method basis, and should not be penalized for operating as a legally recognized partnership.

The repeal of the required use of the accrual method by corporate farmers with under $10 million in gross receipts would alleviate the burden imposed on these farming businesses. However, we believe the repeal of IRC section 447 should only be passed with the cash method farmer exception in place. As noted above, section 212 of the Proposal provides for eliminating an exception allowing the use of the cash method for farmers, and we oppose the elimination of this exception. If the Committee wishes to establish an across-the-board gross receipts test, we would advocate setting a threshold much higher than $10 million for agricultural operations. Given price volatility and narrow margins within agriculture, a $10 million gross receipts test impacts agriculture much more significantly than other industries. Finally, if the repeal provision (section 213) remains in the Proposal with the creation of a larger, across-the-board gross receipts test, the special method of accounting rules for corporations and partnerships with a corporate partner engaged in farming under IRC section 447 should be retained to provide those entities with an unchanged (IRC section 447) threshold on gross receipts for a farm corporation.

As CPAs, we believe tax reform should promote simplicity and economic growth and should *not* create unnecessary administrative and financial burdens for American taxpayers. The current proposal represents a significant challenge to the mid-sized and large agricultural producers that we represent all across this country.

If you have any questions, or if we can be of any further assistance, please do not hesitate to contact me at 970-685-3410.

Thank you for your consideration of this important matter.

Sincerely,

Jeff Wald

Jeff Wald, CEO