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What Should My CPA Know That I Am Not Telling Them?

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As a new year begins, we cannot fully close out the previous year until income tax returns have been filed and paid. I'm not sure which meeting is looked upon less favorably… a visit to the tax office or a visit to the dentist. No offense to the dental profession intended. However, much like going to the dentist, an open and honest conversation is critical with the tax preparer to make sure the process is done cleanly and accurately and to minimize future discomfort.

If a farm has been in business for a few years, the farmer will have a general understanding of what the conversation will their tax preparer will be like. They will discuss crop and livestock sales, farm business expenses, and the recently purchased tractor or bull. The goal on both sides is to make sure the income tax payment accurately reflects the amount of tax due based on net farm income for the year. However, there may be some items of income or expense that may be inadvertently missed without a thorough conversation. Below are a few items that can easily be missed during the tax preparation process.

I traded equipment without cash down-payment. Rarely does a year go by that a farmer does not purchase or trade equipment. These equipment trades are an important subject to discuss with the tax preparer. Hopefully, the tax preparer has access to the farm's financial information through a system supported by reconciled bank statements, such as computer software, spreadsheets, record books, or just a checkbook register. These systems provide a listing of farm transactions during the year. Most equipment purchases or trade-ins will appear on such statements because there will have been a payment made for either the full purchase price or a downpayment accompanied by a loan for the remainder. However, there are times that the only downpayment made is the piece (or pieces) of equipment traded in. The remainer due is financed. In this scenario, there will be no check to appear on a bank statement, thus nothing to note the transaction in the recordkeeping system. Still, the equipment purchase (and any trade-in) needs to be included in the tax return for the year the transaction occurred, and the new piece of equipment was placed in service.

I bought land with depreciable assets. Although land itself is not a depreciable asset, there could be assets included in a land purchase that could be depreciated. Barns, grain bins, ground tile, fencing, perhaps even lime or fertilizer applied in the previous year, could all have a basis assigned to them and thus depreciated and expensed over their appropriate life. Care must be given as to the allocation among the assets purchased. If an appraisal was completed at the time of sale, it should list all the assets purchased and can be used as a guide in allocating basis.

My neighbor did custom work for me, and I gave her leftover soybean seed. Bartering transactions are common on farms. A neighboring farm may help you bale hay, and you may return the favor by giving them some remaining bags of soybean seed. Even though both parties agree that it is an even trade, there still should be a transaction in the farm records (and then on the tax return), reporting the Fair

Market Value of the income and expense associated with the trade. In this example, there would be an added expense for the custom work done (hay baling) and a reduced seed expense (seed paid for but given to someone else). Such a transaction also helps on the farm management side of the business. If, in the above scenario, the farm gave away seed that they had purchased without also showing a reduction of the expense, then the total seed expense would be overstated.

My farm income will be higher (or lower) than normal next year. Most farmers pay taxes on a cash basis; meaning, within some parameters, they record income in the year it is collected and expenses in the year they are paid. Being a cash-based taxpayer allows farmers to try to balance taxable income from one year to the next, while not distorting taxable income. While there is an inclination to want to defer as much income as possible to the following year, it may not always be best to do so. If there is a known (or at least a well-educated guess) that net income in the next year will differ substantially from net income in the current year, the tax preparer can employ certain tactics to help smooth net farm income between years. The tax preparer may discuss options such as depreciation choices, deferment of crop insurance, net operating loss elections, or treatment of CCC loans, for example that will not only impact the current tax year but can assist in planning for the future tax years.

I collected crop insurance last year that was deferred to this year. If a farmer receives a crop insurance payment because of yield loss and they normally defer the sale of that crop to the following year, they will have an option to also defer reporting that crop insurance income to the next year. If you have the same tax preparer as the previous year, then it is likely that deferment will be recorded in the software. However, if you have switched tax preparers for the year of deferment, then they need to be made aware of the crop insurance deferment. The IRS will know that it was deferred as it was reported as such on the previous year’s return. Not reporting the income in the following year will likely result in receiving a letter from the IRS asking why you underreported income and asking for payment of not only additional tax, but penalties and interest as well.

I am retiring next year. As previously mentioned, farmers have the option to file taxes on a cash basis. Over the course of time, many farmers end up deferring income and prepaying expenses to manage their tax liability. Most of the time, that plan works reasonably well. That is until the farmer is ready to retire. Farmers that have deferred income and have prepaid expenses (and fully depreciated equipment purchases) for several consecutive years can potentially create a substantial tax issue for the first year of retirement. Without planning, a farmer could find themselves having a full years’ worth of income (or more), but very few expenses to offset that income. Not to mention that they may also be selling equipment the year after retirement, further increasing taxable income. Talking with your tax preparer at least three to four years before retirement can aid in managing the tax issues that may arise when closing out the farm business.

There is a well-known adage the reminds us that one of the two certainties of life is paying taxes. Paying taxes can be a good thing, especially when you consider that taxes are only owed when there is positive income, and farming is supposed to be a for-profit venture. Farmers are fortunate in the fact that they have many options available to manage their tax liability, within reason. The tax preparer should be considered a member of the farm advisory team. Having an open dialog with their tax preparer both before year end and at preparation time will allow both parties the ability to consider all options and make the process flow smoothly from one year to the next.

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