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Farm Management Guide MF-2358

Computation of Deferred Tax Liability — An Example

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An income tax liability arises from differences between balance sheet values of certain assets and liabilities and the tax basis of those same assets and liabilities. Farm financial statements, especially the balance sheet, should be prepared with recognition given to this income tax liability, or deferred taxes.

Deferred taxes reconcile the tax basis of a balance sheet with the basis currently being used for valuing assets and recording liabilities. That is, if all assets could be liquidated for exactly the amount shown on the balance sheet, and if all liabilities could be satisfied by payment of exactly the amount shown on the balance sheet, then what taxable income would result and what would be the tax liability?

The asset and liability values outlined in the example balance sheet (Table 1) are used to show the derivation of deferred taxes, or income tax liability, using the following three-step procedure.[1]

Step 1. Computation of current portion of deferred taxes. (See Table 2 for example computations.) The total amount by which the balance sheet value of current assets exceeds their taxable basis is calculated. Deferred income, such as crop insurance proceeds — reported for financial statements, but not recorded for tax purposes and for which no asset value exists on the balance sheet — must be included. Subtract the amount of current liabilities that result in deductions for tax purposes, such as accounts payable and accrued interest, from total deferred income calculated. The current portion of deferred taxes is then computed by multiplying an estimated total tax rate — which reflects federal, state, local, and social security taxing authorities — times the net deferred income.

Step 2. Computation of noncurrent portion of deferred taxes related to base value treatment of raised breeding livestock. (See Table 3 for example computations.) The difference between the base value and the tax basis for raised breeding livestock is calculated. The tax basis will be zero for raised breeding livestock that have not been capitalized and depreciated for tax purposes. Multiply the difference times the estimated total tax rate. Social security tax should be considered only on that portion of the difference subject to self-employment taxes.

Step 3. Computation of noncurrent portion of deferred taxes related to differences between market values and tax basis or base value of noncurrent assets. (See Table 4 for example computations.) Calculate the difference between the balance sheet market values of all noncurrent assets and their tax basis (base value for raised breeding livestock). For raised breeding livestock, the base value is subtracted from market value to determine the value — subject to capital gains tax. In most cases, noncurrent assets will be limited to breeding livestock, machinery and equipment, real estate, and improvements. The noncurrent portion of deferred taxes is then computed by multiplying the calculated deferred taxable income times the estimated total tax rate for capital asset sales.

The current and noncurrent portion of deferred taxes are recorded on the balance sheet as liabilities. If the total deferred income value, or taxable income, computed in steps 1 through 3 was negative, then a deferred tax refund would result, with the refund recorded as an asset on the balance sheet.

For more information on the computation of deferred taxes, see the publication *Financial Guidelines for Agricultural Producers II*, revised December 1997.

[1]*The federal and state income tax rates outlined in the following tables were used as an example to demonstrate the methodology of computing deferred taxes. These income tax rates will vary for different farm businesses.*

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Table 1. *Balance Sheet Statement; Example Farm*

Balance Sheet (Farm Business Only)

ASSETS		**Jan. 1**	**Dec. 31**	**Average**
Cash	(1)	$ 22,295	$ 23,778	$ 23,037
Marketable Securities	(2)	0	0	0
Accounts Receivable	(3)	6,397	6,396	6,397
Fertilizer and Supplies	(4)	7,667	8,151	7,909
Crops Held for Sale and Feed	(5)	78,911	82,264	80,588
Market Livestock	(6)	60,264	61,830	61,047
TOTAL CURRENT ASSETS (Add Lines 1 through 6)	(7)	$ 175,534	$ 182,419	$ 178,977
Breeding Livestock	(8)	44,893	45,958	45,426
Machinery and Equipment	(9)	143,480	153,054	148,267
Buildings	(10)	23,341	24,480	23,911
Investments in Cooperatives	(11)	16,183	17,004	16,594
Land	(12)	312,640	322,410	317,525
TOTAL NONCURRENT ASSETS (Add Lines 8 through 12)	(13)	$ 540,537	$ 562,906	$ 551,722
TOTAL ASSETS (Add Lines 7 and 13)	(14)	$ 716,071	$ 745,325	$ 730,698
LIABILITIES AND OWNER EQUITY:				
Accounts Payable	(15)	0	0	0
Taxes Payable	(16)	0	0	0
Accrued Expenses	(17)	3,013	3,145	3,079
Current Portion: Deferred Taxes	(18)	28,345	29,399	28,872
Notes Due Within One Year	(19)	62,442	65,238	63,840
Current Portion of Term Debt	(20)	12,685	13,007	12,846
Accrued Interest	(21)	8,500	8,500	8,500
TOTAL CURRENT LIABILITIES (Add Lines 15 through 21)	(22)	$ 114,985	$ 119,289	$ 117,137
Noncurrent Portion: Deferred Taxes	(23)	39,872	41,580	40,726
Noncurrent Portion: Notes Payable	(24)	42,283	43,355	42,819
Noncurrent Portion: Real Estate Debt	(25)	84,566	86,711	85,639
TOTAL NONCURRENT LIABILITIES (Add Lines 23 through 25)	(26)	$ 166,721	$ 171,646	$ 169,184
TOTAL LIABILITIES (Add Lines 22 and 26)	(27)	$ 281,706	$ 290,935	$ 286,321
OWNER EQUITY (Subtract Line 27 from Line 14)	(28)	$ 434,365	$ 454,390	$ 444,378
TOTAL LIABILITIES AND OWNER EQUITY (Add Lines 27 and 28)	(29)	$ 716,071	$ 745,325	$ 730,698

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Table 2. *Current Portion of Deferred Taxes*

January 1

	Market Value	Tax Basis	Difference
Accounts Receivable	$ 6,397	0	$ 6,397
Fertilizer and Supplies	7,667	0	7,667
Crops Held for Sale and Feed	78,911	0	78,911
Market Livestock	60,264	0	60,264
Excess of Carrying Value Over Tax Basis of Current Assets			$ 153,239
Deferred Income Liability on Crop Insurance, Disaster Payments, and Contracts			0
Total Deferred Income			$ 153,239
Accounts Payable			0
Income Taxes Payable (State and Local Only)			0
Accrued Expenses			3,013
Accrued Interest			8,500
Total Deferred Expenses			$ 11,513
Net Deferred Income Subject to Income Tax			$ 141,726
Estimated Deferred Tax Liability Related to Current Assets and Current Liabilities			$ 28,345

December 31

	Market Value	Tax Basis	Difference
Accounts Receivable	$ 6,396	0	$ 6,396
Fertilizer and Supplies	8,151	0	8,151
Crops Held for Sale and Feed	82,264	0	82,264
Market Livestock	61,830	0	61,830
Excess of Carrying Value Over Tax Basis of Current Assets			$ 158,641
Deferred Income Liability on Crop Insurance, Disaster Payments, and Contracts			0
Total Deferred Income			$ 158,641
Accounts Payable			0
Income Taxes Payable (State and Local Only)			0
Accrued Expenses			3,145
Accrued Interest			8,500
Total Deferred Expenses			$ 11,645
Net Deferred Income Subject to Income Tax			$ 146,996
Estimated Deferred Tax Liability Related to Current Assets and Current Liabilities			$ 29,399

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Table 3. Noncurrent Portion of Deferred Taxes Related to Base Value Treatment of Raised Breeding Livestock

January 1	Market Value	Tax Basis	Difference
Raised Breeding Livestock	$ 22,000	0	$ 22,000
Net Deferred Income Subject to Income Tax			$ 22,000
Estimated Deferred Tax Liability Related to Base Value Treatment of Raised Breeding Livestock			$ 4,400

December 31	Market Value	Tax Basis	Difference
Raised Breeding Livestock	$ 23,000	0	$ 23,000
Net Deferred Income Subject to Income Tax			$ 23,000
Estimated Deferred Tax Liability Related to Base Value Treatment of Raised Breeding Livestock			$ 4,600

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Table 4. *Noncurrent Portion of Deferred Taxes Related to Valuation Equity*

January 1

	Market Value	Tax Basis	Difference
Raised Breeding Livestock	$ 22,000	$ 22,000	$ 0
Purchased Breeding Livestock	22,893	11,500	11,393
Machinery and Equipment	143,480	71,500	71,980
Buildings	23,341	11,500	11,841
Investments in Cooperatives	16,183	16,177	6
Land	312,640	208,500	104,140
Deferred Taxable Income Related to Excess of Market Value over Base Value			$ 199,360
Estimated Deferred Tax Liability Related to Valuation Equity			$ 39,872

December 31

	Market Value	Tax Basis	Difference
Raised Breeding Livestock	$ 23,000	$ 23,000	$ 0
Purchased Breeding Livestock	22,958	11,500	11,458
Machinery and Equipment	153,054	76,500	76,554
Buildings	24,480	12,000	12,480
Investments in Cooperatives	17,004	17,004	0
Land	322,410	215,000	107,410
Deferred Taxable Income Related to Excess of Market Value over Base Value			$ 207,902
Estimated Deferred Tax Liability Related to Valuation Equity			$ 41,580

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Kansas State University Agricultural Experiment Station and Cooperative Extension Service

MF-2358 October 2002

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