KANSAS FARM MANAGEMENT & MARKETING HANDBOOK

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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.*

Table 1. *Balance Sheet Statement; Example Farm*

John P. Recorder
Balance Sheet (Farm Business Only)

ASSETS:		**Jan. 1**	**Dec. 31**	**Average**
Cash	(1)	10,000	8,000	9,000
Marketable Securities	(2)	0	0	0
Market Livestock	(3)	54,091	54,812	54,452
Crops Held for Sale and Feed	(4)	72,571	75,173	73,872
Accounts Receivable	(5)	14,895	15,654	15,275
Fertilizer and Supplies on Hand	(6)	5,941	9,058	7,500
TOTAL CURRENT ASSETS (Add Lines 1 through 6)	(7)	157,498	162,697	160,098
Breeding Livestock	(8)	36,839	37,789	37,314
Machinery and Equipment	(9)	102,199	109,581	105,890
Buildings	(10)	15,613	16,413	16,013
Investments in Cooperatives	(11)	14,895	15,654	15,275
Land	(12)	281,246	290,059	285,653
TOTAL NONCURRENT ASSETS (Add Lines 8 through 12)	(13)	450,792	469,496	460,144
TOTAL ASSETS (Add Lines 7 and 13)	(14)	608,290	632,193	620,242
LIABILITIES AND OWNER EQUITY:				
Accounts Payable	(15)	0	0	0
Taxes Payable	(16)	5,000	5,500	5,250
Accrued Expenses	(17)	4,000	3,500	3,750
Current Portion: Deferred Taxes	(18)	33,500	35,274	34,387
Notes Due Within One Year	(19)	48,635	49,150	48,893
Current Portion of Term Debt	(20)	11,125	12,250	11,688
Accrued Interest	(21)	8,500	9,000	8,750
TOTAL CURRENT LIABILITIES (Add Lines 15 through 21)	(22)	110,760	114,674	112,717
Noncurrent Portion: Deferred Taxes	(23)	33,579	35,018	34,299
Noncurrent Portion: Notes Payable	(24)	32,800	34,540	33,670
Noncurrent Portion: Real Estate Debt	(25)	76,840	77,300	77,070
TOTAL NONCURRENT LIABILITIES (Add Lines 23 through 25)	(26)	143,219	146,858	145,039
TOTAL LIABILITIES (Add Lines 22 and 26)	(27)	253,979	261,532	257,756
OWNER EQUITY (Subtract Line 27 from Line 14)	(28)	354,311	370,661	362,486
TOTAL LIABILITIES AND OWNER EQUITY (Add Lines 27 and 28)	(29)	608,290	632,193	620,242

Table 2
Current Portion of Deferred Taxes

January 1

	Market Value	Tax Basis	Difference
Market Livestock	$ 54,091	0	$ 54,091
Crops Held for Sale and Feed	72,571	0	72,571
Accounts Receivable	14,895	0	14,895
Fertilizer and Supplies on Hand	5,941	0	5,941
Excess of Carrying Value Over Tax Basis of Current Assets			$ 147,498
Deferred Income Liability on Crop Insurance, Disaster Payments, and Contracts			0
Total Deferred Income			$ 147,498
Accounts Payable			0
Income Taxes Payable (State and Local Only)			1,000
Accrued Expenses			4,000
Accrued Interest			8,500
Total Deferred Expenses			$ 13,500
Net Deferred Income Subject to Income Tax			$ 133,998
Estimated Deferred Tax Liability Related to Current Assets and Current Liabilities			$ 33,500

December 31

	Market Value	Tax Basis	Difference
Market Livestock	$ 54,812	0	$ 54,812
Crops Held for Sale and Feed	75,173	0	75,173
Accounts Receivable	15,654	0	15,654
Fertilizer and Supplies on Hand	9,058	0	9,058
Excess of Carrying Value Over Tax Basis of Current Assets			$ 154,697
Deferred Income Liability on Crop Insurance, Disaster Payments, and Contracts			0
Total Deferred Income			$ 154,697
Accounts Payable			0
Income Taxes Payable (State and Local Only)			1,100
Accrued Expenses			3,500
Accrued Interest			9,000
Total Deferred Expenses			$ 13,600
Net Deferred Income Subject to Income Tax			$ 141,097
Estimated Deferred Tax Liability Related to Current Assets and Current Liabilities			$ 35,274

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	$ 18,000	0	$ 18,000
Net Deferred Income Subject to Income Tax			$ 18,000
Estimated Deferred Tax Liability Related to Base Value Treatment of Raised Breeding Livestock			$ 3,600

December 31

	Market Value	Tax Basis	Difference
Raised Breeding Livestock	$ 18,000	0	18,000
Net Deferred Income Subject to Income Tax			$ 18,000
Estimated Deferred Tax Liability Related to Base Value Treatment of Raised Breeding Livestock			$ 3,600

Table 4
Noncurrent Portion of Deferred Taxes Related to Valuation Equity

January 1

	Market Value	Tax Basis	Difference
Raised Breeding Livestock	$ 18,000	$ 18,000	$ 0
Purchased Breeding Livestock	18,839	9,500	9,339
Machinery and Equipment	102,199	50,000	52,199
Buildings	15,613	8,500	7,113
Investments in Cooperatives	14,895	14,895	0
Land	281,246	200,000	81,246
Deferred Taxable Income Related to Excess of Market Value Over Base Value			$ 149,897
Estimated Deferred Tax Liability Related to Valuation Equity			$ 29,979

December 31

	Market Value	Tax Basis	Difference
Raised Breeding Livestock	$ 18,000	$ 18,000	$ 0
Purchased Breeding Livestock	19,789	10,000	9,789
Machinery and Equipment	109,581	55,000	54,581
Buildings	16,413	8,750	7,663
Investments in Cooperatives	15,654	15,654	0
Land	290,059	205,000	85,059
Deferred Taxable Income Related to Excess of Market Value Over Base Value			$ 157,092
Estimated Deferred Tax Liability Related to Valuation Equity			$ 31,418

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