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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 two-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 differences between market values and tax basis or base value of noncurrent assets. (See Table 3 for example computations.) Calculate the difference between the balance sheet market values of all noncurrent assets and their tax basis. Noncurrent assets include breeding livestock, machinery and equipment, real estate, and improvements. The tax basis will be zero for raised breeding livestock that have not been capitalized and depreciated for tax purposes. The noncurrent portion of deferred taxes is 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 and 2 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*, revised January 2008.

[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)	$ 42,189	$ 46,912	$ 44,551
Marketable Securities	(2)	0	0	0
Accounts Receivable	(3)	1,667	1,718	1,693
Fertilizer and Supplies	(4)	16,722	20,599	18,661
Investment in Growing Crops	(5)	0	0	0
Crops Held for Sale and Feed	(6)	108,381	133,817	121,099
Market Livestock	(7)	$ 81,311	$ 81,748	$ 81,530
TOTAL CURRENT ASSETS (Add Lines 1 through 7)	(8)	$ 250,270	$ 284,794	$ 267,532
Breeding Livestock	(9)	51,335	53,027	52,181
Machinery and Equipment	(10)	203,055	220,170	211,613
Buildings	(11)	30,280	32,170	31,225
Investments in Cooperatives	(12)	18,941	19,639	19,290
Land	(13)	485,560	499,132	492,346
TOTAL NONCURRENT ASSETS (Add Lines 9 through 13)	(14)	$ 789,171	$ 824,138	$ 806,655
TOTAL ASSETS (Add Lines 8 and 14)	(15)	$1,039,441	$1,108,932	$1,074,187
LIABILITIES AND OWNER EQUITY:				
Accounts Payable	(16)	0	0	0
Taxes Payable	(17)	0	0	0
Accrued Expenses	(18)	3,346	3,377	3,362
Current Portion: Deferred Taxes	(19)	42,526	51,358	46,942
Notes Due Within One Year	(20)	112,019	117,444	114,732
Current Portion of Term Debt	(21)	13,585	14,059	13,822
Accrued Interest	(22)	2,000	2,000	2,000
TOTAL CURRENT LIABILITIES (Add Lines 16 through 22)	(23)	$ 173,476	$ 188,238	$ 180,857
Noncurrent Portion: Deferred Taxes	(24)	45,163	46,453	45,808
Noncurrent Portion: Notes Payable	(25)	56,866	58,850	57,858
Noncurrent Portion: Real Estate Debt	(26)	119,103	123,259	121,181
TOTAL NONCURRENT LIABILITIES (Add Lines 24 through 26)	(27)	$ 221,132	$ 228,562	$ 224,847
TOTAL LIABILITIES (Add Lines 23 and 27)	(28)	$ 394,608	$ 416,800	$ 405,704
OWNER EQUITY (Subtract Line 28 from Line 15)	(29)	$ 644,833	$ 692,132	$ 668,483
TOTAL LIABILITIES AND OWNER EQUITY (Add Lines 28 and 29)	(30)	$1,039,441	$1,108,932	$1,074,187

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Table 2. *Current Portion of Deferred Taxes*

January 1

	Market Value	Tax Basis	Difference
Accounts Receivable	$ 1,667	$ 0	$ 1,667
Fertilizer and Supplies	16,722	0	16,722
Crops Held for Sale and Feed	108,381	0	108,381
Market Livestock	81,311	60,983	20,328
EXCESS OF CARRYING VALUE OVER TAX BASIS OF CURRENT ASSETS			$147,098
Deferred Income Liability on Crop Insurance, Disaster Payments, and Contracts			0
TOTAL DEFERRED INCOME			$147,098
Accounts Payable			0
Income Taxes Payable (State and Local Only)			0
Accrued Expenses			3,346
Accrued Interest			2,000
TOTAL DEFERRED EXPENSES			$ 5,346
NET DEFERRED INCOME SUBJECT TO INCOME TAX			$141,752
ESTIMATED DEFERRED TAX LIABILITY RELATED TO CURRENT ASSETS AND CURRENT LIABILITIES			$ 42,526

December 31

	Market Value	Tax Basis	Difference
Accounts Receivable	$ 1,718	$ 0	$ 1,718
Fertilizer and Supplies	20,599	0	20,599
Crops Held for Sale and Feed	133,817	0	133,817
Market Livestock	81,748	61,311	20,437
EXCESS OF CARRYING VALUE OVER TAX BASIS OF CURRENT ASSETS			$176,571
Deferred Income Liability on Crop Insurance, Disaster Payments, and Contracts			0
TOTAL DEFERRED INCOME			$176,571
Accounts Payable			0
Income Taxes Payable (State and Local Only)			0
Accrued Expenses			3,377
Accrued Interest			2,000
TOTAL DEFERRED EXPENSES			$ 5,377
NET DEFERRED INCOME SUBJECT TO INCOME TAX			$171,194
ESTIMATED DEFERRED TAX LIABILITY RELATED TO CURRENT ASSETS AND CURRENT LIABILITIES			$ 51,358

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Table 3. *Noncurrent Portion of Deferred Taxes*

January 1

	Market Value	Tax Basis	Difference
Raised Breeding Livestock	$ 25,650	$ 0	$ 25,650
Purchased Breeding Livestock	25,685	12,840	12,845
Machinery and Equipment	203,055	101,525	101,530
Buildings	30,280	15,140	15,140
Investments in Cooperatives	18,941	18,941	0
Land	438,208	292,285	145,923
DEFERRED TAXABLE INCOME RELATED TO EXCESS OF MARKET VALUE OVER BASE VALUE			$ 301,088
ESTIMATED DEFERRED TAX LIABILITY RELATED TO VALUATION EQUITY			$ 45,163

December 31

	Market Value	Tax Basis	Difference
Raised Breeding Livestock	$ 26,500	$ 0	$ 26,500
Purchased Breeding Livestock	26,527	13,265	13,262
Machinery and Equipment	220,170	110,085	110,085
Buildings	19,639	9,820	9,819
Investments in Cooperatives	19,639	19,639	0
Land	450,516	300,495	150,021
DEFERRED TAXABLE INCOME RELATED TO EXCESS OF MARKET VALUE OVER BASE VALUE			$ 309,687
ESTIMATED DEFERRED TAX LIABILITY RELATED TO VALUATION EQUITY			$ 46,453

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