FARM BUSINESS MANAGEMENT

FARM ECONOMICS Facts & Opinions

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January 16, 2001 **FEFO 01-02**

DEFERRED TAXES – A FINANCIAL CONSIDERATION

Deferred taxes are a financial liability that is receiving more and more consideration from agricultural lenders, accountants and other consultants that work with agricultural producers. What are deferred taxes? Deferred taxes are the income and self-employment taxes that would be due if a producer completely liquidated his or her's assets in the farm business.

For many producers this can be a substantial amount. The reason for this is that most farm operators file their income taxes on a cash basis. All the expenses of raising a crop or feeding livestock are deducted in the year the expenses are paid. Many producers retire or leave the farm business with a significant dollar amount of grain and/or livestock inventory. Frequently this inventory is sold in the year or years following when the production expenses of raising this inventory have been deducted. This results in a large amount of income with minimal expenses to offset this income.

SALE OF MACHINERY AND EQUIPMENT

The sale of machinery and equipment used in the farming business can also result in significant taxable income. The sale of a modern line of well-kept equipment can result in a substantial gain over the remaining book value or tax basis. If a producer sells their machinery at an auction, this gain is realized all in one year. Producers who have family members taking over the business may spread this tax burden out over time by selling a piece or two of machinery every year or leasing the machinery over a number of years.

The question that arises is should deferred tax liability be included as a liability on a producer's balance sheet. Historically, this has not been the case. Generally, agricultural lenders have not required that this liability be included and producers normally would not include this unless asked to do so. Listing other assets and liabilities, which are easier to value and more tangible, takes a higher priority.

Why has this not been a concern? This only becomes an issue when a producer retires or liquidates part of their assets. For most ongoing businesses, realization of this liability is not of an immediate concern. Is this becoming more of an issue? It's beginning to be. The Farm Financial Standards Council, which is an organization with a goal of standardizing the financial statement reporting and analysis of farm businesses, has been debating this issue recently and recommending that this liability be included on the balance sheet. From a practical standpoint, as more producers are considering retirement, the realization of this liability is becoming more common. In addition, as businesses grow in size, the size of the deferred tax liability usually grows.

STUDY ESTIMATING AMOUNT OF DEFERRED TAXES

Inclusion of this liability can change the financial analysis of a farm business significantly. A recent study done by Charles Cagley, State Coordinator for the Illinois FBFM Association, analyzed modified cost and fair market value balance sheets from 229 producers enrolled in the FBFM record keeping and business analysis program. The study estimated the deferred tax liability on the current assets (grain, market livestock, etc.) at $62,000, on the intermediate assets (machinery and breeding livestock) at $42,000 and on the long-term assets (land and buildings) at $37,000. The total deferred tax liability was $141,000. If included, the net worth of these businesses would drop by almost 19 percent.

EFFECT ON FINANCIAL RATIOS

Besides the drop in net worth, financial analysis ratios also changed significantly. For example, the current ratio (current assets minus current liabilities) dropped from a respectable 1.76 to 1.19, a decrease of 32 percent. The debt to net worth ratio (total liabilities divided by total net worth) increased from .37 to .68, a significant jump.

Although we are not seeing many agricultural lenders or producers routinely include this liability when completing a balance sheet, producers that are nearing retirement or considering selling some of their farm assets should consider the effect of deferred taxes to their long range plans. For many producers, deferred taxes will become a liability that will have to be reckoned with, even if it is not listed on the balance sheet. It will reduce the amount of cash available for retirement purposes.

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