SOME FOOD FOR THOUGHT
ON POTENTIAL DEFERRED TAX LIABILITY

After a long winter, we are finally moving into spring. We want to continue to recognize those who are still dealing with the recent flooding and blizzard that hit our state. Recovery is going to be long and difficult, but Security Bank is committed to supporting our communities and customers who have been affected. Tax season for most farm producers has wrapped up for the 2018 filing by now. Going forward, we found some food for thought pertaining to one’s potential deferred tax liability. While this month’s information is more general in scope, we encourage you to talk to your accountant about where you might stand with deferred tax liability, especially for those looking to transition to the next generation or retire in the next several years. Your accountant may be able to help you manage this aspect and hopefully prevent surprises!

Best Regards,

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DO YOU KNOW YOUR DEFERRED TAX NUMBER

BY PAUL NIEFFER | CliftonLarsonAllen

Farmers have the unique ability to defer their income tax liability down the road for many years. However, over time, this number can build up and if adequate planning is not done, the final tax hit in year of retirement can be substantial.

A farmer who plans for this and knows their deferred tax number will be in much better shape. But how do you calculate this number?
We typically look at the farm operating assets only to calculate the number. Most farmers will keep the farm land and then pass it onto to the next generation and in this case, the land will get a step-up in tax cost basis and eliminate the deferred tax.

However, operating assets will likely be liquidated in the year after the last harvest. In this situation, the farmer has deducted all of their costs in the year of harvest and will have very little cost when they sell the grain the following year. If they are a Schedule F farmer, full self-employment tax will be owed on the final sale plus federal and state income taxes.

If the farmer calculates the amount of deferred tax liability periodically, it allows them a much better chance to plan on how to reduce this tax. We would recommend calculating this number annually.

The farmer will add up the value of their grain inventories, equipment values, prepaids and other assets related to the farm operation. They will then subtract the tax cost basis (in most cases zero) and then multiply the result by an average tax rate to account for federal, state and self-employment taxes.

Here is a quick example:

John has grain inventories worth $1.5 million, prepaids of $500,000 and farm equipment worth $2 million. His tax cost basis in these assets is zero. He estimates his average tax rate at liquidation to be 45%, therefore, his deferred tax liability is $1.8 million.

\[
\begin{align*}
\text{Grain Inventories} & \quad $1,500,000 \\
\text{Prepaids} & \quad $500,000 \\
\text{Equipment Values} & \quad $2,000,000 \\
\hline
\text{Total Value} & \quad $4,000,000 \\
\text{Tax Cost Basis} & \quad $0 \\
\text{Average Tax Rate} & \quad 45\% \\
\hline
\text{Deferred Tax Liability} & \quad $1,800,000
\end{align*}
\]

Farmers who know this number are much better prepared to deal with it than not knowing. Do you know yours?