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Farm Loan Immediate Relief for Borrowers with At-Risk Agricultural Operations*

What Does it Mean for You and Its Potential Tax Consequences

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Introduction

The Inflation Reduction Act of 2022 was signed by the President in August. The act, through Section 22008, repealed the Farm Loan Assistance Section 1005 of the American Rescue Plan of 2021 (ARP). Section 1005 of ARP was replaced with Section 22006, Farm Loan Immediate Relief for Borrowers With At-Risk Agricultural Operations. It provides $3.1 billion to be made available through Sept. 30, 2031 to deliver assistance through the USDA Farm Service Agency (FSA) to help producers that are having difficulty staying current with their direct or secured FSA loans. The Secretary of Agriculture was to determine how the program would be initiated and program funds to be disbursed.

This publication presents the basics about the program, the tax consequences, tax management methods to consider, and farm management considerations.

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Program Basics

In October of 2022, the Secretary of Agriculture announced that the USDA had rolled out the plan and had already begun providing program funding to those borrowers that are "at-risk". The USDA FSA has already identified individual borrowers placing them into different categories based on 1) the loan type (secured vs. direct borrowers), 2) whether the borrower is current on the loan or 60 days or more behind in payments, 3) borrowers in proceedings of loan closure and or in bankruptcy, 4) those borrowers that were unable to make a payment and utilized FSA's Disaster-Set-Aside option, 5) the loan has already been closed or that bankruptcy has been completed and the borrower still has an outstanding balance, or 6) a borrower that is likely to miss their next loan payment. The category that a borrower has been placed in will determine when assistance may be provided (in 2022 or in 2023), and the amount of the assistance that will be provided. You do not have to sign-up for the program payment, the USDA FSA has already identified those individuals that are eligible.

As of October of 2022, 13,000 borrowers have already received program payments applied to their accounts. Borrowers that were delinquent in payments by 60 days or more on direct or guaranteed loans have received a program payment to make their loan current, those that have a direct loan have also received a payment that has been applied to their next loan payment, while those with a guaranteed loan have received a payment that makes them current to date. Those farms that have already been foreclosed have received a program payment that covers their remaining outstanding debt.

Borrowers that have received program benefits will receive a letter from the USDA FSA stating either that a program payment was made and was directly applied to the loan, or receive a check made out to them and the lender to apply to the loan. While borrowers with direct loans with FSA did not receive a check directly, they have had the amount applied directly to their loan balance. The borrower will also receive a 1099-G (this will show all government program payments received by the individual) and possibly a 1098 (this will show all interest paid by the borrowers on any mortgages) from the USDA FSA for the year.

Tax Consequences

It is important to understand that this program is not formal relief from debt, this is a USDA program payment that is to be directly applied to debt (direct FSA loans or FSA guaranteed loans through a commercial lender). Since this is considered a program payment, the amount of the payment reported on Form 1099-G is taxable for income tax purposes and is subject to Self-Employment (SE) Tax. The program payment is treated as ordinary earned income, which will be taxed at your individual income tax rate plus a 15.3% SE Tax. The SE tax is made up of 12.4% for Social Security on the first $147,000 (for the 2022 tax year), and 2.9% (on 100% of the income). It is possible that an additional 0.9% Medicare tax will be triggered above a threshold amount ($250,000 for Married Filing Jointly filers, and $200,000 for Single filers). The program payment for many borrowers will

cover a principal payment and an interest payment. The portion of the program payment that is paid to cover the outstanding interest portion of the payment, reported on Form 1098, will be a deductible expense to the borrower which should offset that portion of the program payment from income for tax purposes.

Example 1: Eli's Eel Farm

Eli Willy is married and files a joint tax return. Eli received a program payment of $100,000 that was directly applied to Eli's FSA Direct Loan. Eli has no farm profit this year, therefore the $100,000 is treated as income subject to SE tax. Eli may owe as much as $7,563 in federal income tax and owe $15,300 of SE tax dependent on individual credits, other deductions, etc. for a total of $22,863. Dependent on the state Eli lives in, there may also be income taxes owed at the state and local municipal level as well. Eli lives in South Carolina so there could be up to an additional $7,000 in state income tax owed. Since Eli received the program payment, he may owe as much as almost $30,000 in taxes from the $100,000 program payment.

Example 2: Ava Rose Alpaca Farm

Ava is single and began a small Alpaca and specialty crop farm three years ago and does not have much revenue. She is 120 days delinquent in her last loan payment. She received a program payment of $30,000. Ava may owe up to $1,565 in federal income tax, $4,590 in SE Tax, as well as state and local municipal income tax dependent on where Ava's farm is located.

Example 3: Annika's Tiger Lilly Greenhouse

Annika is married and files jointly. She and her husband own a large greenhouse that took a big financial hit due to the COVID pandemic and a natural disaster. They received a program payment of $1 million dollars, and their expenses are more than their revenue this year by $100,000. They do have a some carry over Net Operating Loss(es) of $50,000 that can help offset some of the program payment. This creates a federal income tax bill of up to $287,142 and a SE Tax of up to $42,357 plus any state and local municipal income tax that may be owed.

Tax Management

It is imperative that once a borrower knows that a program payment has been applied to a loan, the borrower should meet with their tax/legal professional to discuss some tax management strategies. There are a number of different strategies that may be useful to reduce the tax bite, each has its own pros and cons, and needs to be considered for future planning and cash flow projections.

Depreciation

Depreciation will offset some of the tax liability if there is any carry-over depreciation available or if there have been any capital asset purchases made during the tax year the program payment was received. Be careful of using Section 179 or bonus depreciation at too high of a level, as it will decrease future carry-over depreciation to offset future income.

Net Operating Loss

As seen in Example 3, any remaining carry over Net Operating Loss(es) (NOL) may be used to offset taxable income up to 80% of the total taxable income for the year. If your taxable income is $100,000 for the year and if the borrower has $250,000 of NOL's only $80,000 will be able to be applied to the $100,000 of taxable income leaving $20,000 of taxable income.

Prepaying Deductible Expenses

Making purchases for products that are going to be used for the coming growing season may be used if the borrower has the cash necessary to make the purchases. There are specific rules that must be followed for those purchases to be deductible in this year including but not limited to: 1) you must have a constructive receipt for the purchase which states the specific product, the quantity of the product and the cost, 2) the product purchase must be made because of a possible issue with availability at the time of need, 3) there is a chance that the product will increase in price at the time of need i.e. it costs less now to purchase it than at the time of need. There are other limitations that should be discussed with a tax professional.

Income Averaging (Schedule J)

Income averaging is a tax management strategy only available to farmers and commercial fishermen. Income averaging allows a taxpayer to take some of the income from this tax year and apply it to the three previous years income tax brackets. This can be advantageous if the taxpayer is in a higher income tax bracket this year than in the three previous years.

Example 4: Jennifer Ann's Berry Farm

Jennifer is married and files jointly. This year Jennifer Ann has had a great year and is in a higher-than-normal tax bracket for her at 35%. Normally she is in the 12% income tax bracket. Because of this she will be utilizing Income Averaging. She is going to take $180,000 of this year's income to be applied to lower unused income tax brackets in the previous three years. The Internal Revenue Code (IRC) requires that the amount of income from this year to be applied to each of the three previous years must be split evenly to the three previous years brackets. The $180,000 will be divided by "3" which equals $60,000 ($\$180{,}000/3 = \$60{,}000$) that will be applied in each of the previous three tax years at lower income tax brackets that are available. This can be beneficial to many farmers for tax purposes. It is important to understand that this is not the same as amending a tax return. This does not open the taxpayer up to a reset of an audit for previous year's tax returns since they are not being amended.

Farm Financial Management

As seen from the above examples, receiving a program payment may very well trigger a taxable event, and the taxes owed may be substantial. It is also likely that the farm/borrower receiving the payment may not have the cash flow necessary to cover the tax liability triggered by the program payment. This may require the borrower to take out an additional loan to cover the tax liability that will be owed. Additional planning and preparation will be required to manage the income tax implications.

Although many farmers will reference the lifestyle, teaching their children responsibility, and other personal purposes why they continue to farm, even with the amount of risk that comes with it, it is still a business and needs to be treated as such. It is a good practice that a farm financial analysis be done at the end of every year. This requires using beginning and ending balance sheets, the farm accounting, and production information to develop an accrual adjusted income statement to view how well the farm did that year from a profit and economic standpoint. Did the net worth increase? Did we use or sell more of the farms inventory to make cash flow compared to normal? Do we have similar accounts receivable or payable from the previous year, or were there significant increases or decreases in accounts receivable and payable at the end of the year?

Performing a true farm financial analysis every year may bring potential issues to light before they become a larger problem. Financial analysis allows the operator to make well-informed management decisions to strengthen the financial position of the farm.

The reality of the situation is that unless changes are made that required the program payment discussed in this document to be made, the farm very well may end up not being able to make debt payments in the future and putting the farming operation in jeopardy. Sometimes this occurs just based on circumstances beyond the control of any one individual not limited to any number of risks including weather, disease and insects, geo-politics, etc. But it is still the borrower that is held accountable for the debt that is owed.

Summary

A borrower does not have to sign up for the program, the USDA FSA has already identified eligible program payment recipients. Most borrowers that receive a payment will not receive any of the cash directly, as it will be applied to the loan that is presently in delinquency. The program payment is considered a taxable event and is treated as ordinary earned income subject to SE tax. The program payment recipient will receive a letter from USDA FSA letting them know of the program payment and that it has been directly applied to the loan or is to be applied to the loan. The borrower should also receive a 1099-G and possibly a 1098 from the USDA FSA in early 2023 for tax year 2022. Once the borrower receives the letter, they should immediately check their loan account to determine and confirm the amount of principal and interest that has been paid. The interest paid as part of the

program payment will also count as a deductible expense to the borrower which should offset that proportion of the income from the program payment. The program payment recipient should also begin to work with their tax professional to let them know of the program payment and that it is considered taxable ordinary earned income subject to SE tax and begin an end of the year tax estimate and develop a tax management plan.

Additional Topics

This fact sheet was written as part of Rural Tax Education a national effort including Cooperative Extension programs at participating land-grant universities to provide income tax education materials to farmers, ranchers, and other agricultural producers. For a list of universities involved, other fact sheets and additional information related to agricultural income tax please see RuralTax.org.

- 1099s: *https://ruraltax.org/files-ou/1099s.pdf*
- Self-Employment Tax: *http://ruraltax.org/files-ou/2022_SE_Tax.pdf*
- Optional Method of Paying Self-Employment Tax: *https://ruraltax.org/files-ou/FarmOptionalSETax.pdf*
- How to Choose a Tax Professional: *https://ruraltax.org/files-ou/ChooseTaxProfessional.pdf*
- Tax Estimator Tool: *http://www.ruraltax.org/tax-estimator*

Other Links

- Inflation Reduction Act Assistance for Distressed Borrowers: *https://www.farmers.gov/inflation-reduction-investments/assistance*
- USDA Tax Information Page: *https://www.farmers.gov/working-with-us/taxes*