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Farm Reorganizations and Payments to Foreign Owners of U.S. Cropland

Statement of
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Before the
Subcommittee on Wheat, Soybeans, and
Feed Grains
Committee on Agriculture
House of Representatives

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Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to discuss our ongoing review of farm reorganizations related to the $50,000 per person payment limitation and their impact on farm payments made by the Department of Agriculture (USDA). This work, Mr. Chairman, was originally requested by Mr. Dorgan, Mr. Panetta, and you in response to concerns that farmers were increasingly reorganizing their farming operations to avoid the payment limitation restrictions by adding new persons. As requested, our work focused on (1) identifying the number of new producers (i.e., persons) created as a result of farm reorganizations from 1984 to 1986; (2) estimating the additional cost to the government of these reorganizations; and (3) projecting the additional costs of such reorganizations, if the trend in reorganizations were to continue in fiscal years 1987 to 1989. My testimony today will address each of these issues and will discuss some options that would enhance the effectiveness of current payment limitations. In addition, as requested we are reviewing USDA's process for determining whether reorganizations were proper for payment limitation purposes. While we have not yet completed this portion of our review, we have identified some areas where improvements need to be made in USDA's application of the current payment limitation program.

The final issue I will highlight, at your request, is the findings of our recently completed work on payments made to foreign owners of U.S. cropland.[1]

BACKGROUND ON PAYMENT LIMITATIONS

The Congress initially passed a limitation on direct income support payments in response to both the high cost of federal farm programs and reports of large subsidy payments to individual producers. The current limit is $50,000 per person in direct subsidy payments for producers of wheat, corn and other feed grains, cotton, and rice. Under the payment limitation regulations, a person is broadly defined to be an individual, joint venture, limited partnership, corporation, association, trust, estate, or other legal entity that is actively engaged in farming.

Besides the $50,000 limit on direct support payments, separate limits have been placed on other agricultural programs. As part of the 1987 continuing appropriations act (Public Law 99-591), a new $200,000 per-person, per-year, limit was placed on marketing loan and other payments beginning with the 1987 crop year. In addition, there is a separate annual limit of $50,000 per person for the long-term conservation reserve program that was established by the Food Security Act of 1985. While separate, these limits use the same legislative and regulatory provisions to determine who or what constitutes a person for payment limitation purposes.

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[1]Payments and Loans to Foreign Owners of U.S. Cropland (GAO/RCED-87-81BR, March 19, 1987).

NUMBER AND COST OF REORGANIZATIONS

During our review we identified an increasing trend in reorganizations from 1984 through 1986 that may have been related to the $50,000 payment limitation. Between 1984 and 1986, these reorganizations added almost 9,000 new persons to USDA payment rolls. Cumulatively, these reorganizations resulted in an additional $328 million in program costs in that same period. We estimate that should the trend in farm reorganizations continue, reorganizations since 1984 could be adding almost $900 million annually to program costs by 1989. Cumulative costs for the 6-year period, 1984 to 1989, could approach $2.3 billion.

1984 Through 1986 Reorganizations

During 1984, 1985, and 1986, about 31,000, 50,000, and 66,000 new persons were added to USDA's program payment rolls for a variety of reasons. These included inheritance of farmland, establishment of totally new farming operations, and farm reorganizations. Some of these new persons were part of operations that received payments in prior years.

The number of persons receiving direct payments of $40,000 or greater increased dramatically from about 4,300 in 1983 to about 29,000 in 1985. While the 1985 figure still represents only about 3 percent of all persons receiving direct payments, it nonetheless shows that a large number of farmers may now have an incentive to reorganize their operations as they near or meet the payment limit.[2]

On the basis of a statistically valid random sample of these new persons, we project, as shown on chart 1, that about 1,400, 1,900, and 5,700 new persons were created as a result of farm reorganizations in 1984, 1985, and 1986. In each instance, at least one producer on the original farming operation received $40,000 or more in payments. The three year cumulative total is about 9,000 new persons.

In 1984, the effect of these reorganizations was to increase government costs by about $28 million. The corresponding increase for reorganizations in 1985 is $49 million and for reorganizations in 1986, $160 million, as shown on chart 2.

We found that as more persons neared or met the payment limitation from 1983 to 1985, the number of new persons created in the following years increased. Although it is not possible to prove that the intent of these reorganizations was to avoid the payment limit, anecdotal evidence we obtained from state and local agricultural officials, farmers who reorganized and other sources tends to support such avoidance as a driving force behind at least some of the reorganizations.

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[2]For the years 1984 to 1986, we used $40,000 in our analysis as the point at which farmers might begin to reorganize their operations in anticipation that they might reach the $50,000 per-person limit in future years because of increasing government per-unit support payments and higher crop yields.

The increase in farmers nearing the payment limit is primarily due to an increase in the per-unit deficiency payment rate and generally higher crop yields over the past few years. The impact of these factors is illustrated by the declining number of acres that must be planted to reach the $50,000 payment limit. For example, as shown on chart 3, the acreage needed to reach the $50,000 payment limit on a corn farm has decreased by about 800 acres, or 51 percent, from 1983 to 1987 on the basis of a nationwide average yield and compliance with the mandatory minimum program requirements. For wheat, the corresponding decline is about 1,000 acres, or 44 percent. The acreage needed to reach the payment limit for cotton and rice has also declined--although not as sharply--by 20 and 13 percent, respectively.

1987 Through 1989 Reorganizations

Should the trend in reorganizations[3] continue over 1987 to 1989, we project that an additional 22,000 new persons could be receiving payments by 1989. While the continuation of this trend is not certain, we believe that it is likely because (1) there can be a significant economic benefit of up to $50,000 for each person added to a farming operation, (2) in the future, additional persons on existing operations may continue to reach the payment limit

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[3]We used the 3-year weighted average number of reorganizations from 1984 to 1986 to estimate the number of producers who might reorganize in subsequent years. Because the year-to-year growth in support payments has slowed considerably, we assumed that only those persons who actually reach the $50,000 limit would have the incentive to reorganize in the 1987 to 1989 time frame. This analysis assumes that producers receive the full deficiency payment permitted under the Food Security Act of 1985 and USDA budget proposals for 1987 to 1989.

because of continued high program payments and increased crop yields and (3) a large reservoir of persons, about 38,000 in 1986, at the payment limit could realize this economic benefit by reorganizing their farming operations in the future. If this trend continues, additional costs to the government, as shown in chart 4, could be about $191 million in 1987, $209 million in 1988, and $219 million in 1989. These figures represent the annual cost of only those new persons added to farming operations in that year. In 1989, the total of almost 31,000 new persons that resulted from farm reorganizations since 1984 could add almost $900 million annually to program costs.

While the annual costs resulting from farm reorganizations have increased significantly over the years, the cumulative cost of these reorganizations are accelerating dramatically. As shown on chart 5, the cumulative cost for 1984 to 1989 would be about $2.3 billion with $900 million added in 1989 alone.

METHODS USED TO AVOID THE PAYMENT LIMITATION

During our review, we saw a wide variety of reorganizations including the addition of individuals, limited partnerships, corporations, and trusts, to the establishment of large partnerships or joint ventures. The two areas of primary concern are the formation of corporations and the renting of farmland for cash by individuals, partnerships or joint ventures with a large number of participants. A corporation can be formed by two persons who each receive the maximum $50,000 payment to receive a third

$50,000 payment as long as neither person owns more than 50 percent of the corporation.

In the cash-rent situation, individuals, general partnerships or joint ventures (all members of which qualify as individuals each with a $50,000 payment limitation) rent farmland for cash. A large number of individuals can be added to the point where all possible payments on a given operation are maximized. We saw instances where farm owners broke up their operation by renting their land to investors who leased equipment, hired labor, and used surrogate managers to operate the farm. The individual investors who supplied only financing for the operation are each entitled to a $50,000 payment. In some cases this financing was obtained by using either the crop or the government payment as collateral. Under this arrangement, the individual members or investors may live hundreds to thousands of miles away from the farming operation for which they are receiving federal payments, including as far as Australia, France, and Pakistan.

At this time Mr. Chairman, I would like to pause for a few moments and have Mr. Ed Zadjura of my staff present two case studies that demonstrate how these types of reorganizations have been used to circumvent the payment limitation and obtain multiple payments.

The first case discusses how a farming operation can be reorganized to take advantage of a loophole in the legislation. It demonstrates how a family of 6 members reorganized a farming operation into 21 separate entities each of which qualified for a

$50,000 payment. The details of this case study are in appendix II.

[Presentation of Case Study #1]

The second case discusses how investors with little or no active farming interests took advantage of USDA's definition of a person by hiring others to operate a farm. The details of this case study are also in appendix II.

[Presentation of Case Study #2]

Mr. Chairman, the case studies just presented are illustrative of some of the most extreme, although legal, cases of avoidance of the payment limitation. In general, most reorganizations involve the creation of only one or a few new persons since total payments are effectively limited by the acreage being farmed and the crop yield.

OPTIONS TO IMPROVE THE EFFECTIVENESS OF PAYMENT LIMITATIONS

Based on our ongoing review, we have tentatively identified some options that we believe would improve the effectiveness of the current payment limitation provisions. We will provide a more complete and detailed set of options with our final report. First, to tighten the provision that allows individuals to form corporations, limited partnerships, or trusts that qualify for separate payments, the legislation could be amended to provide that payments made to such entities would be attributed to the individual payment limitation of persons who are shareholders, members or beneficiaries of those entities. Attribution could be made at some specified level of ownership interest such as 5 or 10 percent. Such a provision would tighten the payment limitation provision without precluding farmers from establishing such entities for other purposes such as tax or estate planning.

In addition, the definition of what constitutes a person could be redefined to limit payments to persons who are actively engaged in farming in some manner other than just supplying financing. This definition could include, for example, the requirement that a person must contribute in addition to financing, one of the following: owned land or equipment, personal labor, or active management participation. We believe such a change would help ensure that benefits continue to flow to the intended beneficiaries --small to medium farmers--and not investors without any active interest in farming. This change could be accomplished legislatively or administratively.

Since other payment limitation provisions, such as those relating to marketing loan, disaster, and conservation reserve payments, use the same rules and regulations, these options would also improve the effectiveness of those limitations.

I want to note, Mr. Chairman, that the options we identified are similar to some of those suggested by USDA in its March 10, 1987 report to the Congress.

PROGRAM ADMINISTRATION PROBLEMS

During our ongoing review of USDA's administration of the payment limitation at the county and state office levels, we identified problems in USDA implementation of the program. These problems contribute to the creation of new persons through reorganizations that are of questionable validity. We plan to provide you with a comprehensive report on this issue in May.

For example, county offices have inconsistently applied the regulation that a reorganization must involve a "substantive" change in the farming operation in order for any new persons to qualify for payments. In part, this inconsistency resulted because USDA has not provided clear guidance or criteria on what constitutes a substantive change. The regulations provide examples of what constitutes a substantive change. These examples include a change in the amount of land being farmed and dissolution of an entity such as a corporation. As a result, USDA headquarters and county offices use different criteria. For example, USDA headquarters officials, when reviewing and approving reorganization cases, apply the criterion that the land being farmed increase or decrease by about 20 percent before they will approve a reorganization that adds new persons. In one county office we visited, simply adding a person is considered a substantive change. In another county office, a 20-percent increase in land is a mandatory requirement for approval.

In another instance, USDA officials in the California state office incorrectly interpreted the regulations relating to financing of general partnership operations. The regulations require that each partner obtains any necessary financing without guarantees from other partners or the partnership as a whole in order to qualify for an individual $50,000 payment limitation. We found, however, that individual partners were using partnership assets to obtain their financing. As a result, three of eight general partnership cases we looked at in one county were incorrectly determined resulting in overpayments to nine persons totaling $206,000 in 1986. The county program director estimated that as many as 50 percent of all general partnerships in the county may have been incorrectly approved.

As a final example, in many instances county offices are not requiring consistent documentation to support reorganization plans submitted for approval. While some offices require evidence of incorporation, financing, lease arrangements, and capital investment, other county offices require little or no documentation to support that a substantive reorganization had taken place, which justified the approval of new persons for payments. In one county office, we found that none of 12 cases we reviewed had sufficient documentation to support the approval of new persons. As a result, 11 new persons were paid $392,000 in 1986. In an audit of 1984 payments, the Department's Inspector General uncovered similar problems. During follow-up work on individual cases, the Inspector General found that in one-third of the cases they questioned there was insufficient documentation to justify approval of the reorganization plans.

We are developing recommendations to USDA on ways it can improve day-to-day program administration as part of our final report.

FARM PROGRAM PAYMENTS AND LOANS TO FOREIGN OWNERS OF U.S. CROPLAND

In another matter on which you asked us to testify we have just completed a study for Representative Panetta that estimates the amount of farm program payments and loans made to foreign individuals and entities who owned U.S. cropland.

Because these data are available only at the county office level, we collected farm program payment and loan data from 401 counties across the country. These 401 counties had about 90 percent of all foreign-owned cropland in the United States for all major crops--wheat, corn, grain sorghum, barley, oats, cotton, rice, and soybeans. We did not gather data on tobacco, sugar, peanuts, honey, wool or mohair, or benefits under the dairy program. The latest data available at the time of our analysis were for 1984 and 1985.

In summary, the information that we collected from the 401 counties shows that foreign owners took out price-support loans of about $3.6 million for crop year 1984 and $12.3 million for 1985. In addition, total farm payments to foreign owners of U.S. cropland were $6.2 million for 1984 and $7.7 million for 1985. The payments made in 1985 represented only about four-tenths of a percent of all payments made in the 401 counties studied.

Although the farm program payments to foreign owners of U.S. cropland for 1984 and 1985 were relatively small when compared to payments to all producers, overall participation and payments for the 1986 farm programs is expected to be higher and as a result, farm payments to foreigners are also expected to be higher for the 1986 programs.

Mr. Chairman, that concludes my prepared statement. My colleagues and I will be happy to answer any questions you may have.

Chart 1: Producers Paid $40,000 or More and New Persons Created by Reorganizations Among Those Producers

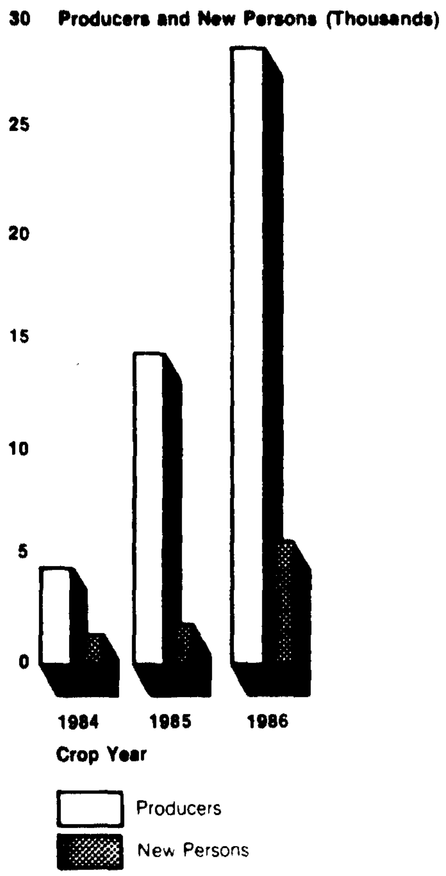


Chart 2: Annual Payments to New Producers Resulting From Farm Reorganizations

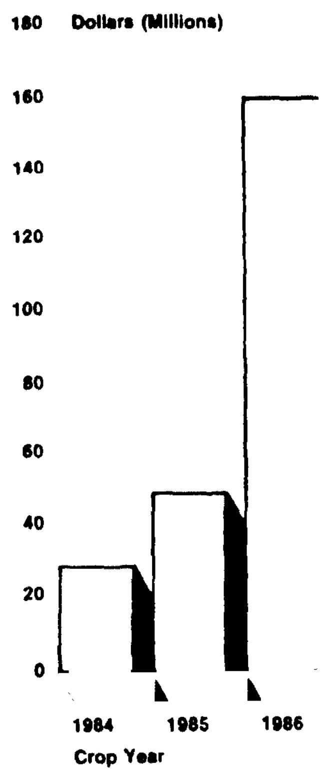
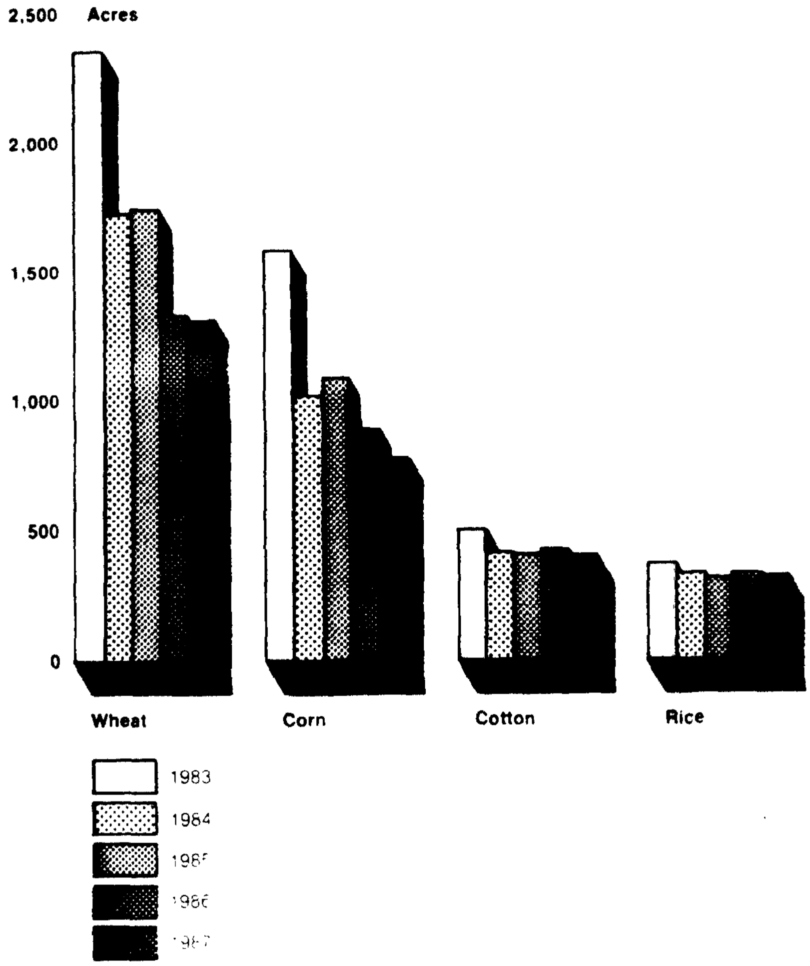


Chart 3: Acreage Needed To Reach $50,000 Limit



APPENDIX I

Chart 4: Annual Payments to New Producers Resulting From Farm Reorganizations

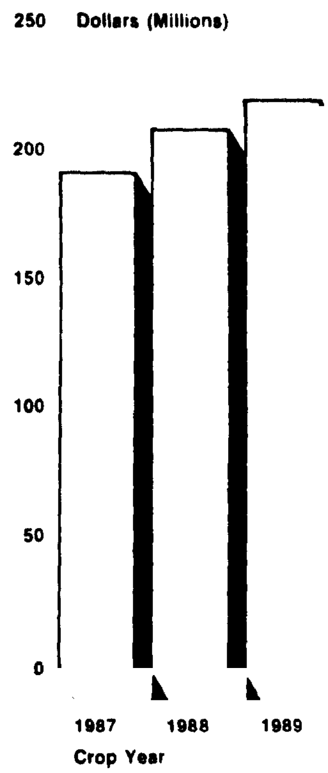
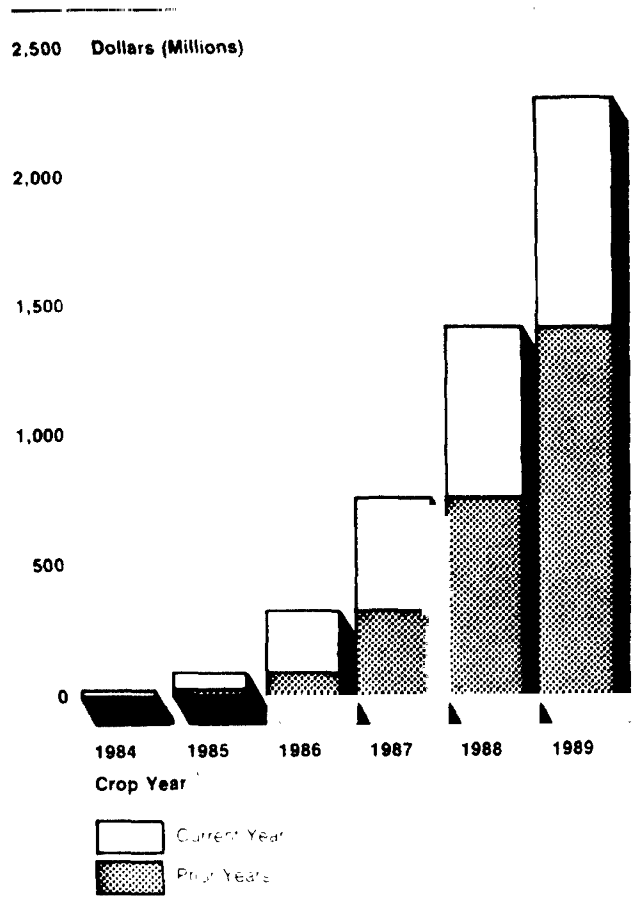


Chart 5: Cumulative Payments to New Producers Resulting From Farm Reorganizations



Case Study #1

Reorganization Using Multiple Corporations

This case demonstrates how a farming operation reorganized to take advantage of a loophole in the legislation that allows the creation of legal or "paper" entities, such as a corporation, limited partnership, or trust to constitute a person in its own right. Such entities qualify for an individual $50,000 payment as long as no stockholder owns or controls more than 50 percent of the stock. As a result, two persons who each are already receiving the maximum $50,000 payment can reorganize their farming operation and form a corporation that also receives $50,000. The co-owner's share of this payment is not charged against their individual limit. As this case study shows, this loophole can lead to the formation of numerous corporations by a small group of people with the potential for multiple payments.

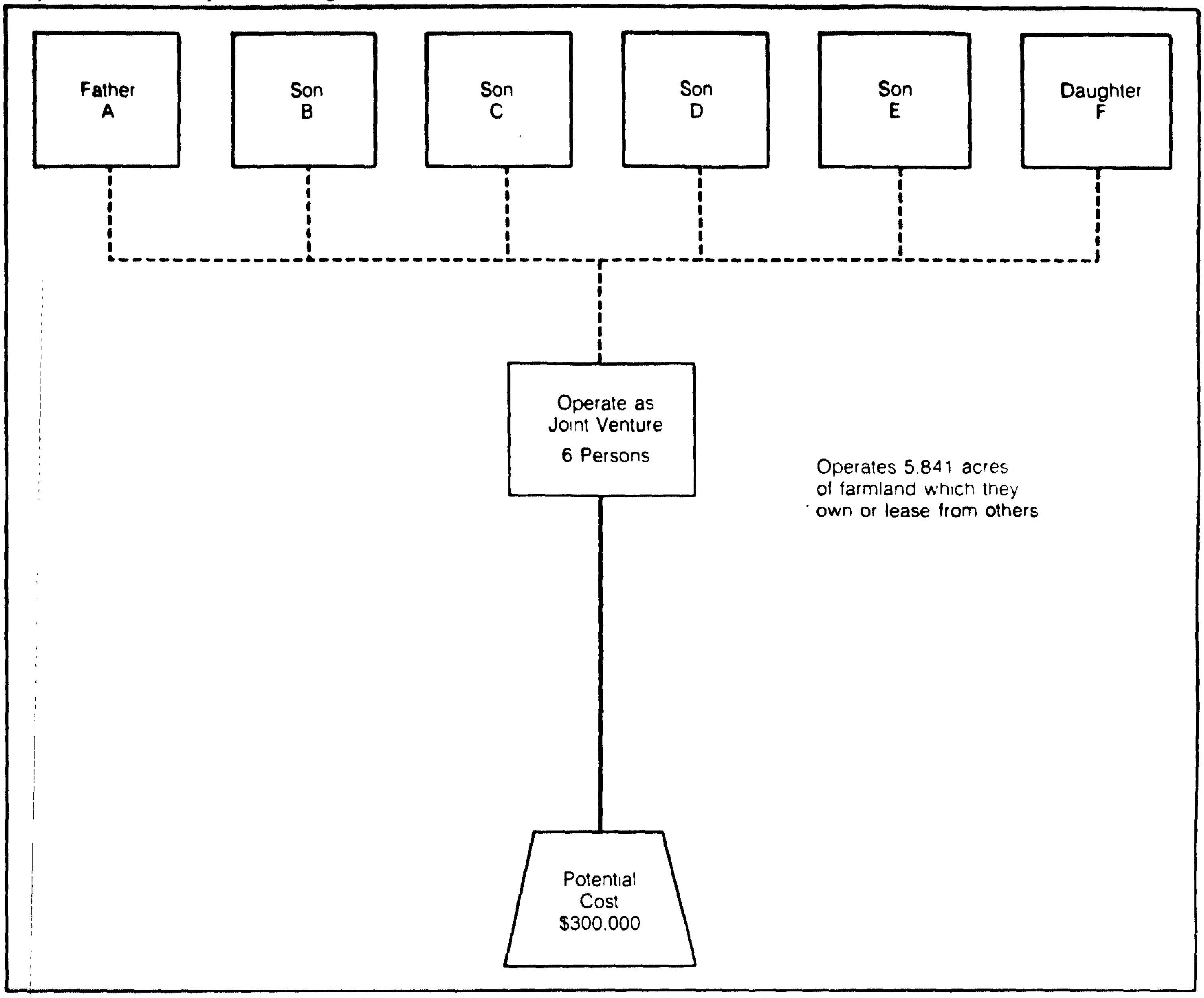
In 1985, a six member joint venture operated 5,841 acres of farm land which the participants in the venture either owned or cash leased from others. The joint venture comprised a father, his four adult sons, and an adult daughter. USDA officials determined that each individual member in the venture qualified as a person for payment limitation purposes under USDA regulations and could receive up to $50,000 in direct support payments subject to the limit.

The joint venture's 1985 farm operation qualified for about $595,000 in payments subject to the limit. The father, since he was operator of much of the land, exceeded the $50,000 limit on his payment and, as a result, he did not receive about $315,000 that was earned and attributable to his interest in the operation. Each of his five children received about $46,000 as the result of their interests in the 1985 operation.

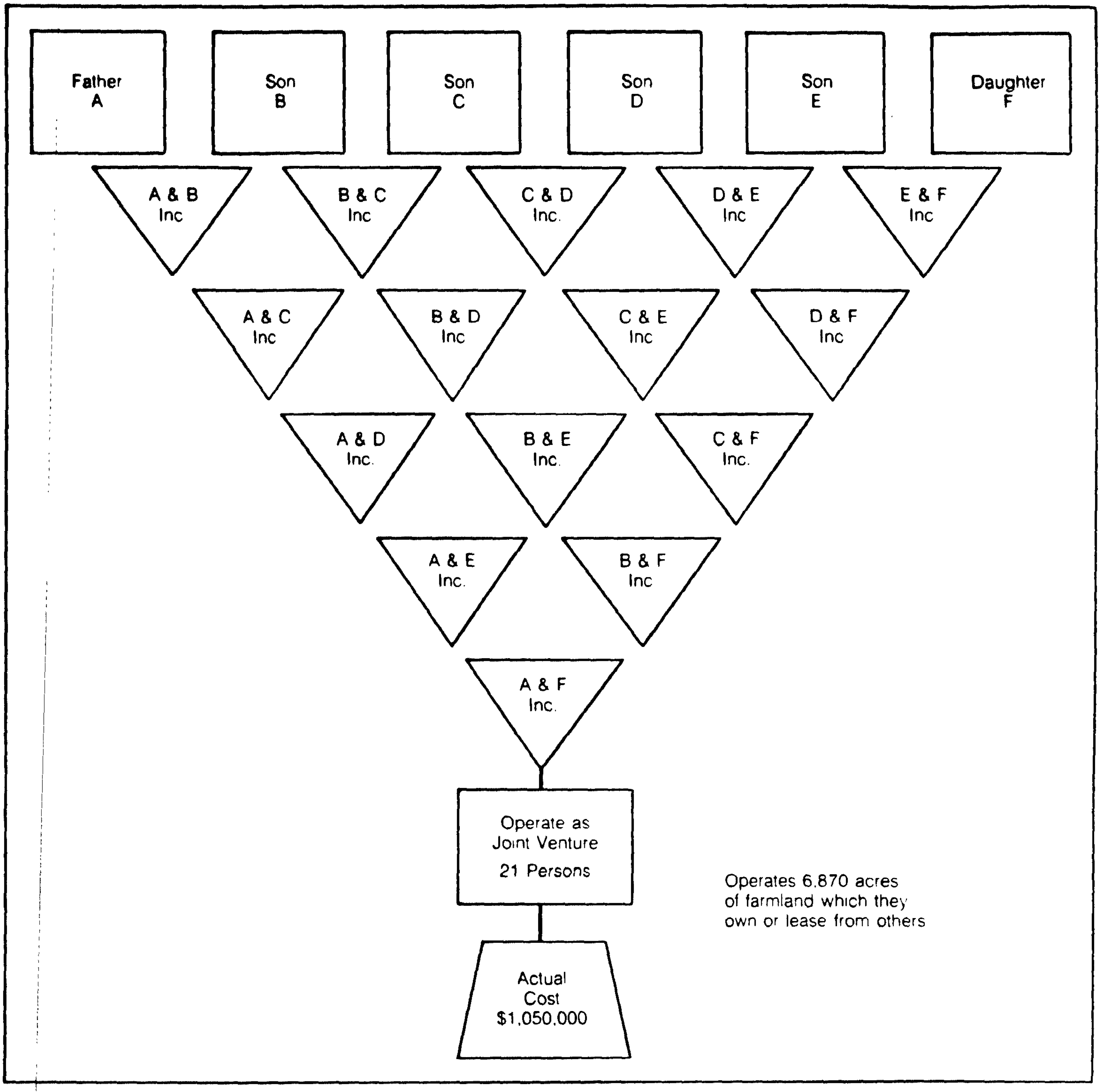
For 1986, the operation was reorganized by the father and his children into a new joint venture that comprises the same six persons as in 1985 plus 15 new corporations they formed. Each corporation is owned on a 50/50 basis by two individuals, each of whom was a member of the 1985 joint venture. The new joint venture operated 6,870 acres of farm land which were either owned or cash leased by its members.

USDA officials determined that each of the six individuals and 15 corporations comprising the 1986 joint venture qualified as a person and could receive up to $50,000 in direct support payments subject to the limit. Their 1986 farm operation earned about $1,230,000 in direct support payments. This resulted in $50,000 to each of the 21 persons comprising the joint venture for payment limitation purposes for a total payment of $1,050,000. The remaining $180,000 is the amount earned payments exceeded the joint venture's cumulative payment limitation under its 1986 organization.

Corporate Case Study — 1985 Organizational Structure



Corporate Case Study — 1986 Organizational Structure



Case Study #2

Reorganization Showing Investors That Cash Rent Farms

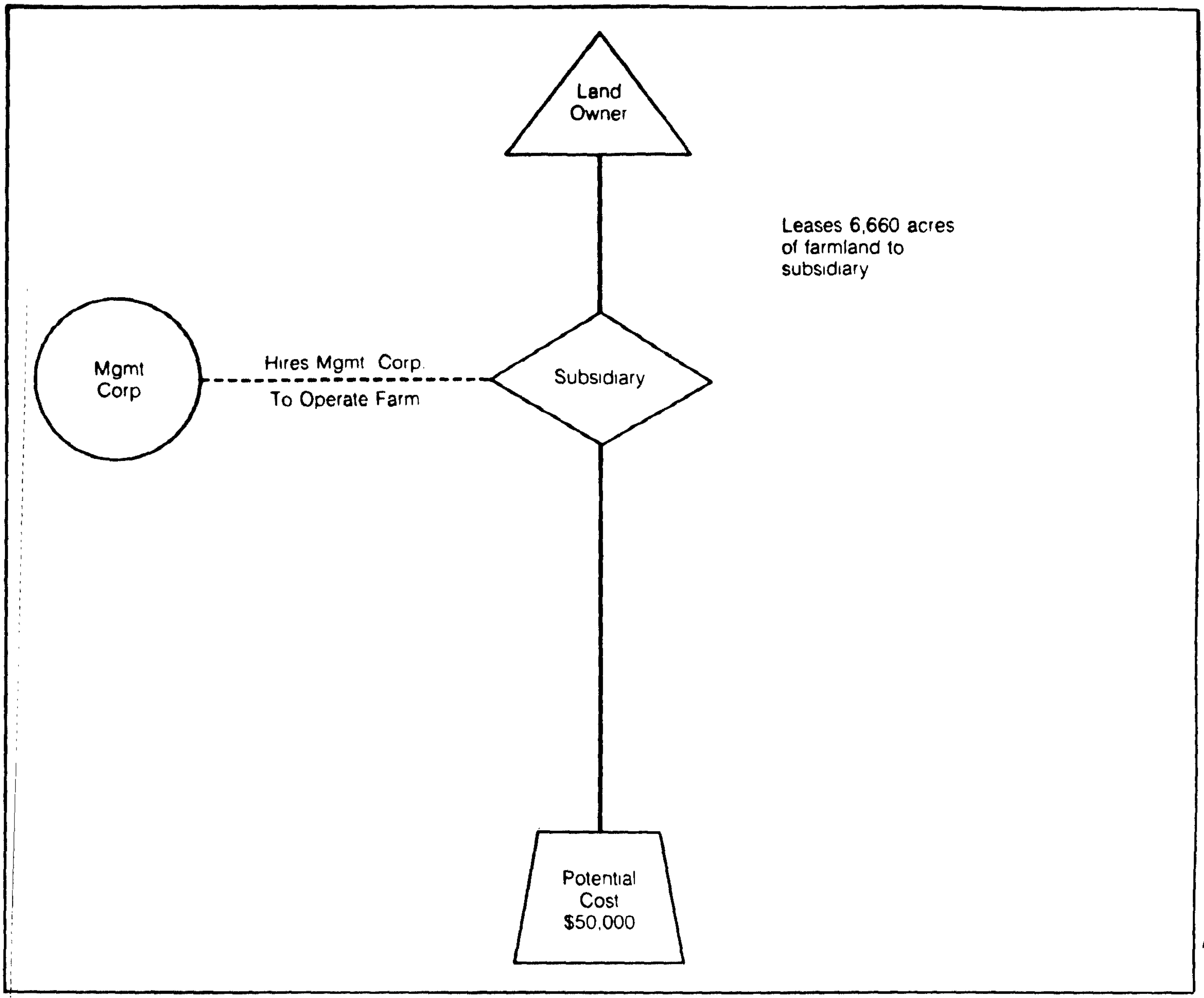
This case study shows how investors with little or no active farming interests of their own can take advantage of USDA's definition of what constitutes a person actively engaged in farming. Under the regulations, a person is someone who has a separate and distinct interest in the land or crop, exercises separate responsibility for that interest, and is responsible for farming costs from a fund or account separate from other persons. As such, an investor who owns no farmland, equipment, or farm buildings, and does not actually work on the land, but has the personal resources to finance or obtain bank financing for operating costs can qualify for payments. In some cases, persons have pledged future government payments as security to obtain operating loans, loans which enable them to finance their operation and obtain the same government payments pledged as collateral for the loan. As this case study shows this can also lead to multiple payments.

In 1985, a subsidiary that cash leases 6,660 acres of farmland from its parent company, hired a management company to run its farm operation. Under this organizational structure, only the subsidiary, as operator of the farm, could qualify as a person for payment limitation purposes and receive up to $50,000 in direct support payments subject to the limit. No payments were made, however, because the subsidiary chose not to participate in the 1985 programs.

For 1986, the same farmland was subleased by the subsidiary to the management company it hired for 1985. The management company in turn subdivided the 6,660 acres into parcels of about 238 acres and subleased them to 28 separate investors under individual cash rental agreements drawn by the management company. The investors supply operating capital, lease equipment, sub-contract for labor, and hire a farm manager.

Under USDA regulations, the 28 investors, as operators of the farms, each qualify as a person for payment limitation purposes. As such, each can receive up to $50,000 in direct support payments subject to the limitation. Each of the investors hit the limit for 1986 for a total cumulative payment of $1.4 million.

Cash Rent Case Study — 1985 Organizational Structure



Cash Rent Case Study — 1986 Organizational Structure