United States General Accounting Office 132744

GAO

Testimony

For Release
on Delivery
Expected at
9:30 a.m. EDT
Wednesday
April 22, 1987

Farm Reorganizations and Their Impact on USDA Payments

Statement of

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Before the

Subcommittee on Cotton, Rice, and Sugar

Committee on Agriculture

House of Representatives

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GAO/T-RCED-87-19

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 Mr. Glickman in response to concerns that farmers were increasingly reorganizing their farming operations to avoid the payment limitation restrictions by adding new persons. 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. In addition, 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.

My testimony today will address each of these issues and will discuss some options that would enhance the effectiveness of current payment limitations. As requested, we are also providing you with our estimates of the potential cost savings associated with changes in current payment limitation provisions, our comments on USDA's recent report on the payment limitation issue, and our observations on the possible impacts of the changes on rural communities.

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.

In addition to the $50,000 limit on direct support payments, separate limits have been placed on other programs, such as the new $200,000 per-person limit on marketing loans and other payments beginning with crop year 1987. Although separate, these other limits use the same definition of a person for payment limitation purposes.

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.[1]

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[1]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.

On the basis of a statistically valid random sample of 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 3-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.

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

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$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[2] 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 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

[2]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.

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 hired 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.

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 in rental situations, a person other than the landowner, 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 and not investors without any active interest in farming. This change could be accomplished legislatively or administratively.

POTENTIAL COST SAVINGS

Because of several factors, it is not possible to precisely quantify the potential cost savings of either the options we presented or any improvements in USDA's program administration. These factors include (1) whether the trend in reorganizations from 1984-1986 will continue at the same rate; (2) the possibility that crop prices will increase above the loan rate thereby reducing both direct payments to producers and the number of persons who would be affected by the limit; (3) the exact requirements of any new rules and regulations; (4) the future effectiveness of USDA's application of the payment limitation rules; and (5) whether new methods to avoid the payment limit will be found. Another key factor is whether any program changes would be applicable to only future reorganizations or would be applied to reorganizations already in place.

Assuming that a blanket prohibition was placed on payments made to new persons as a result of reorganizations and that the trend in reorganizations from 1984-86 continues an estimate of maximum potential savings can be made. If this blanket prohibition was applicable to only new persons resulting from reorganizations in 1988 and 1989, then about $640 million could be saved. If this prohibition was applicable to all new persons created as a result of reorganizations from 1984 through 1989, then about $1.5 billion could be saved. However, the USDA proposals do not include such a blanket prohibition on payments to all new persons. Neither do our suggested options because, in our opinion, it would be unfair to producers with legitimate reasons for reorganizing their farming operations.

Our suggested options relate to the addition of corporations and investors, with little or no active farming interest, to farming operations in order to avoid the payment limitation. About 25 percent of all payments in our sample were made to corporations.

Some portion of the remaining 75 percent represents payments to investors with little or no active interest in farming.

Under current rules, however, it is not possible to distinguish investors from individuals who are actively engaged in farming. As such, it is not possible to estimate the costs associated with this type of reorganization, on the basis of our nationwide random sample. In our detailed review of county office operations, we did see a few cases where a number of investors, in one case 28, were added to farming operations and received payments of up to $50,000 each. USDA has also reported on similar situations. Available evidence suggests that the incidence of passive investors being added to reorganized farming operations is an ongoing and possibly growing phenomenon, which could contribute increased program costs.

Although we did not calculate the cost savings associated with USDA's proposals, we expect that their impact would be larger because they are more restrictive than the options we suggest and affect other areas of the payment limitation regulations.

PROGRAM ADMINISTRATION PROBLEMS

In addition to the overall data we collected on the scope and costs of farm reorganizations, we also identified some administrative 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 a comprehensive report on this issue in June.

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 instead 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, none of the 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.

OBSERVATIONS ON USDA'S PROPOSED CHANGES

We believe that USDA's proposals, if properly implemented, will discourage many farm reorganizations specifically designed to avoid the payment limit.

USDA's proposals remove the advantage of incorporating or adding investors not actually engaged in farming as members of a joint operation to avoid the limit. The proposals accomplish this by

-- treating all entities the same by basing the payment limit for each on the number of its members actively engaged in the entity's farming operation and

-- attributing payments for the entity against the individual payment limits of its owners.

USDA's proposals also include other changes that will make payment limitation rules more restrictive. For example,

-- minor children will always be combined with their parents, except when the child maintains a separate household and carries out the actual farming operations on a farm in which the parents have no interest;

-- custom farmers--those that perform services for other farmers for a fee--will always be combined with the operations they farm except when they have no interest in the farm or crops;

-- the increase in persons with separate payment limitations will be limited in proportion to any increase in land, when land is the substantive change in a farm reorganization that justifies the increase in persons; and

-- all entities will be combined when two or more persons own 50 percent or more of each of the entities.

However, USDA's proposals do not address avoidance of the payment limit through division of land into parcels that earn the payment limit and the leasing of these parcels to investors not otherwise involved in farming. The investors' involvement in farming is limited to providing financing and signing land lease, equipment rental, management, and labor agreements provided by a management firm that put the investment package together. USDA could eliminate this method of legal avoidance by changing its rules to require in rental situations that, in addition to financing, a person other than a landowner, must contribute owned land or equipment, personal labor, or active management to receive program payments.

Some of the changes suggested by USDA will need congressional action to be implemented; others can be implemented administratively. Specifically, for USDA to implement the major thrust of its proposal. Congress will have to (1) eliminate existing legislative requirements about how corporations are considered for payment limitation purposes and (2) authorize the determination of payment limits for legal entities on the basis of the number of its members actively engaged in its operation. However, USDA can change the rules about minor children, custom farming, and substantive change under existing legislative authority.

USDA's proposals include necessary legislative language for implementation but do not include regulatory language. USDA will have to develop clear and precise regulations and guidance to assure effective implementation. For example, USDA county offices will have to determine how many members of an entity are actively engaged in the entity's farming operation, as determined by how many members make significant independent contributions of capital, land, or equipment and labor or management to the entity's operation. USDA will need to define what a significant contribution is and how to value contributions other than capital for this determination.

IMPACT ON RURAL COMMUNITIES

We did not assess the economic impact on rural communities of our proposed changes related to the payment limitation. As part of our review, we did find that the number of reorganizations represented a small minority of all producers of each major commodity, were dispersed across the nation, and the options discussed would only affect some reorganizations and not others. Further, our proposed changes would not cause most farming operations to receive less than their current level of payments.

Most producers, 90 to 95 percent, in fact, received payments significantly below the payment limit and as such did not have an economic reason to reorganize. Even among those producers who received $40,000 or more, the rate of reorganization was less than 20 percent during the 1984 to 1986 crop years. Overall, the average rate of reorganization ranged from less than one-half percent per year for all producers of wheat and feed grains to about 1 percent for cotton and 1.5 percent for rice producers. In 1985, the latest year for which complete data are available only 3 percent of all producers received $40,000 or more. These producers accounted for about 22 percent of payments. Only about 20 percent of these producers reorganized, or about 0.6 percent of all producers. These producers accounted for about 4.5 percent of payments and slightly higher levels of crop production.

Our nationwide sample also indicated that these reorganizations were dispersed across the major producing areas for each commodity. For example, producers from 22 different states were involved in reorganizations in our sample. In all likelihood, probably a few reorganizations were related to the payment limit in most states with significant agricultural production.

As I previously mentioned, the options we have suggested would affect only those reorganizations that involve corporations or the addition of investors not having an active interest in farming. As such, most current and future reorganizations would not be affected. Further, most persons would continue to receive at least their current level of payments. The primary effect of these suggested options would be to slow the potential growth in payments due to reorganizations, not to reduce current benefits.

Nationally, we believe that the impact on rural communities would be minimal, widely dispersed, and spread over several years. USDA proposals, as discussed, contain changes that will make the payment limitation rules more restrictive and could have a larger impact.

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

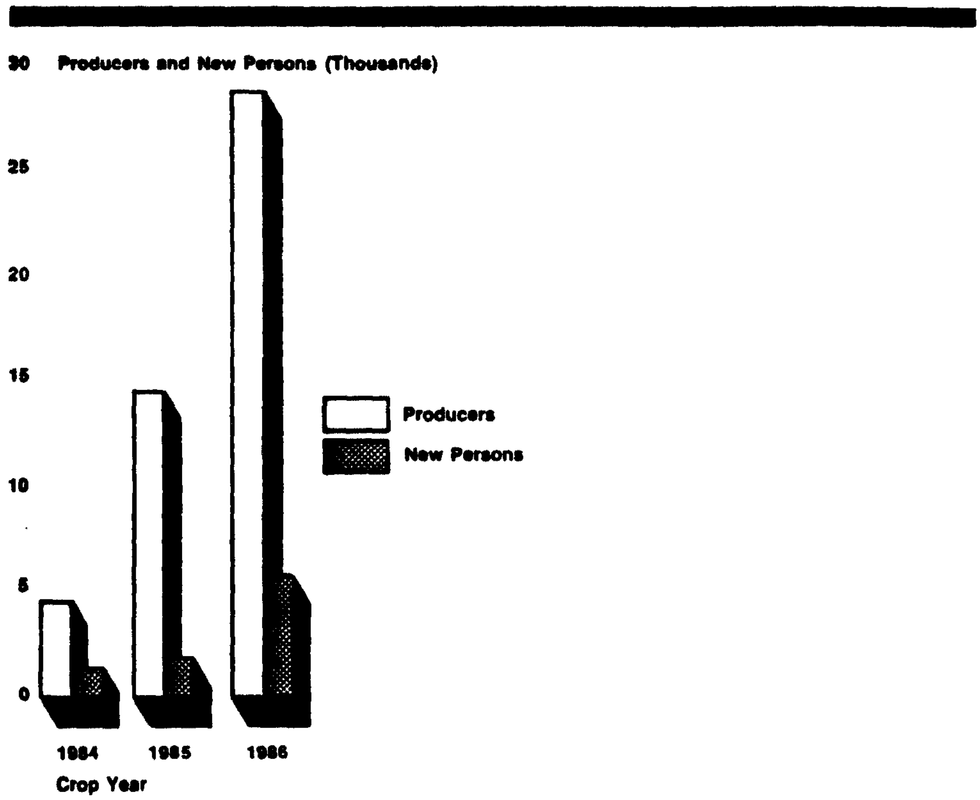


Chart 2: Annual Payments to New Producers Resulting From Farm Reorganizations

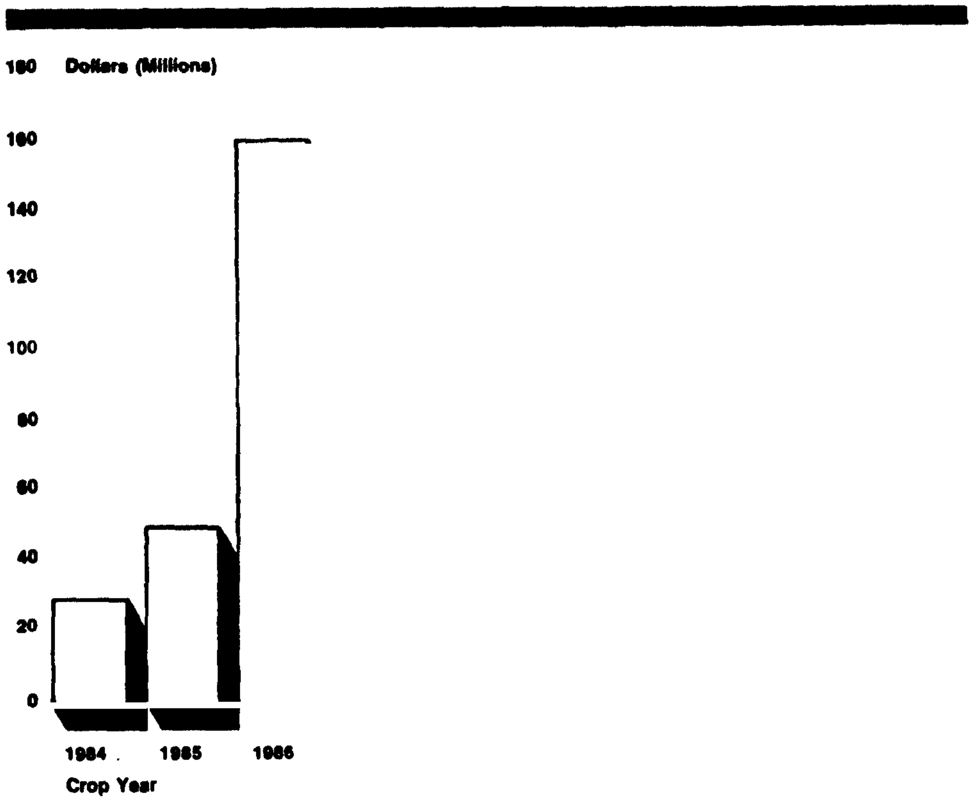


Chart 3: Acreage Needed To Reach $50,000 Limit

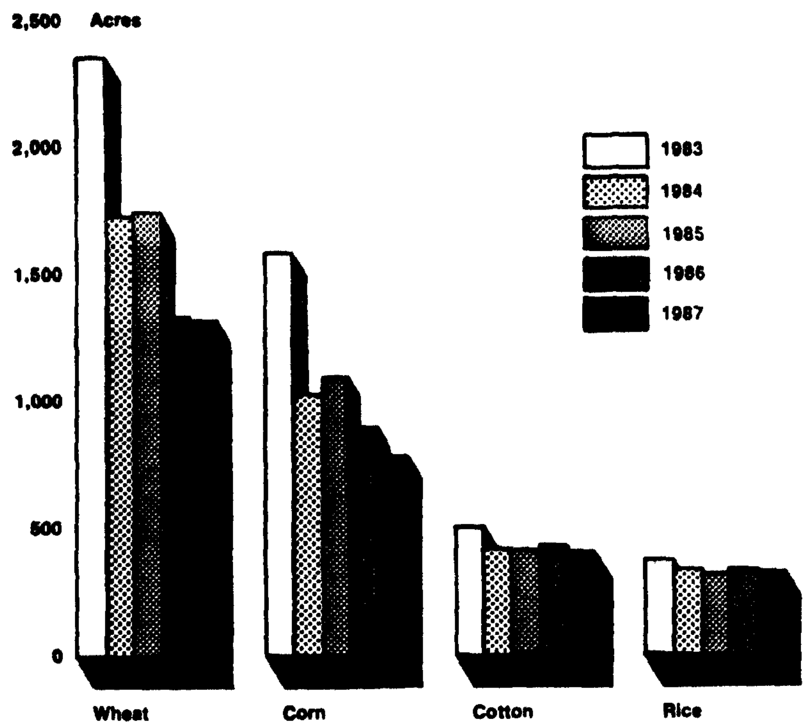


Chart 4: Annual Payments to New Producers Resulting From Farm Reorganizations

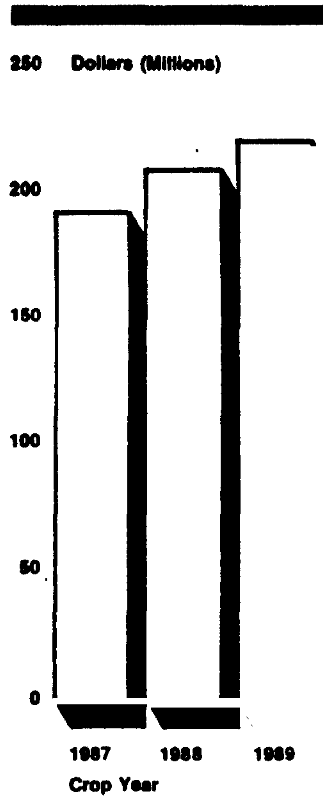
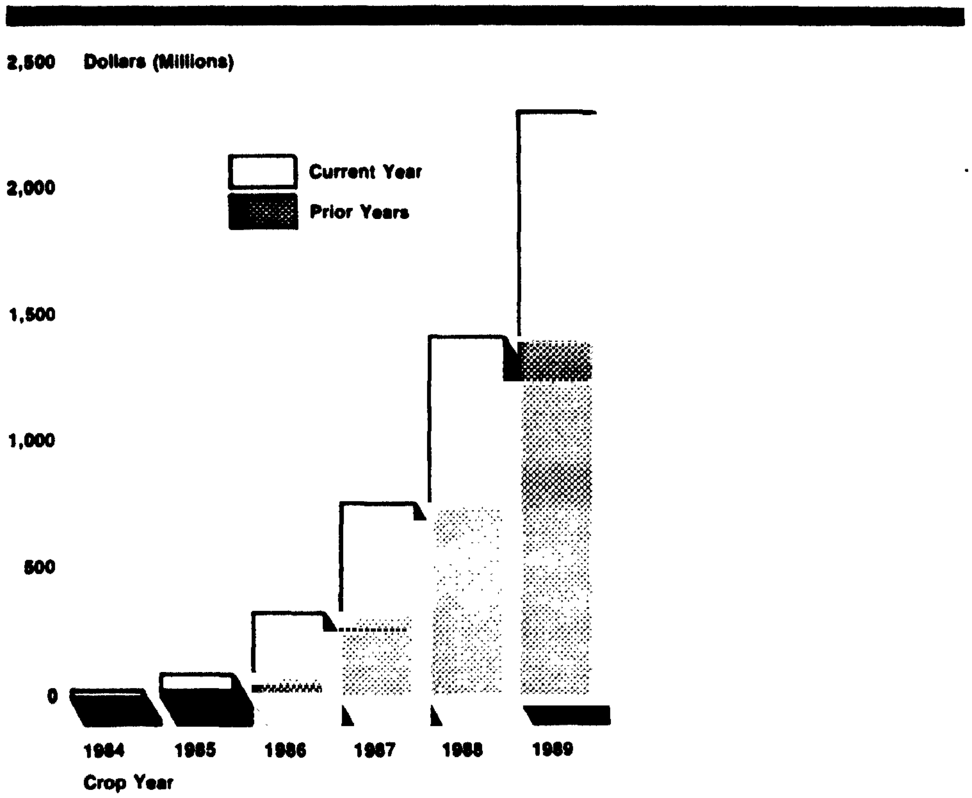


Chart 5: Cumulative Payments to New Producers Resulting From Farm Reorganizations



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.

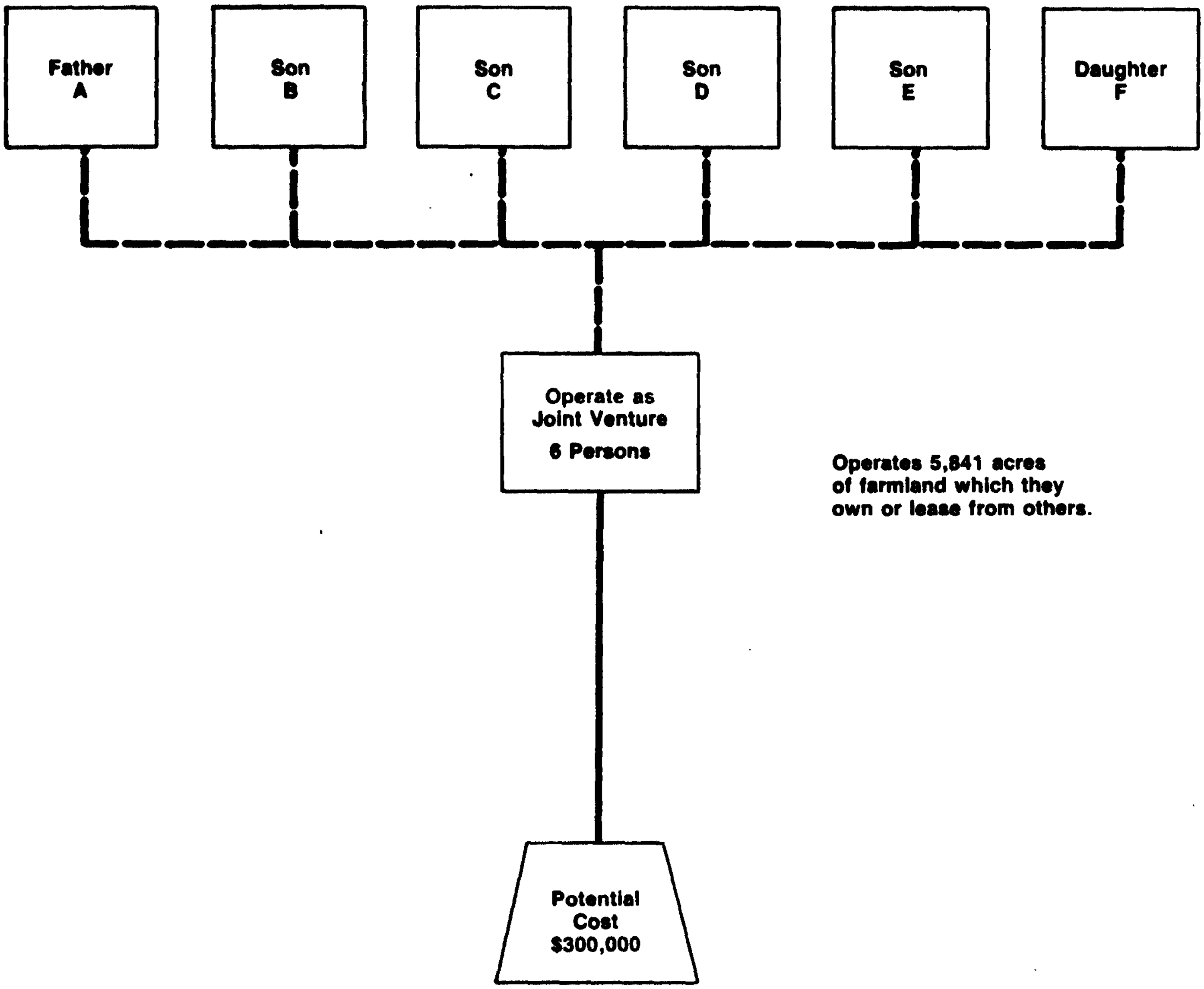
In 1985, a six member joint venture operated 5,841 acres of farm land which the participants in the venture either owned or cash leased from others. The joint venture comprised a father, his four adult sons, and an adult daughter. USDA officials determined that each individual member in the venture qualified 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.

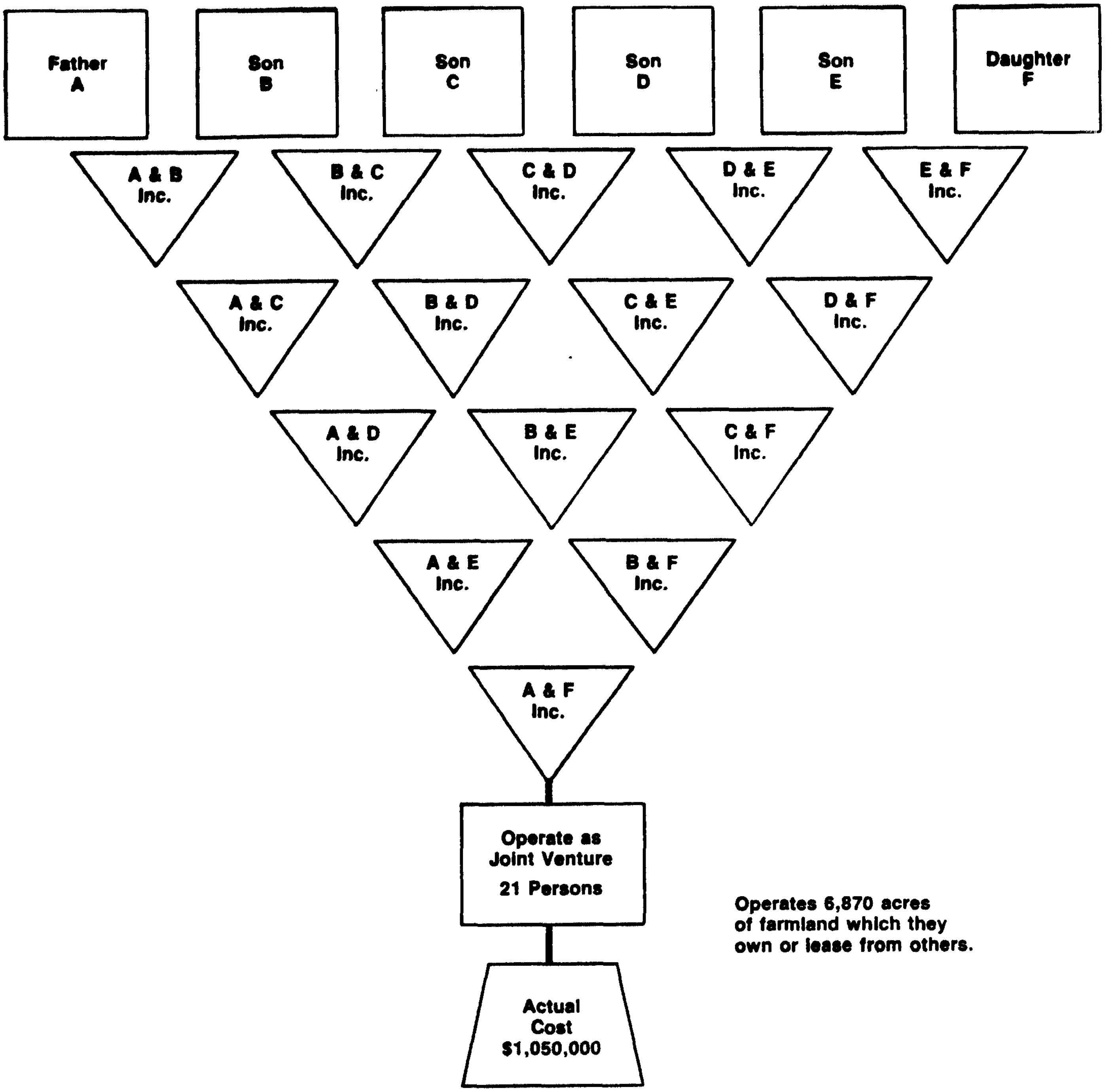
USDA officials determined that each of the six individuals and 15 corporations comprising the 1986 joint venture qualified as a person and could receive up to $50,000 in direct support payments subject to the limit. Their 1986 farm operation earned about $1,230,000 in direct support payments. This resulted 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



Operates 5,841 acres of farmland which they own or lease from others.

Corporate Case Study — 1986 Organizational Structure



Case Study #2

Reorganization Showing Investors That Cash Rent Farms

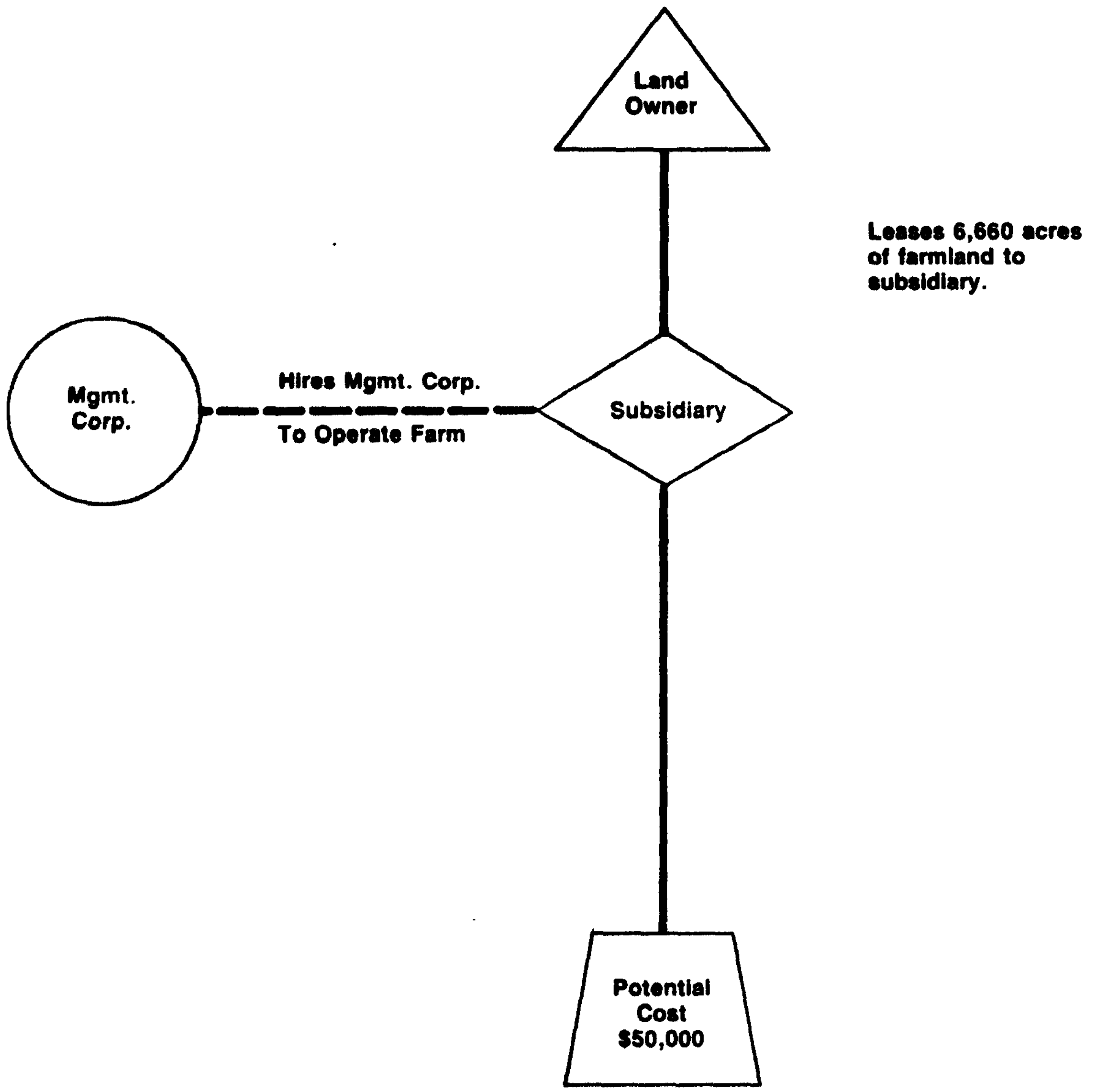
This case study shows how investors with little or no active farming interests of their own can take advantage of USDA's definition of what constitutes a person actively engaged in farming. Under the regulations, a person is someone who has a separate and distinct interest in the land or crop, exercises 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