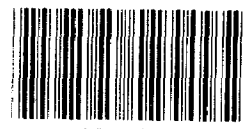


GAO

July 1987

FARM PAYMENTS

Basic Changes Needed to Avoid Abuse of the \$50,000 Payment Limit



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United States
General Accounting Office
Washington, D.C. 20548

**Resources, Community, and
Economic Development Division**

B-225866

July 20, 1987

The Honorable Byron L. Dorgan
The Honorable Dan Glickman
The Honorable Leon E. Panetta
House of Representatives

In response to your June 18, 1986, request and subsequent discussions with your offices, this report discusses the Department of Agriculture's administration of the \$50,000 limit on direct agricultural support payments, farm reorganizations to avoid the limit, and changes necessary to reduce avoidance of the limit. It also briefly summarizes detailed information about the impact of farm reorganizations made to avoid the limit. We reported that information to you in our April 1987 report, Farm Payments: Farm Reorganizations and Their Impact on USDA Program Costs, GAO/RCED-87-120BR. As you also requested, we have included information on the laws and regulations relating to the payment limitation as well as an explanation of the application of these regulations in appendixes I through IV of this report.

As arranged with your office, we are sending copies of this report to the Secretary of Agriculture and the Director, Office of Management and Budget. Copies will also be made available to other interested parties upon request.

This work was conducted under the direction of Brian P. Crowley, Senior Associate Director. Other major contributors are listed in appendix VII.

J. Dexter Peach
Assistant Comptroller General

Executive Summary

Purpose

U.S. Department of Agriculture (USDA) crop support payments increased from \$4.2 billion in 1984 to about \$8.8 billion in 1986.

Representatives Byron L. Dorgan, Dan Glickman, and Leon E. Panetta were concerned that some producers were trying to avoid the \$50,000 limit on payments to individual producers by reorganizing their farming operations to qualify for additional payments and asked GAO to

- determine the scope of the problem and estimate the cost of reorganizations for 1984-89,
- identify the methods used to avoid the payment limit and ways to tighten current payment limitation provisions, and
- review the effectiveness of USDA's administration of the payment limit.

Background

USDA makes direct income support payments to farmers under annual commodity and acreage reduction programs for wheat, feed grains, cotton, and rice. These payments are made in the form of deficiency and diversion payments. Deficiency payments are based on the difference between the government-established target price for a commodity and the higher of the commodity's average market price or its prescribed loan rate. Diversion payments compensate farmers who agree to take a percentage of their acreage out of production for the commodities that they would have grown on the idled acres.

Congress limited direct income support payments to reduce costs and prevent farmers from benefiting excessively. The current \$50,000 per person limit was established in 1981 and extends through 1990. Under existing laws and regulations, persons are broadly defined to be individuals, members of joint operations, or entities such as limited partnerships, corporations, associations, trusts, and estates that are actively engaged in farming. As such, a reorganization which adds a new person or persons to a farming operation can result in greater payments because each new person can qualify for up to \$50,000 in payments. USDA must review and approve all reorganizations that add new persons for payment limitation purposes.

Results in Brief

Under existing law and regulations, it is relatively easy to reorganize a farming operation so that additional persons can receive payments. GAO estimates that if the current trend in reorganizations continues, 31,300 additional persons could be receiving payments by 1989 and total costs could increase by an additional \$2.3 billion from 1984-86.

In March 1987 USDA proposed changes in the law to tighten the payment limit by treating all entities the same and counting payments against the individual owners' limits, thereby eliminating the advantage of adding new persons to farming operations. While USDA's proposal will eliminate most of the existing ways to avoid the payment limit, it does not eliminate all of them. USDA can administratively change other regulations that will further tighten the payment limitation provisions. In addition, GAO found that USDA has not effectively administered existing law and regulations governing the payment limitation. As a result, many of the reorganizations that were approved by USDA did not comply with existing regulations and procedures.

Principal Findings

Scope and Cost of Reorganizations

In 1984-86 reorganizations among producers who were at or near the payment limit added about 9,000 new producers to USDA payment rolls. While it was not GAO's purpose to prove that the intent of these reorganizations was to avoid the payment limitation, that was the effect. If this trend in reorganizations among producers affected by the payment limit continues through 1989, total program costs could increase by \$2.3 billion. (See chapter 2).

Changes to Current Law and Regulations Needed

Individuals and other legal entities can avoid the \$50,000 payment limitation in a variety of ways. Three methods that result in the largest number of new persons for payment limitation purposes involve (1) individuals who form new legal entities, such as corporations, that qualify as new persons to operate parts of their farming operations (2) joint operations that add individuals or other legal entities who qualify as new persons but who otherwise are not engaged in farming; and (3) individuals or entities who previously farmed their own land but now lease their land to investors who can qualify for separate payments. (See chapter 3).

While USDA has proposed changes that will eliminate most existing ways to avoid the payment limitation, they are not as effective as they could be. For example, the changes will not prevent the division and lease of land to investors not otherwise engaged in farming who can qualify as additional persons. GAO has identified ways for USDA to eliminate this and other methods of avoidance also. (See chapter 4).

USDA Program Administration Needs Improvement

GAO and the USDA Inspector General, in two separate reviews, found that USDA improperly approved new persons for program payments in over 20 percent of the cases reviewed. The improper determinations occurred because USDA had not provided adequate guidance and training to or internal control over the officials reviewing the cases.

GAO reviewed 64 new person determination cases in 7 counties based on current law and regulations to determine if USDA was effectively administering the program. Based on the available documentation, GAO's review showed that in 29 cases there were potential overpayments of \$2.4 million in 1986.

The USDA Inspector General's detailed review of 225 cases revealed actual overpayments of \$15.7 million from 1981-86. (See chapter 5).

Recommendations to Congress

USDA has proposed changes to the law and regulations to reduce avoidance of the payment limit by treating all legal entities alike and by counting payments to legal entities against the payment limits of the individuals who own those entities. USDA officials are awaiting congressional action on its legislative proposal before making any regulatory changes.

GAO recommends that the Congress adopt USDA's proposed legislative changes or some alternative proposal that would have a similar effect.

If Congress decides not to adopt USDA's entire legislative proposal, GAO recommends that, at a minimum, Congress remove the existing legislation provision that requires a corporation to be treated as a separate person for payment limitation purposes. If left in place, this provision will prevent USDA from making other regulatory changes necessary to reduce avoidance of the payment limit.

Recommendations to Secretary of Agriculture

GAO is recommending several actions that USDA can take to reduce avoidance of the payment limitation depending on what action the Congress takes on USDA's proposed legislation.

USDA should also improve its guidance and training of officials who are responsible for approving farm reorganizations and improve its internal control of their activities to assure that person determination cases are made in accordance with established regulations.

Specific recommendations are discussed in chapter 6.

Agency Comments

GAO discussed this report with ASCS officials who generally agreed with its contents. However, as agreed with your offices, GAO did not obtain official agency comments on a draft of this report.

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Abbreviations

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| ASCS | Agricultural Stabilization and Conservation Service |
| GAO | General Accounting Office |
| RCED | Resources, Community, and Economic Development Division |
| USDA | United States Department of Agriculture |

Introduction

The U.S. Department of Agriculture (USDA) is authorized by the Agricultural Act of 1949, as amended, to make direct income support payments to farmers under annual commodity and acreage reduction programs for wheat, feed grains, cotton, and rice. Since 1973, these payments have been made in the form of deficiency payments. Deficiency payments are based on the difference between the government-established target price for a commodity and the higher of the commodity's average market price or its loan rate¹. In 1986, for example, participating corn producers received \$0.63 per bushel in deficiency payments based on the difference between the government-established target price of \$3.03 and the original loan rate of \$2.40, which was higher than the market price, for each bushel produced.

In addition, beginning in 1978, land diversion payments were added under acreage set-aside provisions covering specific program crops. Diversion payments compensate farmers who agree to take a percentage of their acreage out of production for the commodities that they would have grown on the idled acres. In 1986, a diversion payment of \$0.73 per bushel was also paid to participating corn producers to compensate them for acreage voluntarily idled. Total combined deficiency and diversion payments are limited under current law to a maximum of \$50,000 per person per year.

The Agricultural Stabilization and Conservation Service (ASCS) within USDA administers the annual commodity and acreage reduction programs and the \$50,000 payment limit. For the 1984 and 1985 programs, total deficiency and diversion payments (those subject to the limit) for wheat, feed grains, cotton, and rice were \$4.2 billion and \$5.9 billion, respectively. USDA estimates 1986 program costs at \$8.8 billion.

Limits on Direct Income Support Payments

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 of \$50,000 per person in direct subsidy payments for producers of wheat, feed grains, cotton, and rice was established in 1980 and extended through 1990 by the Food Security Act of 1985 (Public Law 98-198). Under the payment limitation regulations, persons are broadly defined to be individuals, members of joint operations, or entities such

¹Price support loans are designed to assure farmers of a minimum price for their crop. If the market price is below the loan rate for a crop the farmer can keep the loan amount and turn over the crop to the government as payment in full.

as limited partnerships, corporations, associations, trusts, and estates that are 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 \$250,000 per-person, per-year, limit was placed on these payments. This limit includes the existing \$50,000 per-person limit on deficiency and diversion payments. The remaining portion of the limit applies to disaster payments, which had previously been limited to \$100,000 per person, and various other payments not previously limited. 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.

Under the 1985 Food Security Act, covering crop years 1986-90, it is possible that direct support payments could reach unprecedented high levels. This, in turn, could lead to more producers reaching the \$50,000 per-person limit in 1986 and beyond and to higher overall program costs if those producers reorganized their farming operations to create new producers to avoid the limit. For example, a producer who raises enough crops to earn \$100,000 in payments can receive only \$50,000 because of the payment limit. However, if that producer could reorganize the operating structure of that farm by taking in a partner, then they each could receive up to \$50,000 in payments or a total of \$100,000.

A history of the payment limitation provisions is included as appendix I, and the current payment limitation provisions of the Food Security Act of 1985, as amended, are included as appendix II. The regulations (7 CFR 795) implementing the payment limit are included as appendix III, and an explanation of the current application of these regulations provided by USDA is included as appendix IV.

Objectives, Scope, and Methodology

We made this review at the request of Representatives Byron L. Dorgan, Dan Glickman, and Leon E. Panetta, who were concerned that farm reorganizations to avoid the \$50,000 payment limit were a factor contributing to the increased costs of the commodity programs.

In accordance with agreements reached with the requesters, our objectives in this review were to

- determine the scope and budgetary impact of farm reorganizations by identifying the number of new persons paid in 1984-86 as a result of reorganizations to avoid the \$50,000 payment limit and the impact on fiscal years 1987-89 costs if the trend in reorganizations continues (chapter 2),
- provide a summary and explanation of the laws and regulations that contribute to the avoidance of the payment limit (chapter 3),
- identify any changes in the law and regulations needed to reduce the avoidance of the payment limit (chapter 4), and
- determine whether USDA's administration of the payment limitation is in compliance with existing laws and regulations (chapter 5).

Number of New Persons Paid in 1984-86 as a Result of Reorganizations to Avoid the \$50,000 Limit

ASCS has no central source of data on either the number of new persons approved for payment limitation purposes or the number of new persons resulting from farm reorganizations. Accordingly, we devised our own methodology to obtain the data necessary to determine the number of new persons paid in 1984-86 as a result of reorganizations to avoid the \$50,000 limit.

We matched ASCS's computerized producer payment and address files for crop years 1983 through 1986 to identify a universe of new persons paid for the first time in 1984-86 and randomly selected 1,800 new persons (600 in each year) being paid in 1984, 1985, and 1986. We sent questionnaires to the 986 ASCS county offices making payments to these persons to determine whether these were new persons receiving payments as a result of a reorganization or for other reasons such as the inheritance of an existing farm. If a new person were paid as a result of a reorganization, we asked ASCS county offices to supply actual payment information to allow us to determine if any other person(s) involved in that farming operation received \$40,000 or more in payments subject to the payment limitation the previous year. Where these conditions existed, we counted the new person and their payments as resulting from a reorganization to avoid the \$50,000 payment limitation.

In our analysis, we used \$40,000 as the point where farmers might begin to reorganize their operations in anticipation that they would reach the \$50,000 limit in future years due to increasing per unit deficiency and diversion payments and increasing crop yields.

It was not GAO's purpose to prove that the intent of these reorganizations was to avoid the payment limitation. However, these reorganizations did have the effect of avoiding the limit because the addition of

new persons, each with a new \$50,000 limit, allowed total payments to exceed what could have been paid without the new persons.

Impact on Fiscal Year 1987-89 Costs If the Trend in Reorganizations Related to the \$50,000 Limit Continues

To determine the impact on fiscal year 1987-89 costs if the trend in reorganizations related to the \$50,000 limit continues, we estimated the number of new persons resulting from farm reorganizations from 1987-89 and the payments these persons would receive.

To estimate the number of new persons resulting from farm reorganizations from 1987-89, we first determined the total number of persons who would reach the \$50,000 payment limit and therefore have an economic incentive to reorganize. Our estimation of the payments for 1987-89 are based on built-in program changes in the Food Security Act of 1985 and the USDA budget documents for those years. We assumed that program participation and crop yields would remain constant at the 1986 level.

We used \$50,000 during this period rather than \$40,000 because program payment growth will slow after 1986 because of changes in the 1985 law, and persons will have an economic incentive to reorganize only when they reach \$50,000, not in anticipation of higher payments in future years. After determining the number of persons receiving \$50,000 or more, we estimated the number that would reorganize, based on trend data developed from our questionnaire. We assumed that the trend would remain constant at the 1984-86 level.

Specifics about the statistical sample and estimation methodologies we used, along with the sample results and upper and lower bounds for the estimates included in this report, are discussed separately in our report, Farm Payments: Farm Reorganizations and Their Impact on USDA Program Costs (GAO/RCED-87-120BR, April 1, 1987).

Changes Needed to Prevent Legal Avoidance of the Payment Limit

To identify the changes needed in existing law and regulations to prevent the avoidance of the \$50,000 payment limitation, we

- analyzed the types of reorganizations identified in our random sample of 1,800 new producers in 1984-86 and in our work at the ASCS county offices that resulted in the avoidance of the payment limit;
- identified the provisions in existing law and regulations that allowed these reorganizations; and

- determined how these provisions could be changed to eliminate the advantages of these types of reorganizations for payment limitation purposes without interfering with the farmers' need to reorganize for tax, estate planning, and other legitimate business purposes.

We then used this information to analyze, comment on, and suggest changes to the Secretary of Agriculture's March 10, 1987, report to the Congress which recommended changes to the payment limitation. The Secretary's recommendations were made in response to a requirement included in the Joint Resolution Making Appropriations for Government Agencies for the Fiscal Year 1987, Public Laws 99-500 and 99-591.

Compliance With Existing Law and Regulations

To determine if ASCS is complying with existing law and regulations in administering the payment limitation, we reviewed 64 person determinations made for the 1986 program year at seven ASCS county offices in four states. Because of time constraints imposed by the requesters' needs, we evaluated these cases using the same information that ASCS used to make its decisions. We did not determine what other information was available to ASCS, if it had asked, nor did we determine if the farm reorganizations were carried out as planned.

ASCS does not maintain summary statistics on the number of person determinations made at the county level as a result of reorganizations. Therefore, we chose counties for review from among those with the greatest potential for reorganization by selecting counties with a large number of producers receiving \$40,000 or more in 1985 and new producers paid in 1986.

At the seven county ASCS offices, we randomly selected for review person determinations that resulted in both an increase in the number of persons paid in 1986 and at least one new person being paid in 1986. The only exceptions were at two county ASCS offices in California. In the first, we randomly sampled 30 determinations that resulted in new persons in 1986, whether or not this represented an increase in the number of persons paid because person determinations in this county involved many new persons who had not participated in the program before. At the other California ASCS office, we limited our review to three determinations that the County Executive Director considered to be reorganizations specifically undertaken to avoid the payment limit and two determinations that we selected at random. Our work at the second county was limited to meet the requesters' time constraints.

We also utilized the results of a recent audit of the payment limitation by the USDA Office of the Inspector General. The Inspector General reviewed 371 farming operations involving 1,059 person determinations made at 30 ASCS county offices within seven states. The Inspector General reviewed the decisions made by the ASCS offices based on the information obtained by these offices, additional information that would have been available to these offices if they had asked, and additional information on the actual operations of the farms.

We conducted our review from July 1986 through April 1987 at the ASCS Headquarters in Washington, D.C., the ASCS Kansas City Management Office, the USDA Office of Inspector General's Southwestern Regional Office in Temple, Tx., and at various ASCS state and county offices.

We made our review in accordance with generally accepted government auditing standards except that we did not independently verify the accuracy of ASCS computerized files or the work performed by the USDA Inspector General. We did, however, consider known limitations in the data files and reconciled discrepancies that would impact our analysis.

We discussed this report with ASCS officials, who generally agreed with its contents. However, as agreed with the requesters, we did not obtain official agency comments on a draft of this report.

Farm Reorganizations Are a Growing Problem That Increases Program Costs

Farm reorganizations among producers receiving payments at or near the payment limit allow producers to avoid the payment limit and increase program costs. Because of built-in program changes since 1983, a greater number of producers can and will receive payments at or near the payment limit in each year through 1989. These producers have an economic incentive to reorganize and add new persons, who can qualify for up to \$50,000 per person, to their farming operations. As more and more producers near or meet the limit, the number of new persons from farm reorganizations among those producers can increase correspondingly. We estimate that by 1989 such reorganizations could result in about 31,300 new persons receiving about \$900 million annually. Further, we estimate cumulative additional payments resulting from these reorganizations could total \$2.3 billion for 1984-89.¹

Factors Influencing the Increased Number of Producers Nearing the Payment Limit

The number of producers at or near the payment limit has increased because of higher per-unit deficiency payment rates and generally higher crop yields over the past few years. One way to illustrate the effect of this is to calculate the average acres that must be planted to major program crops to reach the \$50,000 payment limit. As shown in figure 2.1, 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, based on nationwide average crop yield and compliance with the mandatory minimum program requirements.² 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 percent and 13 percent, respectively.

Farm Reorganizations Increased Rapidly During 1984-86

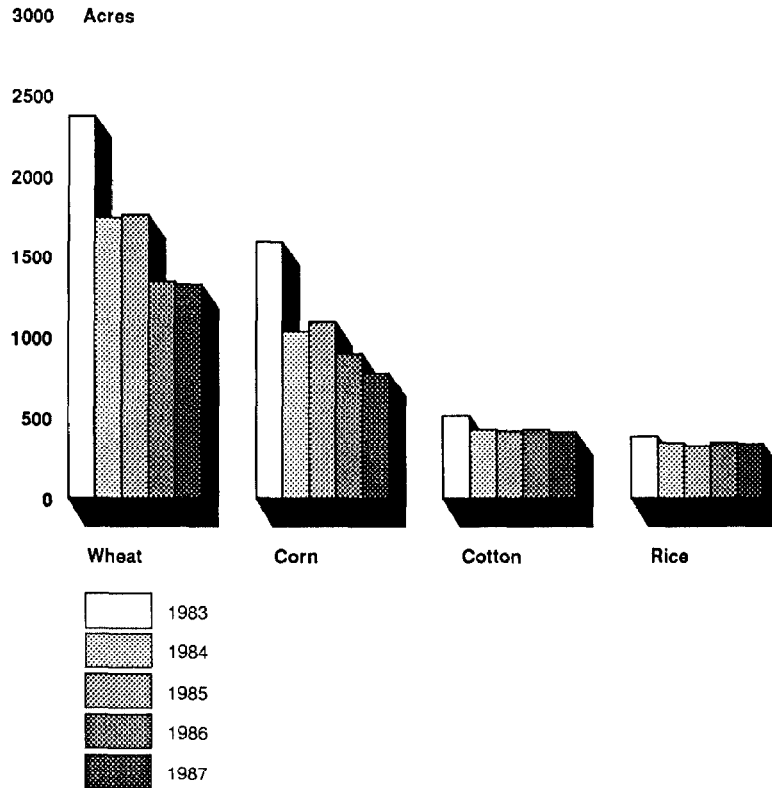
An increasing number of producers reorganized their farm operations as they neared or met the payment limitation from 1983-85. As a result, in each succeeding year, 1984-86, there was a corresponding increase in the number of new persons paid. As producers reorganize their farm operations in a manner that results in new persons, total payments from USDA can increase because each new person created by the reorganization qualifies for a separate \$50,000 payment limit. Although it is not possible to prove that all of these producers reorganized to avoid the payment limit, that was the effect. Anecdotal evidence that we obtained

¹The information in this chapter was originally reported in detail in our report Farm Payments: Farm Reorganizations and Their Impact on USDA Program Costs (GAO/RCED-87-120BR, April 1, 1987).

²Mandatory minimum program requirements are those that a participating farmer must comply with in order to receive government program benefits such as deficiency payments. In 1986, for example, corn farmers had to reduce the amount of acres they planted by 17.5 percent in order to receive deficiency payments on their remaining crop production.

Chapter 2
**Farm Reorganizations Are a Growing
 Problem That Increases Program Costs**

**Figure 2.1: Acreage Needed to Reach
 the \$50,000 Limit**



from state and local agricultural officials, producers who reorganized, and other sources also indicates that avoidance of the payment limit was the driving force in at least some of these reorganizations.

For 1983-85, we assumed that \$40,000 in payments was the point at which a person might reorganize a farming operation in anticipation of increased payments because of built-in program changes. For example, the corn deficiency payment rate increased about 130 percent from 21 cents per bushel to 48 cents a bushel between 1983-85 because of increased target prices in the law. On a hypothetical 1,591 acre corn farm, payments would have increased by 46 percent from \$50,000 in 1983 to \$72,855 in 1985 based on nationwide average crop yields and compliance with required acreage reduction programs. Therefore, we assumed that producers receiving \$40,000 or more in 1983-1985 had an

economic incentive to reorganize in a manner that would add new persons to their operations and increase their payments. When this occurred, we assumed the reorganization was related to the payment limitation.

In crop years 1983, 1984, and 1985, respectively, 4,306, 14,356, and 28,678 producers received payments totaling \$40,000 or more. We estimate, based on our statistical sample, that about 1,400, 1,900, and 5,700 new persons, respectively, were created in the following crop years as the result of farm reorganizations among those producers.

Farm Reorganizations Could Increase During 1987-89

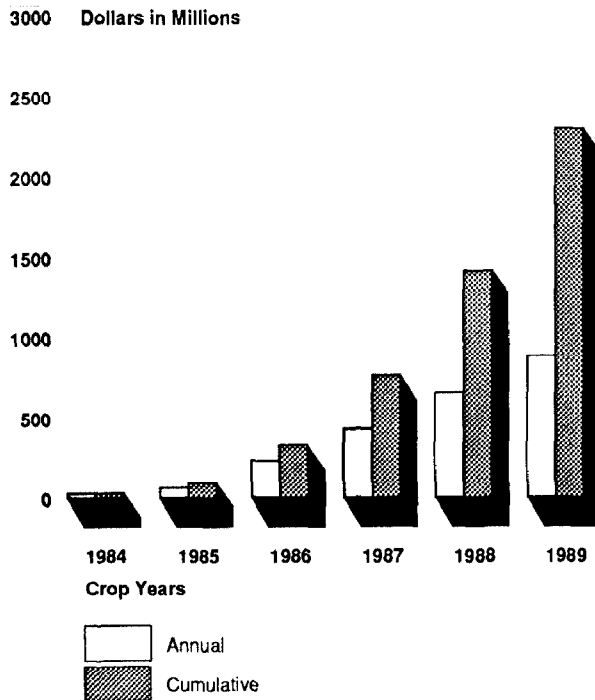
For the years 1983-85, producers could maximize their payments by reorganizing their operations once payments were at or greater than \$40,000 because of high program payment growth during those years. However, payment growth will slow after 1986, pushing fewer operations automatically into higher payment ranges. For example, the corn deficiency payment rate will continue to increase from 1986-88, but it will do so at a slower rate — 56 percent compared with 130 percent for 1983-85. This higher rate will also be offset, to some extent, by increased acreage reduction requirements. As a result, payments on the hypothetical 1,591 acre corn farm should increase about 39 percent from 1986-88 compared with 46 percent in 1983-85. Payment growth should slow even more for the other major crops subject to the limit, but there will still be a slight increase in payments for these crops from 1986-88. Therefore, we assumed that for the years 1987-89, producers will have an economic incentive to reorganize only when payments actually reach \$50,000, not in anticipation of higher payments in future years. After determining the number of producers receiving \$50,000 or more in 1986-88, we estimated the number that would reorganize in 1987-89, based on the trend in reorganizations among producers with an economic incentive to reorganize in 1983-85.

We estimate that the number of producers receiving \$50,000 in payments will be about 37,600 in crop year 1986, 39,400 in crop year 1987, and 41,300 in crop year 1988. We also estimate that the farm reorganizations among these producers will increase in each of the following years resulting in about 7,100, 7,400, and 7,800 new persons respectively in 1987-89.

Total New Persons Resulting From Reorganizations Related to the Payment Limitation in 1984-89 and Their Annual and Cumulative Program Payments

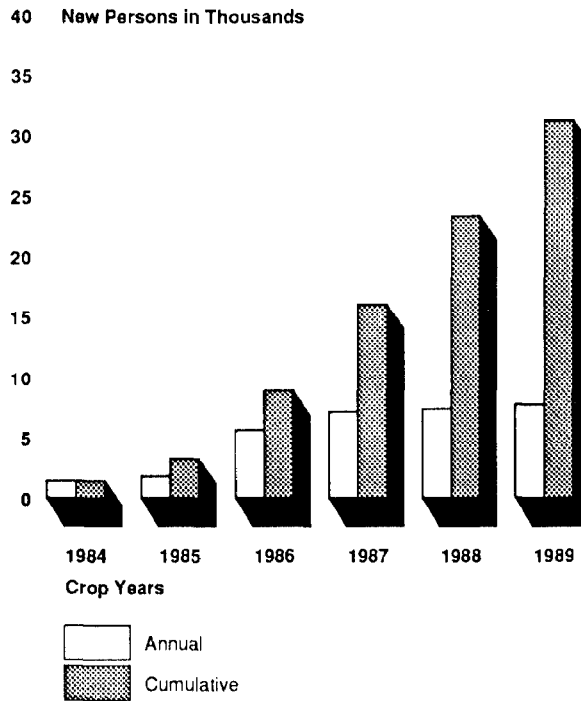
We estimate that about 31,300 new persons could be paid approximately \$2.3 billion as a result of farm reorganizations related to the payment limitation during 1984-89, with these new persons receiving about \$900 million in 1989. Figure 2.2 shows the year-to-year changes in the estimated annual and cumulative number of new persons from 1984-89, and figure 2.3 shows the annual and cumulative payments to these new persons during the same time period.

Figure 2.2: Number of New Persons Resulting From Reorganizations Related to the Payment Limitation, 1984-89



Chapter 2
Farm Reorganizations Are a Growing
Problem That Increases Program Costs

Figure 2.3: Total Annual and Cumulative Payments to New Persons Resulting From Reorganizations Related to the Payment Limitation, 1984-89



Current Law and Regulations Make It Relatively Easy to Avoid the Payment Limit

Under existing law and regulations, producers can avoid the \$50,000 payment limitation by reorganizing their farming operations in a manner that results in new persons for payment limitation purposes. The most frequent methods used to avoid the payment limit were for two producers who are already at the payment limit to form a corporation which qualifies for its own \$50,000 payment limit or by adding a new member, who may or may not be actively engaged in the actual farming operation, to a joint venture or partnership. While the rules relating to corporations and joint operations were used most frequently to avoid the payment limit, other rules, such as the basic definition of who or what constitutes a person, were also used. For any one farming operation, these methods of avoiding the payment limit usually result in the addition of only one or a few new persons because total payments for each operation are effectively limited by the amount of acreage farmed and crop yield. However, these and other methods of avoidance, such as the division and lease of land, can result in significant increases for any one farming operation.

Use of Corporation and Joint Operation Rules to Avoid the Payment Limit

We found that it is relatively easy to increase the number of persons for payment limitation purposes by incorporating. The Secretary of Agriculture, as required by the Agriculture and Consumer Protection Act of 1973 (Public Law 93-86), defined a corporation as a separate person if no stockholder owns or controls more than 50 percent of the stock. In addition, each corporation is considered a separate person from any other corporation provided the same two or more individuals do not own or control more than 50 percent of the stock in the corporations. By using a combination of two stockholders per corporation, each of whom owns exactly 50 percent of the stock, three individuals—A, B, and C—can form three corporations—AB, BC, and AC. The three individuals and three corporations would then qualify for a total of six payments.

Joint operations, such as general partnerships or joint ventures, can also be used to increase the number of new persons on a farming operation. ASCS regulations provide that the individual members of a joint operation, not the joint operation, are separate persons. To qualify as a separate person with a separate \$50,000 payment limit, each member must make contributions of either capital, land, equipment, labor, or management to the joint operation in proportion to their share of the payments from the joint operation. As a result, joint operations can increase the number of payment limits for their operations simply by adding additional members, even if those members are not actively engaged in the

actual farming operation. For example, a four member general partnership can increase the payment limits for its operation from four to five (e.g. from \$200,000 to \$250,000) by adding a fifth general partner, provided the fifth partner's share of the payments is in proportion to that partner's contributions to the partnership, which may consist only of capital.

The following actual example illustrates how a six-member joint venture increased the payment limit for its operation from \$300,000 in 1985 to \$1,050,000 in 1986 by forming a series of corporations and entering into a new joint venture with the corporations. In 1985, as shown in figure 3.1, the six-member joint venture consisted of a father and his five adult children, each of whom qualified as a separate person with a \$50,000 payment limit or a total of \$300,000 for the joint venture.

In 1986, the father and his children formed 15 new corporations, each of which is owned on a 50/50 basis by two of the six individuals and qualifies as a separate person with a \$50,000 payment limit. As shown in figure 3.2, the family members reorganized their farming operation by forming a new joint venture, consisting of 21 persons—the six individuals and the 15 corporations—with a combined payment limit of \$1,050,000.

Other Rules That Contribute to the Avoidance of the Payment Limit

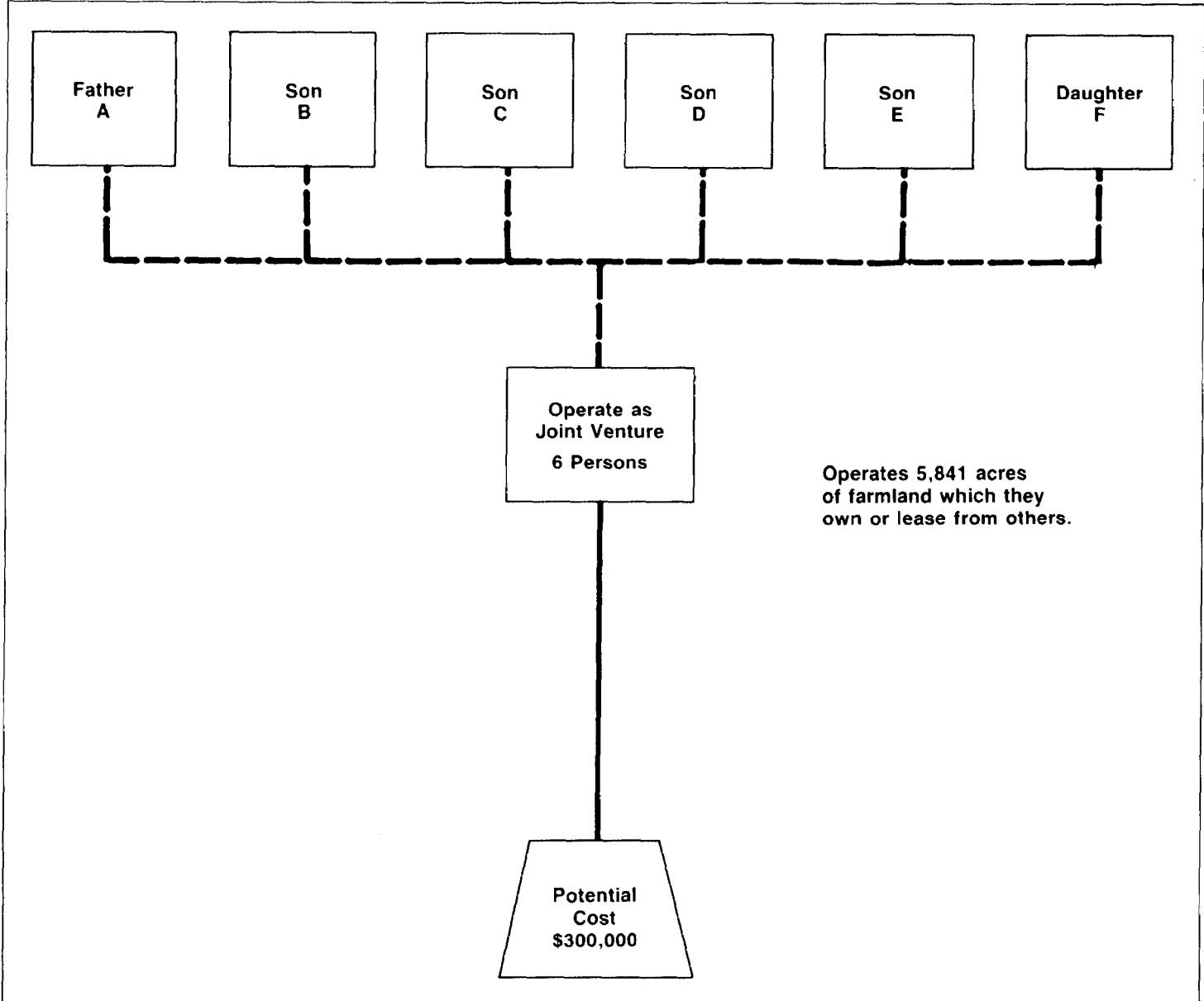
While the provisions relating to corporations and joint operations have been used most often to avoid the payment limit, other ASCS rules also have been used. These include the basic definition of who or what constitutes a person and rules relating to minor children, custom farming, substantive change, and entities with common ownership.

Basic Definition of a Person for Payment Limitation Purposes

The basic definition of a person for payment limitation purposes is any individual or legal entity that (1) has a separate and distinct interest in the land or crop, (2) exercises separate responsibility for that interest, and (3) is responsible for farming costs related to the interest from a fund or account separate from that of any other individual or entity.

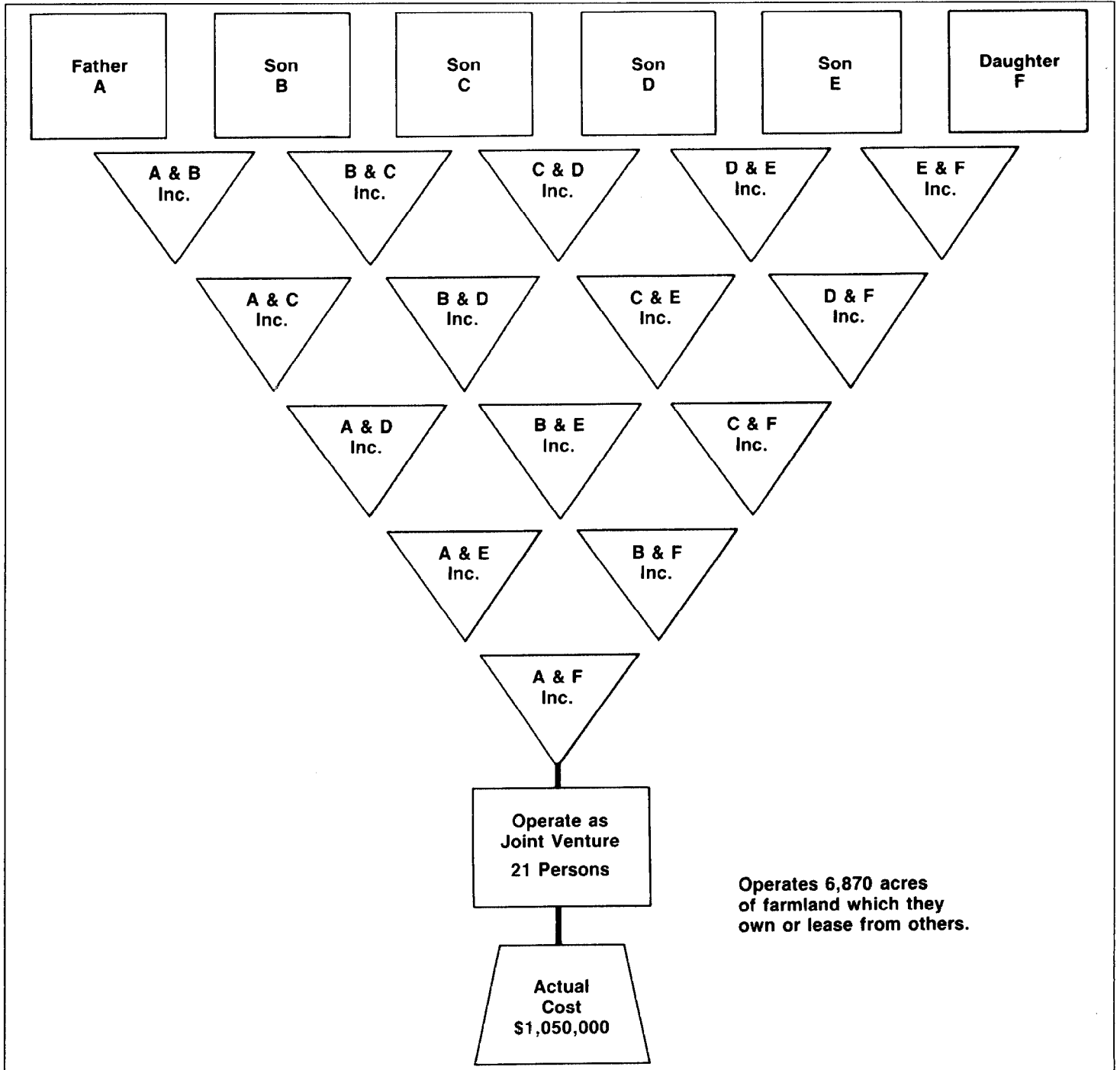
This definition allows avoidance of the payment limit through the division of land into parcels that earn payments at or near the limit and the cash lease of these parcels to investors not otherwise engaged in farming. The investors' involvement in farming can be limited to investing

Figure 3.1: Corporate Case Study-1985 Organizational Structure



Chapter 3
 Current Law and Regulations Make It
 Relatively Easy to Avoid the Payment Limit

Figure 3.2: Corporate Case Study-1986 Organizational Structure



capital and signing agreements to lease the land, rent equipment, and hire management and labor. In some cases, the investors borrowed the investment capital using the anticipated crop or government payment as collateral. This type of reorganization can result in a significant increase in the number of new persons and the payment limit for an operation. For example, we found one instance where a management firm used this method to increase the payment limit from \$50,000 to \$1,400,000 by leasing land it managed to 28 investors.¹ The organization of this farming operation is illustrated in figure 3.3.

Minor Children

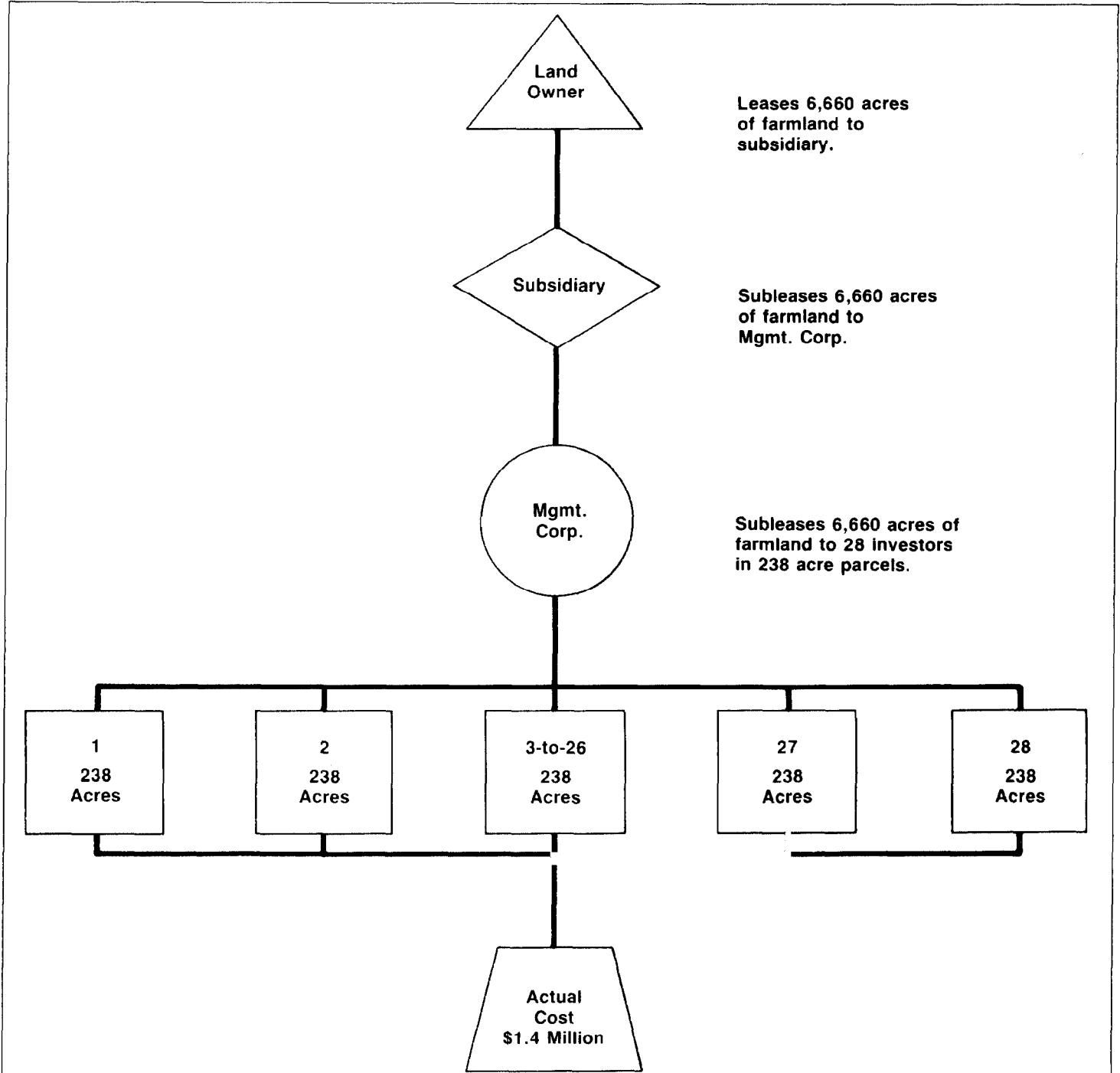
ASCS regulations require that minor children 17 years of age or younger be combined with their parents and treated as one person for payment limitation purposes. However, minor children can qualify as separate persons if they have a farming operation and a residence or guardianship separate from their parents. In its March 10, 1987, report to Congress on the payment limitation, USDA noted that parents were establishing separate residences for the children or relinquishing legal guardianship so that their minor children could qualify as separate persons for payment limitation purposes. In fact, in the previous example, shown in figure 3.3, two of the 28 new persons were minor children, 10 years old.

Custom Farming

Custom farming is the hiring of others to perform services on a farm, such as harvesting a crop, on a unit of work basis (e.g. \$100 per acre harvested). In its report to the Congress regarding the payment limitation, USDA described the following situation involving custom farming. An individual rented a portion of his land to four individuals who had not farmed before. He then formed a corporation with the four individuals and transferred ownership of his equipment to the new corporation, which custom farmed for himself and the four new individuals. The original individual and the four new individuals qualified as producers and separate persons, even though the corporation was farming the land. This effectively increased the number of persons for payment limitation purposes from one to five and the total payment limit from \$50,000 to \$250,000.

¹As discussed further in Chapter 4, ASCS subsequently disallowed this increase on the basis of information we developed but stated that this type of reorganization, if done properly, is legal.

Figure 3.3: Division and Lease of Land Case Study



Substantive Change

A substantive change in operations is required in any farm reorganization that increases the number of persons with separate payment limits. ASCS payment limitation rules identify several actions that constitute substantive change, including a 20-percent increase or decrease in the land involved and a change from share lease to cash lease or vice versa.² Therefore, operations which are incorporating or adding new members can meet the substantive change rule by simply reducing the amount of land farmed or, if land is leased, by changing the type of lease. For example, we found a case where a father and his two sons, who qualified as three persons, reorganized their operation to add three more family members for a total of six persons for payment limitation purposes. The substantive change, which ASCS officials cited as justification for the increase in persons, was a 35-percent decrease in the amount of land farmed. In effect, government program payments on this operation could double, while the amount of land being farmed declines by one-third.

Entities With Common Ownership

Because of legislative restrictions on the treatment of corporations, ASCS combines two or more corporations owned by the same two or more individuals for payment limitation purposes only when those individuals own "more than 50 percent" of the corporations. This permits the use of corporations and joint operations in the manner described on page 22 where six individuals increased payment limits for their operation to 21 by forming 15 new corporations because none of the six persons owned "more than 50 percent" of any of the corporations. The 15 new corporations would have resulted in only one additional person rather than 15, if for example, ASCS could combine entities where the same individual(s) owns "50 percent or more" rather than "more than 50 percent" of two or more entities. This would occur because each of the individuals own 50 percent of several corporations. Therefore, all of these corporations could be combined for payment limit purposes until there was only one corporate entity that qualified for a payment. There would always be that one entity remaining because the rule combines the entities with common ownership into one person for payment limitation purposes.

²In a cash lease arrangement, the lessee pays the land owner a fixed sum, either in cash or commodities, and retains all of the federal payments. In a share lease arrangement, the lessee shares the crop and associated federal payments with the land owner.

USDA Has Proposed Changes to Reduce Avoidance of the Payment Limit, but Additional Changes Are Needed

In its March 1987 report to the Congress, USDA proposed a number of changes to reduce avoidance of the payment limit. USDA's proposals eliminate the advantage of incorporating or adding members to a joint operation to avoid the limit. USDA's proposals also include changes that will make other rules that contribute to avoidance of the limit, such as the rule for combining entities with common ownership, more restrictive. Some portions of USDA's proposal can be implemented under current legislation, while other portions require congressional action.

Overall, we believe USDA's proposals are positive actions and would be more effective than other options suggested for reducing avoidance of the payment limit. We also believe that with certain revisions, USDA's proposals can be made even more effective. The adoption of USDA's proposals, with our suggested revisions, will discourage many farm reorganizations designed to avoid the payment limit without adversely affecting other legitimate reorganizations. However, ASCS must develop clear and precise implementing regulations and administrative guidance to assure that its county offices effectively implement the changes.

Principal Thrust of USDA's Proposals

The principal thrust of USDA's proposals eliminates the advantage of incorporating or adding members to a joint operation to avoid the limit. USDA plans to accomplish this by

- treating all entities the same, as opposed to the current situation where a corporation is one person separate from its members while a general partnership is two or more persons, depending on the number of partners;
- determining the payment limit for each entity based on the number of its members "actively engaged" in the entity's farming operation, with actively engaged defined as a significant independent contribution of capital, land, or equipment and labor or management;
- attributing payments for the entity to the individual payment limits of its members on the basis of the members' interest (ownership)¹; and
- limiting total payments for an individual to \$50,000, whether the payments are from their own farming operation or attributed to them from an entity, such as a corporation, in which they have an ownership interest.

¹Attribution to all owners in some situations would create an unacceptable administrative burden for ASCS, especially in the case of a publicly-held corporation with hundreds or thousands of stockholders. USDA's proposal would limit attribution to those individuals owning 10 percent or more of an entity in such situations.

These changes will reduce reorganizations to avoid the \$50,000 limit because individual payment limits and the number of individuals actively engaged in farming, not the type of organizational structure, will be the driving force in applying the payment limit. Specifically, these changes will reduce the advantages of (1) adding members to increase the payment limit for an entity's operation, which is now possible for joint operations, by limiting payments to the persons actively engaged in farming and (2) creating corporations that qualify as separate persons by attributing payments for an entity to the owners and counting these payments against the owners' individual payment limits.

USDA's Proposals Will Also Make Other Rules That Contribute to Avoidance More Restrictive

USDA's proposals will make the payment limitation rules for minor children, custom farming, substantive change, and entities with common ownership more restrictive. Specifically, USDA's proposals would make the following changes in these rules.

- Minor children who can now be separate persons in several situations would always be combined as one person with their parents in all situations, 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.
- Individuals or entities who use the same custom farming organization and who are now separate persons would be combined as one person if the owners of the organization that does their custom farming has any interest in their land or crop.
- The substantive change rule that now allows an increase in the number of persons when there is a 20-percent increase or decrease in the land involved would be changed to require that (1) the amount of land being farmed must increase before the number of persons can increase and (2) the number of new persons added would be limited by the payments that result from the increase. For example, if enough crops are grown on the added land to qualify for an additional \$100,000 in payments, only two new persons—each with a \$50,000 limit—could be added. In addition, the rule that now allows an increase in the number of persons in a reorganized farming operation when a different land lease arrangement is used would be changed to allow an increase in the number of persons only if the new person(s) is the landowner and the change is from a cash to a share lease arrangement.
- Finally, the rule for combining entities with common ownership would be changed so that entities will be combined as one person when the same one or more individual(s) owns or controls 50 percent or more of

the entities², rather than when “the same two or more” individuals own or control “more than 50 percent” of the entities.

ASCS can implement all of these changes under its existing legislative authority, except the rule for combining entities with common ownership. However, ASCS officials stated that they did not want to make any of these changes until the Congress reaches a consensus about what changes ASCS should make. ASCS can change its rules for combining entities with common ownership only if the Congress removes the legislative restriction on the treatment of corporations for payment limitation purposes.

Changes in Law Necessary to Implement USDA’s Proposals

Before ASCS can implement USDA’s proposal, the Congress will have to (1) eliminate existing legislative requirements on the treatment of corporations for payment limitation purposes and (2) authorize payment limits for legal entities based on the number of their members actively engaged in the farming operation. Under existing legislation, ASCS must consider a corporation as a separate person for payment limitation purposes provided that

- no stockholder owns more than 50 percent of the corporation’s stock, otherwise the corporation and the stockholder are combined as one person, and
- the same two or more stockholders do not own more than 50 percent of two or more corporations, otherwise the corporations with common ownership are combined as one person.

This restriction effectively prevents ASCS from changing the manner in which a corporation is treated for payment limitation purposes. The Congress would also have to authorize the determination of payment limits for entities on the basis of the number of members actively engaged in the entities’ farming operations, as existing law does not provide for this. USDA’s proposal includes a suggested amendment to the Food Security Act of 1985 to make these legislative changes (see appendix VI).

²USDA’s proposal actually states, however, that this will occur when two or more persons own 50 percent or more of the entities, but ASCS officials intended for this to read as shown above.

USDA's Proposals Still Have Some Loopholes

USDA officials stated that they intended that total payments to any individual would be limited to the \$50,000 limit established in law, whether these payments were from the individual's own farming operations or attributed from legal entities in which the individual shares ownership. However, we found that USDA's proposed amendment to the Food Security Act of 1985 will not limit payments attributed to a member of an entity if the entity qualifies as a separate person under the current rules unless these individuals have other farming interest outside of the entity.

For example, four individuals form a corporation to operate a farm on which 3 of those persons meet USDA's definition of actively engaged in farming. The three individuals, who are actively engaged in the corporation's farming operation, also have farming interests of their own outside the corporation that qualify them as separate persons, but the fourth individual does not. Under USDA's proposal the corporation will qualify for up to \$150,000 in payments (\$50,000 x 3 members actively engaged in farming). The payments will then be divided among the 4 owners of the corporation (\$37,500 each). The three owners who are considered as persons for payment limitation purposes have individual \$50,000 per person payment limits. However, under the proposed and current rules the fourth owner, who has no farming interest outside the corporation, does not qualify as a person and does not have an individual payment limit because he does not have a separate interest in the crop which is one of the basic requirements under the rules. In this case the corporation would be considered to have the only interest in the crop. The reason the other three individuals have a payment limit is because they have other farming interests where they have a separate interest in the crop. As such, the fourth individual could own portions of a number of corporations and receive payments from those corporations in excess of \$50,000. ASCS can correct this problem by including these individuals in its definition of a person.

We also found that USDA's proposals do not address avoidance of the payment limit through the division and lease of land to investors not otherwise engaged in farming. Therefore, individual investors like those in the example discussed on page 25 will continue to qualify as separate persons, even though their only contribution to farming may be investment capital, which in some instances comes from a loan secured by the government payments they are receiving on the farming operation. USDA could have addressed this method of avoidance by applying its proposed definition of actively engaged in farming to individual producers as well as members of an entity.

ASCS officials did not apply the proposed definition of actively engaged in farming to individuals because this would preclude payments to land owners who share rent their land. However, ASCS can reduce avoidance of the limit through the division and lease of land without impacting these land owners by requiring that the person leasing land but not the land owner also make a substantive contribution of owned-land or owned-equipment and personal labor or active management in addition to capital to the farming operations that include the leased land.

Other Options to Reduce Avoidance of the Payment Limitation Are Less Effective Than Those Proposed by USDA

Several other options to reduce avoidance of the payment limit have been suggested by Members of the Congress, their staffs, the USDA Inspector General, and others concerned about this problem. These options include (1) applying a \$50,000 payment limit to each legal entity and attributing each owner's share of that payment against their individual payment limits, (2) combining owners of a legal entity as one person with the entity, (3) defining only individuals as persons, and (4) increasing the payment limit.

We believe these options would be less effective than USDA's proposal for reducing avoidance of the payment limit, primarily because they would likely cause an increase in other types of reorganizations. In some cases program costs would not necessarily rise, but the increase in reorganizations would be an unnecessary administrative burden on ASCS.

Except for increasing the payment limit, each option requires that the Congress remove the legislative restriction on how a corporation is treated for payment limitation purposes. In evaluating these options, we assumed that ASCS would change the rules for minor children, custom farming, substantive change, and combining entities as proposed by USDA.

Apply a \$50,000 Limit to Each Legal Entity and Attribute That Payment to the Owners' Payment Limits

Under this option, ASCS would establish a two-tier payment limitation when legal entities other than individuals are involved. This option is very similar to USDA's proposal. The only difference is that, under this proposal, each entity would have one \$50,000 payment limit regardless of the number of its members actively engaged in its farming operations. Payments up to this limit would then be attributed to the owners of the entity and count against their individual payment limits.

This option would remove the advantages of incorporating or adding new members to a joint operation. However, it would increase the

number of reorganizations because members of a joint operation who are now separate persons would have an economic incentive to dissolve the joint operation and farm separately as individuals. For example, payments which now total \$200,000 to a four-member general partnership would be limited to \$50,000 under this proposal. As a result, the members would have an economic incentive to dissolve the partnership and farm separately to continue receiving \$200,000.

**Combine Owners of a
Legal Entity as One Person
With the Legal Entity**

Under this option, ASCS would basically combine all legal entities with the owners of those entities for payment limitation purposes. It would remove the advantages of incorporating or adding new members to a joint operation. However, members of these entities who now qualify as separate persons would be combined with the entities as one person, and as a result, they would also have an economic incentive to dissolve the entity and farm separately as individuals. The four members of the partnership discussed in the previous example would be limited to \$50,000 in payments under this proposal unless they dissolved the partnership and farmed separately.

**Define a Person as
Individual Producer Only**

Under this option, ASCS would not include any legal entity other than an individual in its definition of a person, and payments would be made only to producers who are individuals. Its application would pose legal problems because legal entities do qualify as producers and are entitled to receive payments. However, even if the legal questions involved in its application could be resolved, the proposal would interfere with the ability of individual producers to reorganize their operations as legal entities for tax, estate planning, or other legitimate business reasons if those entities could not receive payments. In addition, individuals involved in existing entities would be encouraged to dissolve those entities and operate as individuals so they could receive payments.

**Increase the Payment
Limit**

An increase in the payment limit would decrease the number of producers affected by the limit and, as a result, the number of farm reorganizations to evade the limit would probably decrease. Program costs would increase because less than 20 percent of producers with an economic incentive to reorganize (those at or near the limit) do so, and payments to those producers who do not reorganize would automatically increase. The amount of increase for each producer would depend on the extent to which the payments the producer is eligible for exceed the current limit and the amount of the new limit. In addition, the economic incentive to

avoid the limit would still exist for those affected by the new higher limit, and some portion of these persons would probably reorganize.

Clear Regulations and Guidance Required to Implement USDA's Proposals

If USDA's proposals are adopted by the Congress, ASCS will need to develop clear and precise regulations and guidance for its county offices to assure their effective implementation. ASCS county officials, who make the person determinations for payment limitation purposes, will then have to determine how many members of an entity are actively engaged in the farming operation based on the number of members who make significant independent contributions of capital, land, equipment, labor, or management to the entity's operation.

ASCS will need to define what a significant independent contribution is and how to value land, equipment, labor, and management for this determination. Currently, as discussed in Chapter 5, ASCS does not provide adequate guidance to its county offices for similar determinations under existing payment limitation regulations.

Further, ASCS will need to be explicit as to what labor and management contributions are acceptable. Otherwise, an individual can contribute capital in an amount that meets the criteria established for a "significant independent contribution" and then complete the necessary requirements to be considered "actively engaged" by providing only a few days labor or brief consultations for management purposes. In one instance, for example, we found three family members who claimed to share equally in the management of a general partnership. However, this is hard to accept when one of them lived in Australia, another lived over 100 miles from the land being farmed, and the third was paid to provide the day-to-day management of the farming operation.

ASCS Needs to Improve Its Administration of the Payment Limitation

ASCS county offices determine which individuals and entities are separate persons for payment limitation purposes based on a farm operating plan provided by producers and applicable rules and regulations. This determination is fundamental to the effective administration of the payment limitation provisions.

In separate reviews, GAO and the USDA Inspector General found that ASCS county officials incorrectly applied or failed to obtain information necessary to correctly apply payment limitation regulations in over 20 percent of the person determination cases reviewed. In addition, although required to, county officials did not always verify that reorganized farming operations resulting in new persons were carried out as planned.

These incorrect determinations occurred primarily because of inadequate guidance and training on how the regulations should be implemented and ineffective internal control procedures to ensure correct implementation of the regulations. During 1986, ASCS took some actions that should improve person determinations made for the 1987 and later program years. These changes include revising some program guidelines and increasing training. However, ASCS needs to further improve its guidance and training on implementation of the regulations as well as its internal controls.

Results of Reviews of County Office Operations

We reviewed 64 person determinations for program year 1986 and questioned 29 determinations that resulted in 70 new persons and potential overpayments of \$2.4 million. We questioned 11 determinations because they were incorrect based on the available information. These 11 determinations resulted in 20 new persons and potential overpayments of \$413,000. We questioned the remaining 18 determinations because they were made without adequate information to make a proper determination.

Because of time constraints, we did not verify these determinations against the actual farming operations of the individuals and entities involved. If we had done so, it is likely that some of the determinations made without adequate information may have been correct. However, it is important to note that county officials would not have known this at the time they made the determinations because they did not have the necessary information to make the determinations. We did, however, request that ASCS obtain additional information about one determination made without adequate information that involved the division and lease

of land to 28 investors not otherwise involved in farming. On the basis of this information, ASCS headquarters officials determined that none of the investors were eligible for payments and initiated actions to collect about \$1.4 million in payments subject to the limit.

In addition to our review, the USDA Inspector General reviewed 1,059 person determinations made between 1981 and 1986 and found 225 in error that resulted in overpayments of \$15.7 million. The Inspector General went a step further than we did and reviewed the actual farming operations of the individuals and entities involved in these determinations. On the basis of these reviews, the Inspector General found that the determinations were in fact erroneous.

Need for Improved Guidance

We found that the regulations that were incorrectly applied or applied without sufficient information involved requirements that (1) a substantive change be made in the farming operation when a farm reorganization results in a new person for payment limitation purposes, (2) each person's financing be separate and distinct, and (3) payments to a person who is a member of a joint operation be commensurate with that person's contributions to the joint operation. The USDA Inspector General found that custom farming and other rules also were incorrectly applied. These rules are important factors in determining whether separate persons exist for payment limitation purposes. We found that the ASCS guidance to its county offices was generally inadequate or vague about how these factors should be considered in person determinations. In addition, ASCS guidance about the information needed to make a person determination and how to verify that reorganized farming operations were carried out as planned was also inadequate.

Substantive Change

ASCS requires that the change in farming operation be "substantive" if the reorganization results in new persons for payment limitation purposes. However, ASCS guidance is vague about the nature or extent of change required to meet this criteria. For example, ASCS guidance for the 1986 program year provided that

- a "substantial" change in farm size by purchase, sale, or lease of land is a substantive change, but the guidance did not include criteria on specifically what constituted a substantial change;
- transfer of ownership for equipment or land from an existing person to a new person can constitute substantive change but did not specify how much equipment or land must be transferred; and

- a “paper change” in which essentially the same individuals or legal entities continue to farm the same land with the same equipment is not a substantive change but did not clarify whether this rule applies when the ownership of some or all of the land or equipment changes among the individuals and entities involved.

As a result of the vague guidance, ASCS county officials interpreted substantive change differently. For example, officials in one county considered the addition of a new individual to an operation as a substantive change, while officials in another county required a 20-percent increase in land.

The effect of such differing interpretations is illustrated by the following reorganization. In 1985, five individuals and a corporation owned by two of the individuals had six separate farming operations involving 8,900 acres. In 1986, these individuals reorganized their operations into 10 separate operations by creating four new corporations among themselves and by leasing approximately 2 percent more land. In the county that required a 20-percent increase in land, the new organization would have been determined to be six persons receiving \$300,000 in payments. In the county where the reorganization occurred and where a 20-percent increase in land was not required, the reorganization resulted in 10 persons receiving \$452,000.

In total, ASCS county officials incorrectly determined or failed to obtain sufficient information to determine if a substantive change occurred in 8 of the 29 person determinations we questioned. The Inspector General found no substantive change in 141 of the 225 determinations questioned.¹ ASCS has issued revised guidelines which should improve the application of the substantive change rule in future program years.

Financing

The basic definition of a person for payment limitation purposes requires that a person finance his or her operation separately from any other person. ASCS headquarters interpreted this requirement to preclude any individual or legal entity with an interest in the new person's farm or crop from providing financing in any manner including making, co-signing, or providing collateral for a loan or paying operating expenses of the new person. ASCS headquarters provided county offices

¹The number of determinations noted as being in error for each type of error discussed in this section, if added together, will exceed the total determinations found to be in error. This is because some erroneous determinations involved more than one type of error.

with little guidance on their interpretation of this requirement for the 1986 or prior year programs.

California state ASCS officials incorrectly interpreted this rule during 1986 for members of a general partnership or joint venture by allowing common assets to be pledged as security for operating loans of individual members. We reviewed 13 person determinations involving partnerships or joint ventures in California and found that three were in error because of this incorrect interpretation. As a result, nine persons were overpaid \$206,000. The ASCS Executive Director in the county where these errors occurred estimated that as many as 50 percent of their determinations for partnerships or joint ventures could be in error because of the incorrect interpretation of the financing rule.

In total, ASCS county officials incorrectly determined or failed to obtain sufficient information to determine if financing was separate in 18 of the 29 person determinations we questioned. Similarly, the Inspector General found that financing was not separate in 99 of the 225 determinations questioned. ASCS has revised its guidance on financing beginning with the 1987 program year but does not intend that the revised guidelines be used to collect overpayments in prior years because in their view it would be unfair to the producers because it was ASCS' error.

Commensurate Shares

ASCS guidance provides that members of joint operations, such as general partnerships, are separate persons provided each member involved in the joint operation contributes capital, land, equipment, labor, or management in proportion to (commensurate with) their share of the payments. However, no guidance is provided about how to evaluate, for example, contributions of labor and management to determine if the contributions are commensurate with the payments received.

ASCS headquarters' interpretation of this requirement is that if the assets of a joint operation are used to produce the crop, then the contribution of each member in the joint operation is equal to the member's share of ownership and consequently should be equal to his share in the payments in the joint operation. If any of the members contributes additional capital, land, equipment, labor, or management to the production of the crop, then the value of this additional contribution must be added to that member's share of ownership to determine whether the member's share of the payments is commensurate.

In total, nine of the 29 determinations we questioned involved joint operations. In five of these cases, we found that ASCS county officials failed to obtain sufficient information to determine if members' contributions were commensurate with their payments. For example, ASCS county officials determined that members' contributions were commensurate with their share of payments even though they did not know which members contributed the land or equipment or the value of those contributions. The Inspector General also found 131 determinations in error because contributions were not commensurate with the payments received in joint operations.

Information Needed to Make a Person Determination

ASCS guidance to its state and county offices requires that they obtain whatever documentation is necessary to make the person determination. The guidance notes that the documentation may include legal documentation about land ownership, the legal entity, operating agreements, leases, financial arrangements, and any other information needed to apply the payment limitation rules. However, no guidance is provided about what information is needed to apply specific rules or how this information should be documented.

County ASCS officials were not consistent in the information or documentation they required to support approval of new persons for payment limitation purposes. Officials in one county office requested evidence of incorporation, financing, lease arrangements, and capital investment. Other offices, however, obtained little information or documentation on which to base their decisions. In one county, we found that none of the 12 determinations we randomly selected for review had sufficient documentation to support the approval of new persons. For example, the county officials did not have documentation in some cases to show who owned the land or equipment that was used by the new partnership. As a result, 11 new persons may have been incorrectly paid \$392,000 in 1986. However, without the needed documentation there is no way to know.

The documentation ASCS officials accepted as evidence of a corporation's stock ownership illustrates the confusion that exists regarding what information and documentation are needed to apply specific rules. A corporation cannot be a person separate from its stockholders if any individual owns more than 50 percent of its stock. To verify the extent of individuals' ownership of a corporation's stock, ASCS county and state officials accepted letters from attorneys or stockholders, minutes of Board of Directors' meetings, and copies of stock certificates without

assurance that all outstanding stock was included. ASCS officials rarely obtained the corporation's stock transfer ledgers that would have provided the information necessary to verify ownership of the corporation's stock.²

In total, 24 of the 29 determinations that we questioned were made without sufficient documentation to determine that (1) a substantive change had occurred, (2) financing was separate, (3) partners' contributions were commensurate with their share of payments or (4) ownership of land, equipment, or legal entities had changed when this information was critical to the person determinations.

The Inspector General found similar documentation problems. Of the 225 person determinations the Inspector General found in error, 77 also involved county officials making person determinations without sufficient information.

Verification of Farming Operations

ASCS regulations require county officials to verify, beginning with the 1986 program year, that key aspects of reorganized farming operations resulting in new persons were implemented according to the farm operating plan because this plan was the basis for adding the new persons. However, except for one generalized example, ASCS guidance does not indicate what key aspects of a farming operation should be verified. In addition, no guidance is provided about how this should be done beyond noting that the documentation used for this purpose should include (1) evidence of how crops were marketed, bills were paid, and who did the farming and (2) legal documents to verify ownership, existence of legal entities, or other transactions.

We found that county officials did not consistently implement the verification requirement. For example, officials in two counties followed an earlier state office requirement to make a review of at least two determinations resulting in new persons or involving operations they considered suspicious. Officials in a third county requested general documentation without analyzing the determinations to identify what key information needed to be documented or what documentation was needed to support the information. In a fourth county, officials stated that they did not plan to implement this requirement. Subsequently,

²Most corporations involved in person determinations are family owned or closely held corporations with only a few stockholders. Review of stock transfer ledgers is not burdensome for either ASCS or the corporations in these instances, and ASCS has alternative certification procedures for publicly traded corporations where this would be burdensome.

however, they did request some information for those determinations that we questioned.

The Inspector General's review illustrates the need to verify that farming operations are carried out according to their farm operating plan—the basis for determining the number of persons who qualify for payments. For example, in some cases farmers misrepresented their source of financing or misrepresented farm employees, who continued to work for wages, as new persons in partnerships. The Inspector General found that 63 of the 225 person determinations reviewed were in error because producers did not operate in accordance with their plans.

Need for Improved Internal Controls

ASCS county officials are required to submit 10 percent of their determinations to the ASCS state offices for review, and state officials are required to submit 10 percent of the cases they review to ASCS headquarters for review to assure that person determinations are made in accordance with regulations. However, ASCS internal control procedures are inadequate for this purpose.

The fundamental fault with ASCS internal control procedures is that the determinations are selected for review by the officials whose work is, in effect, being reviewed. Therefore, ASCS management officials have no assurance that the determinations being reviewed are representative of these determinations, as required by ASCS procedures.

Further, ASCS has not established procedures to assure that the required number of determinations is submitted for review. At the suggestion of the Inspector General, ASCS required that state and county offices maintain logs of the person determinations made in 1986 to assure that the required number of determinations is submitted for higher level review. However, we found that headquarters officials and officials in three of four state offices we visited did not use this information.

Finally, ASCS has not established a systematic approach to analyze the determinations submitted for review to identify the types of errors found or to advise other offices of the results of such analyses. Only the county or state office submitting a case for review receives feedback on the cases reviewed. Other ASCS state and county offices do not receive timely information about policy decisions made in response to new types of reorganizations or common errors found in these reviews. For example, ASCS headquarters officials were aware that reorganizations were occurring with very little change in land or capital investment as early

as 1984. In response, ASCS officials began requiring that there be a 20-percent change in land and that reorganized entities have capital equal to 30 percent of their first year operating costs when reviewing and approving determinations at the headquarters level. However, almost 2 years passed before this information was incorporated into ASCS guidance for state and county offices.

Need for Improved Training

ASCS' training for its officials making person determinations is inconsistent and, as evidenced by the number of errors found in our review and the Inspector General's review, inadequate. ASCS's training program does not (1) identify who should be trained and how much training they should receive, (2) provide an approach for considering the wide variety of factors that impact person determinations, or (3) provide training materials such as a course manual for use by state officials in training county officials.

ASCS has not established minimum training requirements for officials making person determinations that identify who should be trained and how much training they should receive. Headquarters officials train state officials on an ad hoc basis and allow the state officials to determine which county officials will be trained and how much training they receive. Some state officials train all county officials involved in person determinations. Other state officials train only the County Executive Director, who then trains or advises the County Office Committee members who actually make the person determinations. This ad hoc approach to training may be part of the reason that the regulations were not being consistently applied in the state and county offices visited by us.

ASCS training provides an overview of the regulations, but it does not provide an approach for applying these regulations to the wide variety of factors that impact person determinations. For example, there is wide variance in the type and complexity of ownership arrangements, organizational structures, leasing arrangements, farming practices, and financing arrangements that must be considered when making person determinations. Different rules apply depending on which of the many possible combinations of these factors are present in a particular situation, and ASCS training does not provide a systematic approach for analyzing each situation to determine which rules apply.

ASCS also has not developed standardized training materials such as a course manual for use in training state and county officials. The need

for uniform training materials is illustrated by the fact that officials in at least one state incorrectly interpreted the financing rules and officials in another state provided incorrect training and guidance to county officials. In this second state, officials (1) described a hypothetical reorganization as not meeting the substantive change requirement when in fact it did and (2) instructed county officials to make a separate person determination for each farming operation even though all related farming operations should be considered together for person determination purposes.

ASCS has increased the amount of training provided to state officials, as discussed later in this chapter, but still has not established any specific training requirements for county officials who actually make the person determinations or developed standardized training materials to assure consistent applications of program rules.

Corrective Actions by ASCS

ASCS has recently taken some actions that should improve the person determinations made by county office officials in 1987 and later program years. These actions include improving the forms used, revising guidelines for implementing the regulations, and increasing the training provided state officials.

ASCS revised the form on which producers will provide the information used by county officials in making 1987 program year person determinations. ASCS replaced a one-page form with three new forms: a one-page form for individuals, a two-page form for joint operations such as partnerships and joint ventures where the individual members not the organization may be persons, and a two-page form for legal entities such as corporations that may be persons separate from their members. These new forms should make it easier for county officials to focus on the rules applicable to each type of organization. In addition, the new forms focus attention on factors important to the person determinations such as financing, leasing arrangements, and ownership of land and equipment.

Beginning in December 1986, ASCS also revised its guidance for state and county offices to incorporate the criteria used by headquarters officials in reviewing determinations beginning with the 1987 program year. These revisions address some but not all of the problems noted in our review. For example, the revised guidance reemphasizes the need to verify that actual farming operations were carried out as planned and improves the application of this requirement by requiring that it be done

for all determinations on a random sample basis. The revised guidance requires that determinations submitted to state and headquarters officials for review be selected randomly, but the officials being reviewed rather than the reviewing officials will continue to make the selection. Also, the revised guidance does not address such important considerations as how much equipment or land must change ownership to qualify as a substantive change, how to make the computations necessary to determine if payment shares are commensurate with actual contributions in joint operations, and the type of information and documentation needed to apply specific rules or verify that the operations were carried out as planned.

Finally, ASCS has increased the training provided to state ASCS officials, who in turn provide training to county officials. Prior to 1985 very little training was provided to state officials. ASCS provided a half day of training on the payment limitation provisions during meetings of these officials in 1985 and 1986 and more recently provided a full day of training on this subject for these officials. However, ASCS has not established minimum training requirements or developed uniform course materials these officials can use when training county officials, nor does it have any plans to do so at present.

Conclusions and Recommendations

Commodity program changes have increased payments to producers and placed an increasing number of them at or near the payment limit. Provisions of the current law and regulations allow individuals and entities to reorganize their farming operations by creating corporations, adding new members to joint operations, or establishing other entities that qualify for additional payment limits and thereby avoid the limit. As a result, both the number of new persons resulting from reorganizations related to the payment limit and payments to these persons increased significantly in 1984-86. The number of producers affected by the payment limit and reorganizations among these producers could continue to increase through 1989. We estimate that as many as 31,300 new persons could be receiving almost \$900 million annually by 1989 and that cumulative payments to these new persons for 1984-89 could total \$2.3 billion.

USDA has proposed changes that will eliminate the advantages of incorporating and adding members to a joint operation by (1) determining the payment limit for each legal entity based on the number of members actively engaged in its farming operation, (2) attributing the entity's payments to the individual payment limits of the members based on their share of ownership in the entity and (3) limiting payments to \$50,000 for individuals whether these payments are earned from their own operations or are attributed to them. USDA's proposals also include other changes that would make rules for minor children, substantive change, custom farming, and entities with common owners more restrictive. USDA's proposal also includes suggested legislative changes necessary for implementation.

We believe USDA's proposals are basically sound and will significantly enhance the effectiveness of the payment limitation. We also believe, however, that USDA's proposals could be made even more effective with some revision. Specifically, USDA's proposals should be revised to (1) address the division and lease of land to investors not otherwise involved in farming and to (2) define owners of an entity who have no separate interest in any farming operation outside the entity as a person in order to limit payments to them.

USDA's proposal does not include regulations and guidelines necessary to ensure the proper implementation of the new rules at the county office level. In addition, current ASCS guidance to county and state offices, training of officials in these offices, and internal controls over their activities are not adequate to ensure that person determinations are made properly or consistently. As a result, ASCS county officials are

making person determinations without obtaining information critical to those determinations and are making incorrect determinations based on the information they do obtain. While ASCS has taken a number of positive actions to correct this situation, additional corrective action is required whether or not USDA's proposed changes are enacted.

Recommendations to Congress

We recommend that Congress enact legislation to limit payments to legal entities and attribute their payments to the individual limits of the entities' owners. USDA's proposal includes legislation that would remove the existing legislative restrictions about how corporations are treated for payment limitation purposes and authorize ASCS to determine the payment limit for a legal entity on the basis of the number of its members actively engaged in its farming operations.

If Congress decides not to adopt the legislation proposed by USDA, we recommend that, at a minimum, Congress remove the existing legislative restriction that requires a corporation to be considered as a separate person for payment limitation purposes as long as no stockholder owns or controls more than 50 percent of its stock and as long as the same two or more stockholders do not own more than 50 percent of two or more corporations. If left in place, this restriction will allow producers to continue to reorganize under the corporate rules in a manner that avoids the limit and will prevent ASCS from making changes necessary to reduce avoidance of the payment limit.

Recommendations to the Secretary of Agriculture

We recommend that the Secretary of Agriculture direct the ASCS Administrator to make the following changes in the payment limitation provisions.

If the Congress adopts the legislative changes offered by USDA, ASCS should be required to (1) ensure that implementing regulations and guidance to its county offices specify the extent of contributions necessary to determine if a member of a legal entity is actively engaged in the entity's farming operation and how the member's contributions are to be valued for this determination, (2) change its rules to limit payments through attribution to members of a legal entity who are not now persons for payment limitation purposes, and (3) change its rules to require that a person who leases land make a substantive contribution of owned land or equipment and personal labor or active management in addition to capital for the farming operation that includes the leased land.

If the Congress does not adopt USDA's legislative proposal, ASCS should be required to (1) implement the changes included in USDA's proposal to make the payment limitation rules for minor children, custom farming, and substantive change more restrictive and (2) change its rules to require that a person, other than a landowner, in a lease situation make a substantive contribution of owned land or equipment and personal labor or active management in addition to capital.

If Congress removes the legislative restriction on the treatment of corporations, but does not implement the remainder of USDA's legislative proposal, ASCS should be required to make the rule for combining entities with common ownership more restrictive by combining all entities as one person for payment limitation purposes when the same one or more individual(s) owns or controls 50 percent or more of the entities, as well as the other changes discussed above that it can make under its existing legislative authority.

We recommend that the Secretary of Agriculture also direct the ASCS Administrator to make the following changes in ASCS's administration of the payment limitation:

- Improve ASCS guidance to state and county offices by describing (1) how much equipment or land must change ownership to justify the approval of a new person for payment limitation purposes, (2) how to value contributions by members of a joint operation to determine if those contributions are commensurate with their share of the payments, and (3) the type of information and documentation needed to apply specific rules and verify that farm operations were carried out as planned. An acceptable alternative to describing the information and documentation needed to apply specific rules or verify farming operations in its guidance would be for ASCS to include this description in the training program discussed below.
- Revise ASCS's management review system so that reviewing officials select the determinations to be reviewed, analyze these determinations to identify the emerging trends in errors and methods of reorganization, and disseminate information about needed changes identified by this analysis on a systematic and continuing basis. ASCS headquarters officials should be responsible for disseminating the results of these analyses to assure uniformity and consistency.
- Establish a training program for ASCS state and county officials involved in person determinations that (1) identifies who should be trained and

how much training they should receive, (2) sets out an approach to making and reviewing person determinations, and (3) provides standardized training materials for use by state officials in training county officials.

Payment Limit History

Congress established an annual \$55,000 per person per crop limit for wheat, feed grains, and upland cotton in the Agriculture Act of 1970 (Public Law 91-524) to reduce program costs and to prevent producers from benefiting excessively from commodity program support payments. Payments authorized by this act included land diversion payments, wheat certificate payments, and other payments based on parity prices in use at that time.

The Agriculture and Consumer Protection Act of 1973 (Public Law 93-86) introduced the concept of target prices and deficiency payments used today and reduced the annual payment limitation for 1974 through 1977 to \$20,000 per person for the combined wheat, feed grain, and upland cotton deficiency and diversion payments.

The Rice Production Act of 1975 (Public Law 94-214) imposed an annual \$55,000 per person limit on payments for rice in 1976 and 1977.

The Food and Agriculture Act of 1977 (Public Law 95-113) continued to combine wheat, feed grain, and upland cotton deficiency and diversion payments, but it increased the annual per person limit to \$40,000 for 1978 and \$45,000 for 1979. It also limited rice deficiency payments to a separate per person limit of \$52,250 in 1978 and \$50,000 per person limit for 1980 and 1981.

In addition, the act provided discretionary authority for the Secretary of Agriculture to reduce the loan rate for wheat and feed grains to increase exports. However, if the Secretary reduced the loan rate, farmers were to receive compensation equal to the reduction in additional deficiency payment. These additional deficiency payments, commonly referred to as Findley Amendment payments, were not subject to the payment limitation.

The Agriculture and Food Act of 1981 (Public Law 97-98) provided for a \$50,000 per person limit for wheat, feed grains, upland cotton, and rice; the authority to reduce the wheat and feed grain loan rate; and the provision for Findley Amendment payments not subject to the payment limit through 1985. In addition, the act established a separate \$100,000 per person limit on disaster payments for these crops. The Extra Long Staple Cotton Act of 1983 (Public Law 98-88) amended the Agriculture and Food Act of 1981 to add deficiency and diversion payments for long staple cotton to the total payments subject to the \$50,000 limit.

The Food Security Act of 1985 (Public Law 99-198) continued the payment limitation provisions of the Agriculture and Food Act of 1981 through 1990. In addition, the Food Security Act of 1985 allowed farmers to repay loans for cotton and rice at a reduced rate when the market price was less than the loan rate. The subsidies represented by the difference between the loan and repayment rates were referred to as a marketing loan and were not subject to the \$50,000 per person limit.

In October 1986, Congress amended the Food Security Act of 1985 to establish a new \$250,000 limit. The new limit did not change but included the existing \$50,000 per person limit for deficiency and diversion payments. Other payments subject to the \$250,000 limit include disaster payments and various payments not previously subject to a payment limitation such as Findley Amendment payments and marketing loans. The payment limitation provisions of the Food Security Act of 1985, as amended, are included as appendix II.

Section 1001 of the Food Security Act of 1985, as Amended

Note: GAO comment supplementing those in the report text appear at the end of this appendix.

Sec. 1001. Notwithstanding any other provision of law:

(1) For each of the 1987 through 1990 crops, the total amount of deficiency payments (excluding any deficiency payments described in paragraph (2)(B)(I)(iv) of this section) and land diversion payments that a person shall be entitled to receive under one or more of the annual programs established under the Agricultural Act of 1949 (7 U.S.C. 1421 et seq.) for wheat, feed grains, upland cotton, extra long staple cotton, and rice may not exceed \$50,000.

(2)(A) For each of the 1987 through 1990 crops, the total amount of payments set forth in subparagraph (B) that a person shall be entitled to receive under one or more of the annual programs established under the Agricultural Act of 1949 for wheat, feed grains, upland cotton, extra long staple cotton, rice, honey, and (with respect to clause (iii)(II) of subparagraph (B)) other commodities, when combined with payments for such crop described in paragraph (1), shall not exceed \$250,000.

(B) As used in subparagraph (A), the term "payments" means--

(i) any part of any payment that is determined by the Secretary of Agriculture to represent compensation for resource adjustment (excluding land diversion payments) or public access for recreation;

(ii) any disaster payments under one or more of the annual programs for a commodity established under the Agricultural Act of 1949;

(iii)(I) any gain realized by a producer from repaying a loan for a crop of wheat, feed grains, upland cotton, rice, or honey at the rate permitted under section 107D(a)(5), 105C(a)(4), 103A(a)(5), 101A(a)(5), or 201(b)(2), respectively, of the Agricultural Act of 1949, or (II) any gain realized by a producer from repaying a loan for a crop of any other commodity at a lower level than the original loan level established under the Agricultural Act of 1949;

(iv) any deficiency payment received for a crop of wheat or feed grains under section 107D(c)(1) or 105C(c)(1), respectively, or the Agricultural Act of 1949 as the result of a reduction of the loan level for such crop under section 107D(a)(4) or 105C(a)(3) of such Act;

(v) any loan deficiency payment received for a crop of wheat, feed grains, upland cotton, or rice under section 107D(b), 105C(b), 103A(b), or 101A(g), respectively, of the Agricultural Act of 1949; and

(vi) any inventory reduction payment received for a crop of wheat, feed grains, upland cotton, or rice under section 107D(g), 105C(g), 103A(g), or 101A(g), respectively, of the Agricultural Act of 1949.

Such terms shall not include loans or purchases, except as specifically provided for in this paragraph.

(C) The total amount of loans on a crop of honey that a person may have outstanding at any one time under the annual program established for such crop under the Agricultural Act of 1949 may not exceed \$250,000 less the amount of payments, as described in paragraph (1) and subparagraphs (A) and (B) of this paragraph, received by such person for the crop year involved.

(3) Notwithstanding the foregoing provisions of this section, if the Secretary of Agriculture determines that any of the limitations provided for in paragraph (2) will result in a substantial increase in the number or dollar amount of loan forfeitures for a crop of a commodity, will substantially reduce the acreage taken out of production under an acreage reduction program for a crop of a commodity, or will cause the market prices for a crop of a commodity to fall substantially below the effective loan rate for the crop, the Secretary shall adjust upward such limitation, under such terms and conditions as the Secretary determines appropriate, as necessary to eliminate such adverse effect on the program involved.

(4) If the Secretary determines that the total amount of payments that will be earned by any person under the program in effect for any crop will be reduced under this section, any acreage requirement established under a set-aside or acreage limitation program for the farm or farms on which such person will be sharing in payments earned under such program shall be adjusted to such extent and in such manner as the Secretary determines will be fair and reasonable in relation to the amount of the payment reduction.

(5) (A) The Secretary shall issue regulations--
(i) defining the term "person"; and
(ii) prescribing such rules as the Secretary determines necessary to assure a fair and reasonable application of the limitation established under this section.

Such regulations shall provide that the term "person" does not include any cooperative association of producers that markets commodities for producers with respect to the commodities so marketed for producers.

(B) The regulations issued by the Secretary on December 18, 1970, under section 101 of the Agricultural Act of 1970 (7 U.S.C. 1307) shall be used to establish the percentage ownership of a corporation by the stockholders of such corporation for the purpose of determining whether such corporation and stockholders are separate persons under this section.

(6) The provisions of this section that limit payments to any person shall not be applicable to lands or animals owned by States, political subdivisions, or agencies thereof, so long as such lands are farmed or animals are husbanded primarily in the direct furtherance of a public function, as determined by the Secretary.

GAO Comments

1. Source: Report to Congress by the Secretary of Agriculture With Respect to the Implementation of the Maximum Payment Limitation, March 10, 1987, Appendix A.

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Note: GAO comment supplementing those in the report text appear at the end of this appendix.

PART 795—PAYMENT LIMITATION

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AUTHORITY Sec 1001, Pub L. 98-199, 7 U.S.C. 1308, 99 Stat. 1444.

SOURCE 43 FR 9784, Mar. 10, 1978, unless otherwise noted.

GENERAL

§ 795.1 [Reserved]

§ 795.2 Applicability.

(a) The provisions of this part are applicable to payments when so provided by the individual program regu-

lations under which the payments are made. The amount of the limitation shall be as specified in the individual program regulations.

(b) The limitation shall be applied to the payments for a commodity for a crop year.

(c) The limitation shall not be applicable to payments made to States, political subdivisions, or agencies thereof for participation in the programs on lands owned by such States, political subdivisions, or agencies thereof so long as such lands are farmed primarily in the direct furtherance of a public function. However, the limitation is applicable to persons who rent or lease land owned by States, political subdivisions, or agencies thereof.

(d) The limitation shall not be applicable to payments made to Indian tribal ventures participating in the programs where a responsible official of the Bureau of Indian Affairs or the Indian Tribal Council certifies that no more than the program payment limitation shall accrue directly or indirectly to any individual Indian and the State committee reviews and approves the exemption.

(49 FR 14719, Apr. 13, 1984, as amended at 51 FR 8453, Mar. 11, 1986, 51 FR 36905, Oct. 16, 1986)

DEFINITIONS

§ 795.3 Definition of the term "person".

Subject to the provisions of this part, the term "person" shall mean an individual, joint stock company, corporation, association, trust, estate, or other legal entity. In order to be considered a separate person for the purpose of the payment limitation, in addition to the other conditions of this part, the individual or other legal entity must:

(a) Have a separate and distinct interest in the land or the crop involved.

(b) Exercise separate responsibility for such interest, and

(c) Be responsible for the cost of farming related to such interest from a fund or account separate from that of any other individual or entity.

§ 795.4 Definitions of other terms

In the regulations in this part and in all instructions, forms, and documents in connection therewith, all words and phrases, other than the term "person", shall have the meanings assigned to them in the regulations governing reconstitutions of farms, allotments, and bases. Part 719 of this chapter, as amended.

DETERMINATION WHETHER MULTIPLE INDIVIDUALS OR OTHER ENTITIES CONSTITUTE ONE OR SEPARATE PERSONS

§ 795.5 Timing for determining status of persons

Except as otherwise set forth in this part, the status of individuals or entities as of March 1, or such other date as may be determined and announced by the Administrator shall be the basis on which determinations are made in accordance with this part for the year for which the determination is made.

(51 FR 21836, June 18, 1986, 51 FR 36905, Oct. 16, 1986)

§ 795.6 Multiple individuals or other entities.

The rules in §§ 795.5 through 795.16 shall be used to determine whether certain multiple individuals or legal entities are to be treated as one person or as separate persons for the purpose of applying the limitation. In cases in which more than one rule would appear to be applicable, the rule which is most restrictive on the number of persons shall apply.

§ 795.7 Entities or joint operations not considered as a person.

A partnership, joint venture, tenants-in-common, or joint tenants shall not be considered as a person but, not-

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withstanding the provisions of § 795.3, each individual or other legal entity who shares in the proceeds derived from farming by such joint operations shall be considered a separate person, except as otherwise provided in this part, and shall be listed as a producer for payment purposes on program documents. The payment shares listed on the program documents for each individual or other legal entity shall be the same as each individual or other legal entity shares in the proceeds derived from farming by such joint operation. Notwithstanding the foregoing, each individual or other legal entity who shares in the proceeds derived from farming by such joint operation shall not be considered as a separate person unless the individual or other legal entity is actively engaged in the farming operations of the partnership or other joint operation. An individual or other legal entity shall be considered as actively engaged in the farming operation only if its contribution to the joint operation is commensurate with its share in the proceeds derived from farming by such joint operation. Members of the partnership or joint venture must furnish satisfactory evidence that their contributions of land, labor, management, equipment, or capital to the joint operation are commensurate with their claimed shares of the proceeds. A capital contribution may be a direct out-of-pocket input of a specified sum or an amount borrowed by the individual. If the contribution consists substantially of capital, such capital must have been contributed directly to the joint operation by the individual or other legal entity and not acquired as a result of (a) a loan made to the joint operation, (b) a loan which was made to such individual or other legal entity by the joint operation or any of its members or related entities, or (c) a loan made to such individual or other legal entity which was guaranteed by the joint operation or any of its members or related entities.

§ 795.8 Corporations and stockholders.

(a) A corporation (including a limited partnership) shall be considered as one person, and an individual stockholder of the corporation may be considered as a separate person to the extent that such stockholder is engaged in the production of the crop as a separate producer and otherwise

meets the requirements of § 795.3, except that a corporation in which more than 50 percent of the stock is owned by an individual (including the stock owned by the individual's spouse, minor children, and trusts for the benefit of such minor children), or by a legal entity, shall not be considered as a separate person from such individual or legal entity.

(b) Where the same two or more individuals or other legal entities own more than 50 percent of the stock in each of two or more corporations, all such corporations shall be considered as one person.

(c) The percentage share of the value of the stock owned by an individual or other legal entity shall be determined as of March 1 of the crop year, except that where a stockholder voluntarily acquires stock after March 1 and before the harvest of the crop, the amount of any stock so acquired shall be included in determining the percentage share of the value of the stock owned by the stockholder. Where there is only one class of stock, a stockholder's percentage share of the value of the outstanding stock shall be equal to the percentage of the outstanding stock owned by the stockholder. If the corporation has more than one class of stock the percentage share of the value of the stock owned by a stockholder shall be determined by the Deputy Administrator on the basis of market quotations, and if market quotations are lacking or too scarce to be recognized the percentage share of the value of the stock shall be determined by the Deputy Administrator on the basis of all relevant factors affecting the fair market value, including the rights and privileges of the various stock issues.

(Title I, Agricultural Act of 1970, as amended by the Agriculture and Consumer Protection Act of 1973, Pub. L. 93-86, 87 Stat. 221 (7 U.S.C. 1307) and under Title I, Rice Production Act of 1975, Pub. L. 94-214, 90 Stat. 181 (7 U.S.C. 428c note), and Pub. L. 95-156, 91 Stat. 1264 (7 U.S.C. 1307 note, 7 U.S.C. 1307, 7 U.S.C. 1441))

(43 FR 9784, Mar. 10, 1978, as amended at 45 FR 10311, Feb. 15, 1980, 45 FR 11795, Feb. 22, 1980)

§ 795.9 Estate or trust.

(a) An estate or irrevocable trust shall be considered as one person except that, where two or more estates or irrevocable trusts have common beneficiaries or heirs (including

spouses and minor children) with more than a 50-percent interest, all

such estates or irrevocable trusts shall be considered as one person.

(b) An individual heir of an estate or beneficiary of a trust may be considered as a separate person to the extent that such heir or beneficiary is engaged in the production of crops as a separate producer and otherwise meets the requirements of § 795.3, except that an estate or irrevocable trust which has a sole heir or beneficiary shall not be considered as a separate person from such heir or beneficiary.

(c) Where an irrevocable trust or an estate is a producer on a farm and one or more of the beneficiaries or heirs of such trust or estate are minor children, the minor children's pro rata share of the program payments to the trust or estate shall be attributed to the parent of the minor children except as otherwise provided in § 795.12.

(d) A revocable trust shall not be considered as a separate person from the grantor.

§ 795.10 Club, society, fraternal or religious organization.

Each individual club, society, fraternal or religious organization may be considered as a separate person to the extent that each such club, society, fraternal or religious organization is engaged in the production of crops as a separate producer and otherwise meets the requirements of § 795.3.

§ 795.11 Husband and wife.

A husband and wife shall be considered as one person.

§ 795.12 Minor children.

(a) A minor child and his parents or guardian (or other person responsible for him) shall be considered as one person, except that the minor child may be considered as a separate person if such minor child is a producer on a farm in which the parents or guardian or other person responsible for him (including any entity in which the parents or guardian or other person responsible for him has a substantial interest, i.e., more than a 20-percent interest) takes no part in the operation of the farm (including any

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activities as a custom farmer) and owns no interest in the farm or all or part of any portion of the production on the farm, and if such minor child:

(1) Is represented by a court-appointed guardian who is required by law to make a separate accounting for the minor and ownership of the farm is vested in the minor, or

(2) Has established and maintains a different household from his parents or guardian and personally carries out the actual farming operations on the farm for which there is a separate accounting, or

(3) Has a farming operation resulting from his being the beneficiary of an irrevocable trust and ownership of the property is vested in the trust or the minor.

(b) A person shall be considered a minor until he reaches 18 years of age. Court proceedings conferring majority on a person under 18 years of age will not change such person's status as a minor for purposes of applying the regulations.

§ 795.13 Other cases.

Where the county committee is unable to determine whether certain individuals or legal entities involved in the production of a commodity are to be treated as one person or separate persons, all the facts regarding the arrangement under which the commodity is produced shall be submitted to the State committee for decision. Where the State committee is unable to determine whether such individuals or legal entities are to be treated as one person or separate persons, all the facts regarding the arrangement under which the farming operation is conducted shall be submitted to the Deputy Administrator for decision.

FARMING OPERATIONS

§ 795.14 Changes in farming operations.

(a) Subject to the provisions of this part, a person may exercise his or her right heretofore existing under law, to divide, sell, transfer, rent, or lease his or her property if such division, sale, transfer, rental arrangement, or lease is legally binding as between the parties thereto. However, any document

representing a division, sale, transfer, rental arrangement, or lease which is fictitious or not legally binding as between the parties thereto shall be considered to be for the purpose of evading the payment limitation and shall be disregarded for the purpose of applying the payment limitation. Any change in farming operations that would otherwise serve to increase the number of persons for application of the payment limitation must be bona fide and substantive.

(b) A substantive change includes, for example, a substantial increase or decrease in the size of the farm by purchase, sale, or lease; a substantial increase or decrease in the size of allotment by purchase, sale, or lease; a change from a cash lease to a share lease or vice versa; and dissolution of an entity such as a corporation or partnership.

(c) Examples of the types of changes that would not be considered as substantive are the following:

Example 1. A corporation is owned equally by four shareholders. The corporation owns land, buildings, and equipment and in the prior year carried out substantial farming operations. Three of the shareholders propose forming a partnership which they would own equally. The partnership would cash lease land and equipment from the corporation with the objective of having the three partners considered as separate persons for purposes of applying the payment limitation under the provisions of § 795.7 of the regulations.

The formation of such a partnership and the leasing of land from a corporation in which they hold a major interest would not constitute a substantive and bona fide change in operations. Therefore, the corporation and the partners would be limited to a single payment limitation.

Example 2. Three individuals each have individual farming operations which, if continued unchanged, would permit them to have a total of three payment limitations.

The three individuals propose forming a corporation which they would own equally. The corporation would then cash lease a portion of the farmland owned and previously operated by the individuals with the objective of having the corporation considered as a separate person for purposes of applying the payment limitation under the provisions of § 795.8 of the regulations. The formation of such a corporation and the leasing of land from the stockholders would not constitute a substantive and bona fide

change in operations. Therefore, the corporation and the three individuals would be limited to three payment limitations.

§ 795.15 Determining whether agreement is a share lease or a cash lease.

(a) *Cash lease.* If a rental agreement contains provisions for a guaranteed minimum rental with respect to the amount of rent to be paid to the landlord by a tenant, such agreement shall be considered to be a cash rental agreement. In addition, the rental agreement must be customary and reasonable for the area.

(b) *Share lease.* If a rental agreement contains provisions that require the payment of rent on the basis of the amount of the crop produced or the proceeds derived from the crop, such agreement shall be considered to be a share rental agreement. In addition, the rental agreement must be customary and reasonable for the area.

(51 FR 8454, Mar. 11, 1986 and 51 FR 36905, Oct. 16, 1986)

§ 795.16 Custom farming.

(a) Custom farming is the performance of services on a farm such as land preparation, seeding, cultivating, applying pesticides, and harvesting for hire with remuneration on a unit of work basis, except that, for the purpose of applying the provisions of this section, the harvesting of crops and the application of agricultural chemicals by firms regularly engaged in such businesses shall not be regarded as custom farming. A person performing custom farming shall be considered as being separate from the person for whom the custom farming is performed only if:

(1) The compensation for the custom farming is paid at a unit of work rate customary in the area and is in no way dependent upon the amount of the crop produced, and (2) the person performing the custom farming (and any other entity in which such person has more than a 20-percent interest) has no interest, directly or indirectly, (i) in the crop on the farm by taking any risk in the production of the crop, sharing in the proceeds of the crop, granting or guaranteeing the financing of the crop, (ii) in the allotment on the farm, or (iii) in the farm

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as landowner, landlord, mortgage holder, trustee, lienholder, guarantor, agent, manager, tenant, sharecropper, or any other similar capacity.

(b) A person having more than a 20 percent interest in any legal entity performing custom farming shall be considered as being separate from the person for whom the custom farming is performed only if

(1) The compensation for the custom farming service is paid at a unit of work rate customary in the area and is in no way dependent upon the amount of the crop produced, and
(2) the person having such interest in the legal entity performing the custom farming has no interest, directly or indirectly, (i) in the crop on the farm by taking any risk in the production of the crop, sharing in the proceeds of the crop, granting or guaranteeing the financing of the crop, (ii) in the allotment on the farm, or (iii) in the farm as landowner, landlord, mortgage holder, trustee, lienholder, guarantor, agent, manager, tenant, sharecropper, or in any other similar capacity.

SCHEME OR DEVICE

§ 795.17 Scheme or device

All or any part of the payments otherwise due a person under the upland cotton, wheat, feed grain and rice programs on all farms in which the person has an interest may be withheld or required to be refunded if the person adopts or participates in adopting any scheme or device designed to evade or which has the effect of evading the rules of this part. Such acts shall include, but are not limited to, concealing from the county committee any information having a bearing on the application of the rules of this part or submitting false information to the county committee (for example, a set-aside agreement which is entered into that differs from information furnished to the county committee concerning the manner in which program payments are actually shared, concerning the actual facts of a sale, or concerning the transfer of property or creating fictitious entities for the purpose of concealing the interest of a person in a farming operation).

MISCELLANEOUS

§ 795.20 Joint and several liability.

Where two or more individuals or legal entities, who are treated as one person hereunder, receive payments which in the aggregate exceed the limitation, such individuals or legal entities shall be liable, jointly and severally, for any liability arising therefrom. The provisions of this part requiring the refund of payments shall be applicable in addition to any liability under criminal and civil fraud statutes.

§ 795.21 Appeals.

Any person may obtain reconsideration and review of determinations made under this part in accordance with the appeal regulations, Part 780 of this chapter, as amended.

§ 795.22 Interpretations.

In interpretations previously issued pursuant to the payment limitation regulations and published at 36 FR 16569, 37 FR 3049, 39 FR 15021 and 41 FR 17527 shall be applicable in construing the provisions of this part.

§ 795.23 Paperwork Reduction Act assigned number.

The information collection requirements contained in these regulations (7 CFR Part 795) have been approved by the Office of Management and Budget under the provisions of 44 U.S.C. Chapter 35 and have been assigned OMB control number 0560-0096.

(49 FR 14719, Apr. 13, 1984)

§ 795.24 Relief.

If a producer relied on a county committee and/or State committee "person" determination for a crop year and higher reviewing authority makes a more restrictive determination, the Deputy Administrator may grant relief only for such crop year if the producer was not afforded an opportunity to exercise other alternatives with respect to the producer's farming operation and the program provisions and the county committee has determined that the producers acted in good faith based upon the original "person" determination.

(51 FR 8454 Mar. 11, 1986, 51 FR 36913 Oct. 16, 1986)

GAO Comment

1. Source: Report to Congress by the Secretary of Agriculture With Respect to the Implementation of the Maximum Payment Limitation, March 10, 1987, Appendix B.

USDA's Explanation of How the Payment Limitation Is Applied

Note: GAO comment supplementing those in the report text appear at the end of this appendix.

I. DISCUSSION OF CURRENT APPLICATION OF THE PAYMENT LIMITATION

A. MANNER IN WHICH "PERSON" DETERMINATIONS ARE MADE

The Administrator of the Agricultural Stabilization and Conservation Service (ASCS) has been delegated the responsibility of implementing the maximum payment limitation requirement. In order to determine the amount of annual farm program payments a "person" is receiving, ASCS must determine all possible sources through which an individual or entity may be receiving farm program payments. Therefore, producers are required to annually submit information to the local county Agricultural Stabilization and Conservation (ASC) committees detailing all of their interest in farming operations. Forms have been developed for collecting the information needed to make "person" determinations. These forms are as follows:

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| <u>Number</u> | <u>Title</u> | <u>Appendices</u> |
|---------------|---|-------------------|
| ASCS-561 | Farm Operating Plan for Payment Limitation Review (Individual) | C |
| ASCS-561-A | Farm Operating Plan for Payment Limitation Review for a Limited Partnership, Corporation, Estate or Trust | D |
| ASCS-561-B | Farm Operating Plan for Payment Limitation Review for Joint Venture or General Partnership | E |

Producers must file these forms with the local county ASC committee whenever there is a change in the producer's farming operation from the previous year. If there has been no change, the producer must submit a signed statement to that effect.

Initial "person" determinations are made by the county ASC committee. A producer may appeal a county ASC committee determination to the State ASC committee and ultimately to the Deputy Administrator, State and County Operations, ASCS in accordance with the Administrative Appeal Regulations, 7 CFR Part 780.

B. OVERVIEW OF REGULATIONS GOVERNING THE APPLICATION OF THE PAYMENT LIMITATION.

1. General. The regulations implementing the payment limitation focus primarily on the definition of a "person."

Each producer meeting the definition of a "person" may be eligible to receive the maximum level of annual commodity payments allowed by section 1001 of the Food Security Act of 1985, as amended. The fundamental precept of the regulations is that each producer determined to be a "person" for payment limitation purposes must:

- (a) have a separate and distinct interest in the land or the crop involved,
- (b) exercise separate responsibility for such interest, and
- (c) be responsible for the cost of farming related to such interest from a fund or account separate from that of any other individual or entity.

2. Treatment of Individuals or Entities. In applying the basic concept set forth in item 1 above, the regulations further provide for the treatment of individuals or entities as follows:

- (a) Entities or joint operations are not considered to be a "person". Generally, a partnership, joint venture, tenant-in-common, or joint tenant is not considered as a "person" but each individual or other legal entity who shares in the proceeds derived from farming by such joint operations is considered to be a separate person. However, each

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individual or other legal entity who shares in the proceeds derived from farming by such joint operation is not considered to be a separate person unless the individual or other legal entity is actively engaged in the farming operations of the partnership or other joint operation.

An individual or other legal entity is to be considered as actively engaged in the farming operation only if its contribution to the joint operation is commensurate with its share in the proceeds derived from farming by such joint operation. Members of the partnership or joint venture must furnish satisfactory evidence that their contributions of land, labor, management, equipment, or capital to the joint operation are commensurate with their claimed shares of the proceeds. A capital contribution may be a direct out-of-pocket input of a specified sum or an amount borrowed by the individual.

If the contribution consists substantially of capital, such capital must have been contributed directly to the joint operation by the individual or other legal entity and not acquired as a result of: (i) a loan made to the joint operation, (ii) a loan which was made to such individual or

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other legal entity by the joint operation or any of its members or related entities, or (iii) a loan made to such individual or other legal entity which was guaranteed by the joint operation or any of its members or related entities.

(b) A corporation (including a limited partnership) is considered to be one "person", and an individual stockholder of the corporation may be considered to be a separate "person" to the extent that such stockholder is engaged in the production of the crop as a separate producer and otherwise meets the requirements of the regulations. However an individual stockholder or legal entity that owns more than 50 percent of the stock of a corporation (including the stock owned by the individual's spouse, minor children, and trusts for the benefit of such minor children) shall be combined with the corporation for the purpose of applying the payment limitation.

Where the same two or more individuals or other legal entities own more than 50 percent of the stock in each of two or more corporations, all such corporations are combined for the purpose of applying the payment limitation.

(c) An estate or irrevocable trust is considered to be a "person" except that, where two or more estates or irrevocable trusts have common beneficiaries or heirs (including spouses and minor children) with more than a 50-percent interest, all

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such estates or irrevocable trusts are considered to be combined.

An individual heir of an estate or beneficiary of a trust may be considered as a separate "person" apart from the trust or estate to the extent that such heir or beneficiary is engaged in the production of crops as a separate producer and otherwise meets the requirements of the regulations. However, a sole heir or beneficiary of an estate or irrevocable trust shall be combined with the estate or trust.

Where an irrevocable trust or an estate is a producer on a farm and one or more of the beneficiaries or heirs of such trust or estate are minor children, the minor children's pro rata share of the program payments made to the trust or estate is attributed to the parent of the minor children, unless such minor children are determined to be "independent minors." (See subparagraph (f), infra.)

A revocable trust is not considered as a separate "person" from the grantor.

(d) Each individual club, society, fraternal or religious organization is considered to be a separate "person" to the extent that each such club, society, fraternal or religious organization is engaged in the production of crops as a separate producer and otherwise meets the requirements of the regulations.

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(e) A husband and wife are considered as one "person."

(f) Minor children and their parents or guardians (or other person responsible for them) are considered to be one "person", except that the minor child may be considered to be a separate "person" if such minor is determined to be "independent." A minor child will be determined to be independent if such minor child is a producer on a farm in which the parents or guardian or other person responsible for the minor child (including any entity in which the parents or guardian or other person responsible for the child has a substantial interest, i.e., more than a 20-percent interest) takes no part in the operation of the farm (including any activities as a custom farmer) and owns no interest in the farm or in any portion of the production on the farm and if such minor child:

(i) Is represented by a court-appointed guardian who is required by law to make a separate accounting for the minor and ownership of the farm is vested in the minor child, or

(ii) Has established and maintains a different household from the minor child's parents or guardian and personally carries out the actual farming operations on the farm for which there is a separate accounting,
or

(iii) Has a farming operation as a result of the minor child's being the beneficiary of an irrevocable trust and ownership of the property is vested in the trust or the minor child.

A "person" is considered to be a minor child until attaining 18 years of age. Court proceedings conferring majority on a person under 18 years of age do not change such person's status as a minor for purposes of applying the payment limitation regulations.

3. Substantive Change Rule.

The payment limitation regulations recognize that persons may exercise their right, under law, to divide, sell, transfer, rent, or lease their property. Any change in the farming operations that would otherwise serve to increase the number of persons for application of the payment limitation must be bona fide and substantive.

As examples, a substantive change includes: a substantial increase or decrease in the size of the farm by purchase, sale, or lease; a substantial increase or decrease in the size of allotment by purchase, sale or lease; a change from a cash lease to a share lease or vice versa; and dissolution of an entity such as a corporation or partnership.

Examples of the types of changes that would not be considered as substantive are the following:

Example 1:

A corporation is owned equally by four shareholders. The corporation owns land, buildings, and equipment and in the prior year carried out substantial farming operations. Three of the shareholders propose forming a partnership which they would own equally. The partnership would cash lease land and equipment from the corporation with the objective of having the three partners considered to be separate "persons" for purposes of applying the payment limitation.

The formation of such a partnership and the leasing of land from a corporation in which they hold a major interest would not constitute a substantive and bona fide change in operations. Therefore, the corporation and the partners would be limited to a single payment limitation.

Example 2:

Three individuals each have individual farming operations which, if continued unchanged, would permit them to have a total of three payment limitations. The three individuals propose forming a corporation which they would own equally. The corporation would then cash lease a portion of the

farmland owned and previously operated by the individuals with the objective of having the corporation considered as a separate "person" for purposes of applying the payment limitation. The formation of such a corporation and the leasing of land from the stockholders would not constitute a substantive and bona fide change in operations. Therefore, the corporation and the three individuals would be limited to three payment limitations.

4. Custom Farming. Custom farming is the performance of services on a farm such as land preparation, seeding, cultivating, applying pesticides, and harvesting for hire with remuneration on a unit of work basis, except that, for the purpose of applying the payment limitation, the harvesting of crops and the application of agricultural chemicals by firms regularly engaged in such businesses are not regarded as custom farming.

A person performing custom farming shall be considered to be separate from the person for whom the custom farming is performed only if:

- (a) The compensation for the custom farming is paid at a unit of work rate customary in the area and is in no way dependent upon the amount of the crop produced, and

(b) the person performing the custom farming (and any other entity in which such person has more than a 20-percent interest) has no interest, directly or indirectly, (i) in the crop on the farm by taking any risk in the production of the crop, sharing in the proceeds of the crop, granting or guaranteeing the financing of the crop, (ii) in the allotment on the farm, or (iii) in the farm as landowner, landlord, mortgage holder, trustee, lienholder, guarantor, agent, manager, tenant, sharecropper, or any other similar capacity.

A person having more than a 20-percent interest in any legal entity performing custom farming is considered as being separate from the person for whom the custom farming is performed only if:

(a) The compensation for the custom farming service is paid at a unit of work rate customary in the area and is in no way dependent upon the amount of the crop produced, and

(b) the person having such interest in the legal entity performing the custom farming has no interest, directly or indirectly, (i) in the crop on the farm by taking any risk in the production of the crop, sharing

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in the proceeds of the crop, granting or guaranteeing the financing of the crop, (ii) in the allotment on the farm, or (iii) in the farm as landowner, landlord, mortgage holder, trustee, lienholder, guarantor, agent, manager, tenant, sharecropper, or in any other similar capacity.

Appendix IV
USDA's Explanation of How the Payment
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GAO Comment

1. Source: Report to Congress by the Secretary of Agriculture With Respect to the Implementation of the Maximum Payment Limitation, March 10, 1987, pages 1 through 12.

ASCS State and County Offices Included in GAO Review

| State | County |
|--------------|----------------------------|
| California | Butte Kings |
| Nebraska | Custer Dawson Phelps |
| Texas | Hockley |
| Washington | Adams |

USDA's Proposed Amendment to Section 1001 of the Food Security Act of 1985

Note: GAO comment supplementing those in the report text appear at the end of this appendix.

A BILL

To provide for the fair and equitable application of the maximum limitation on farm program payments that may be received by a person.

Be it enacted by the Senate and the House of Representatives in Congress assembled, That section 1001(5) of the Food Security Act of 1985 is amended by striking subparagraph (B) and inserting in lieu thereof the following new subparagraphs (B), (C), and (D):

"(B) In applying the limitation provided for by this section, the Secretary shall--

"(i) provide for similar treatment of all entities;

"(ii) except as provided in clause (iii), determine the amount of payments that may be received by any entity based upon the number of members of the entity who are determined to be actively engaged in farming;

"(iii) consider any entity that is conducting a farming operation independently of all of its members to be a separate person;

"(iv) attribute all payments received by an entity to the members of the entity that have an interest in the entity, such attribution to be based upon the member's interest in the entity; and

"(v) consider an individual or entity to be actively engaged in farming if such individual or entity has made a significant contribution (determined based upon the total value of the farming operation) of (I) land, cash, or equipment, and (II) labor or management to the farming operation.

"(C) For the purpose of this section the term 'entity' means a corporation, trust, estate, limited partnership, general partnership, joint venture, charitable organization and, except as provided in subparagraph (A), any other entity or association.

"(D) The Secretary may determine not to attribute payments to a member of an entity as provided for in subparagraph (B) (iv) if it is determined that--

"(i) such member's interest in the entity is less than 10 percent; and

"(ii) attribution of such payments to such member would have little or no impact on the implementation of the limitation provided for by this section."

Appendix VI
USDA's Proposed Amendment to Section 1001
of the Food Security Act of 1985

SEC. 2. The amendments provided for by this act shall be effective with respect to the 1988 through 1990 crops of wheat, feed grains, upland cotton, extra long staple cotton, rice, and honey.

GAO Comment

1. Source: Report to Congress by the Secretary of Agriculture With Respect to the Implementation of the Maximum Payment Limitation, March 10, 1987, pages 39 and 40.

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