United States General Accounting Office 133503

GAO

Testimony

For Release
on Delivery
Expected at
10:00 a.m. EDT
Tuesday
July 21, 1987

Farm Reorganizations and Their

Impact on USDA Payments

Statement of
John W. Harman, Associate Director
Resources, Community, and Economic
Development Division
Before the
Subcommittee on Nutrition and Investigations
Committee on Agriculture
United States Senate

GAO/T-RCED-87-40

Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to discuss our work on farm reorganizations related to the $50,000 per person payment limitation. Specifically, I will be discussing the scope and cost of reorganizations and changes that are needed to improve the effectiveness of the payment limitation. This work, Mr. Chairman, was originally requested by Representatives Dorgan, Panetta, and Glickman in response to concerns that farmers were increasingly reorganizing their farming operations to avoid the payment limitation restrictions by adding new persons.

Our work on this issue was done in two segments. In April of this year we reported on the first segment which focused on (1) identifying the number of new producers (i.e., persons) created as a result of farm reorganizations from 1984 to 1986; (2) estimating the additional cost to the government of these reorganizations; and (3) projecting the additional costs of such reorganizations, if the trend in reorganizations were to continue in fiscal years 1987 to 1989.[1] Just this week, we reported on the second segment of our work which looked at the methods used to avoid the payment limit, USDA's proposed changes to the law and regulations which

---

[1]Farm Payments: Farm Reorganizations and Their Impact on USDA Program Costs (GAO/RCED-87-120BR, April 1, 1987).

are designed to tighten the limitation, and USDA's process for determining whether reorganizations were proper for payment limitation purposes.[2]

My testimony today will use our earlier work on the number and cost of reorganizations as a backdrop for presenting our analysis of USDA's proposals to tighten the payment limitation including some additional changes that USDA could make to enhance the effectiveness of its proposals.

BACKGROUND ON PAYMENT LIMITATIONS

The Congress initially passed a limitation on direct income support payments in response to both the high cost of federal farm programs and reports of large subsidy payments to individual producers. The current limit is $50,000 per person in direct subsidy payments for producers of wheat, feed grains, cotton, and rice. Under the payment limitation regulations, persons are broadly defined to be individuals, members of joint operations, or entities such as limited partnerships, corporations, associations, trusts, or estates that are actively engaged in farming.

In addition to the $50,000 limit on direct support payments, separate limits have been placed on other programs, such as the new

[2] Farm Payments: Basic Changes Needed to Avoid Abuse of the $50,000 Payment Limit (GAO/RCED-87-176, July 21, 1987.)

$200,000 per-person limit on marketing loans and other payments beginning with crop year 1987. Although separate, these other limits use the same definition of a person for payment limitation purposes.

NUMBER AND COST OF REORGANIZATIONS

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

1984 Through 1986 Reorganizations

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

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

On the basis of a statistically valid random sample of new persons, we project, as shown on chart 1, that about 1,400, 1,900, and 5,700 new persons were created as a result of farm reorganizations in 1984, 1985, and 1986, respectively. In each instance, at least one producer on the original farming operation received $40,000 or more in payments. The 3-year cumulative total is about 9,000 new persons.

We found that as more persons neared or met the payment limitation from 1983 to 1985, the number of new persons created in the following years increased. Although it was not our objective to prove that the intent of these reorganizations was to avoid the payment limit, that was the effect. Further, anecdotal evidence we obtained from state and local agricultural officials, farmers

---

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

who reorganized, and other sources tends to support such avoidance as a driving force behind at least some of the reorganizations.

The increase in farmers nearing the payment limit is primarily due to an increase in the per-unit deficiency payment rate and generally higher crop yields over the past few years. The impact of these factors is illustrated by the declining number of acres that must be planted to reach the $50,000 payment limit. For example, as shown on chart 2, the acreage needed to reach the $50,000 payment limit on a corn farm has decreased by about 800 acres, or 51 percent, from 1983 to 1987 on the basis of a nationwide average yield and compliance with the mandatory minimum program requirements. For wheat, the corresponding decline is about 1,000 acres, or 44 percent. The acreage needed to reach the payment limit for cotton and rice has also declined--although not as sharply--by 20 and 13 percent, respectively.

1987 Through 1989 Reorganizations

Should the trend in reorganizations[4] continue over 1987 to 1989, we project that an additional 22,000 new persons could be

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

receiving payments by 1989. While the continuation of this trend is not certain, we believe that it is likely because (1) there can be a significant economic benefit of up to $50,000 for each person added to a farming operation, (2) in the future, additional persons on existing operations may continue to reach the payment limit because of continued high program payments and increased crop yields, and (3) a large reservoir of persons, about 38,000 in 1986, at the payment limit could realize this economic benefit by reorganizing their farming operations in the future. If this trend continues, additional costs to the government, as shown in chart 3, could be about $191 million in 1987, $209 million in 1988, and $219 million in 1989. These figures represent the annual cost of only those new persons added to farming operations in that year. In 1989, the total of almost 31,000 new persons that resulted from farm reorganizations since 1984 could add almost $900 million annually to program costs.

While the annual costs resulting from farm reorganizations have increased significantly over the years, the cumulative cost of these reorganizations are accelerating dramatically. As shown on chart 4, the cumulative cost for 1984 to 1989 would be about $2.3 billion with $900 million added in 1989 alone. Another $900 million would be added in 1990, the last year covered by the 1985 Food Security Act.

Even if we were to assume that no new reorganizations would take place after 1987, the cumulative costs of reorganizations that took place from 1984-87 would be about $1.7 billion through 1989 and about $2.1 billion through 1990. The costs for only the 1988-90 program years would be between $1.3 billion if you assume that new reorganizations would stop entirely after 1987 and $2.4 billion if you assume that they continue after 1987.

METHODS USED TO AVOID THE PAYMENT LIMITATION

During our review, we saw a wide variety of reorganizations including the addition of individuals, limited partnerships, corporations, and trusts, to the establishment of large partnerships or joint ventures. The two areas of primary concern are the formation of corporations and the renting of farmland for cash by individuals, partnerships, or joint ventures with a large number of participants. A corporation can be formed by two persons who each receive the maximum $50,000 payment to receive a third $50,000 payment as long as neither person owns more than 50 percent of the corporation.

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

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

[Presentation of Case Studies]

Mr. Chairman, the case studies just presented are illustrative of some of the most extreme, although legal, cases of avoidance of the payment limitation. In general, most reorganizations involve the creation of only one or a few new persons.

OBSERVATIONS ON USDA'S PROPOSED CHANGES

In March of this year, USDA presented to the Congress a report containing its proposals to tighten the payment limitation. USDA's proposals include changes to both the law and regulations. We believe that USDA's proposals, if properly implemented, will discourage many farm reorganizations specifically designed to avoid the payment limit like the examples just discussed.

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

- -- treating all entities the same by basing the payment limit for each on the number of its members actively engaged in the entity's farming operation;
- -- attributing payments for the entity against the individual payment limits of its owners; and
- -- limiting total payments for individuals to $50,000, whether the payments originate from their own farming operations or are attributed to them from an entity, such as a corporation, in which they share ownership.

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

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

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

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

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

USDA's proposals do not, however, address avoidance of the payment limit through division of land into parcels that earn the payment limit and the leasing of these parcels to investors not otherwise involved in farming. The investors' involvement in farming is limited to providing financing and signing land lease, equipment rental, management, and labor agreements provided by a management firm that put the investment package together. USDA could eliminate this method of legal avoidance by changing its rules to require that in rental situations, in addition to financing, a person other than a landowner, must contribute (1) owned land or equipment, and (2) personal labor or active management to receive program payments.

Also, while USDA intended that payments to any individual be limited to $50,000 whether the source of the payments was the individual's own farming operation or one in which they shared ownership, their proposal will not achieve this intended goal in all cases. This can occur because the basic definition of a person requires that a person have a separate interest in the crop. However, owners of corporations are not considered to have a separate interest in the crop, rather the corporation has the only interest in the crop.

As such, owners of corporations under current and proposed rules will not be considered persons for payment limits unless they have some other farming interest outside the corporation that qualifies them as persons. As a result, such individuals could receive payments in excess of $50,000 because they are not considered persons for payment limitation purposes and therefore there is no limit on their payments. ASCS can correct this problem by including these individuals in its definition of a person.

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

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

PROGRAM ADMINISTRATION PROBLEMS

We also identified some problems in USDA's administration of the payment limitation at the county and state office levels. These problems contribute to the creation of new persons through reorganizations that are of questionable validity. In separate reviews, GAO and USDA's Inspector General found that over 20 percent of the reorganization cases reviewed may have been incorrectly approved.

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

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

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

Incorrect person determinations occurred primarily because USDA did not provide adequate guidance and training on how the regulations should be implemented and did not exercise effective internal control to ensure that person determinations were made in accordance with regulations. In all fairness, Mr. Chairman, we need to recognize that USDA has taken some corrective actions that will improve administration of the payment limitation beginning with the 1987 program year.

In December 1986 ASCS revised its guidance for state and county offices use in reviewing person determinations for the 1987 program year. These revisions address some but not all of the problems we noted. For example, the revised guidance reemphasizes the need to verify that actual farming operations were carried out according to the farm operating plan that was the basis for approving new persons. ASCS has also increased the amount of training provided to state officials from a half-day of training in 1985 and 1986 to a full day of training during a recent meeting.

However, the revised guidance still does not address such important considerations as how to determine if payment shares are commensurate with actual contributions in joint operations or the type of information and documentation needed to apply specific rules or verify that operations are carried out as planned. Further, ASCS still has not developed minimum training requirements for county officials who actually make person determinations or developed uniform course materials to assure that the rules are consistently applied by different counties and states.

Providing adequate guidance, training and internal control of person determinations will be even more important if changes are made to the existing law and regulations.

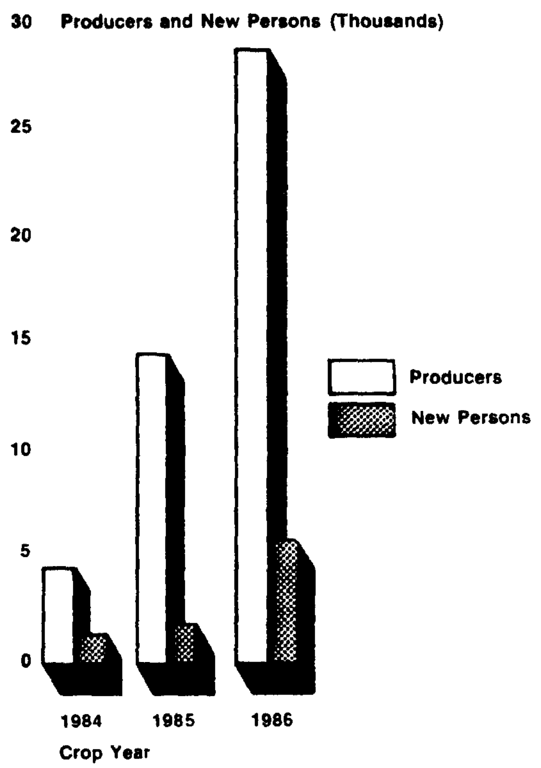
- - - -

In closing, Mr. Chairman, I would like to emphasize two points that help put this issue in context. First, while reorganizations are significantly increasing program costs, they represent the actions of less than one percent of all producers. Second, most producers, 90-95 percent, receive payments of less than $50,000 and are not subject to the payment limit. As a result, most persons will not be affected by the proposed changes and will continue to receive at least their current level of payments.

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

APPENDIX I

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



APPENDIX I

Chart 2: Acreage Needed To Reach $50,000 Limit

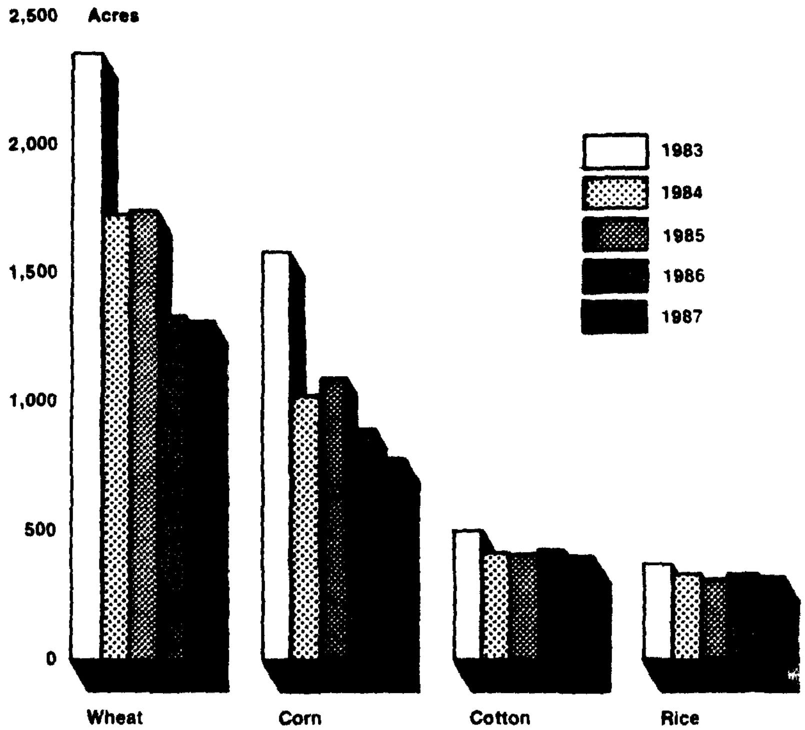


Chart 3: Annual Payments to New Producers Resulting From Farm Reorganizations

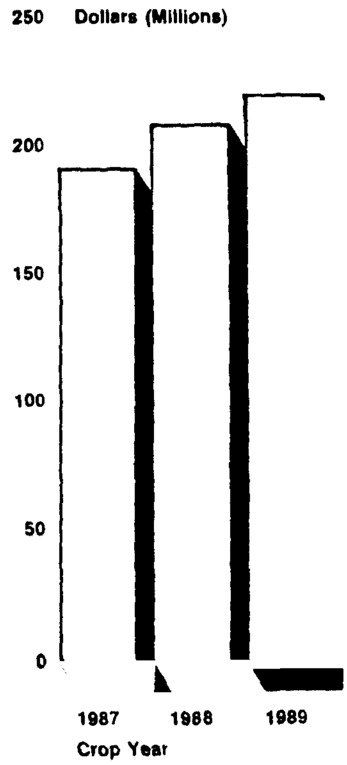
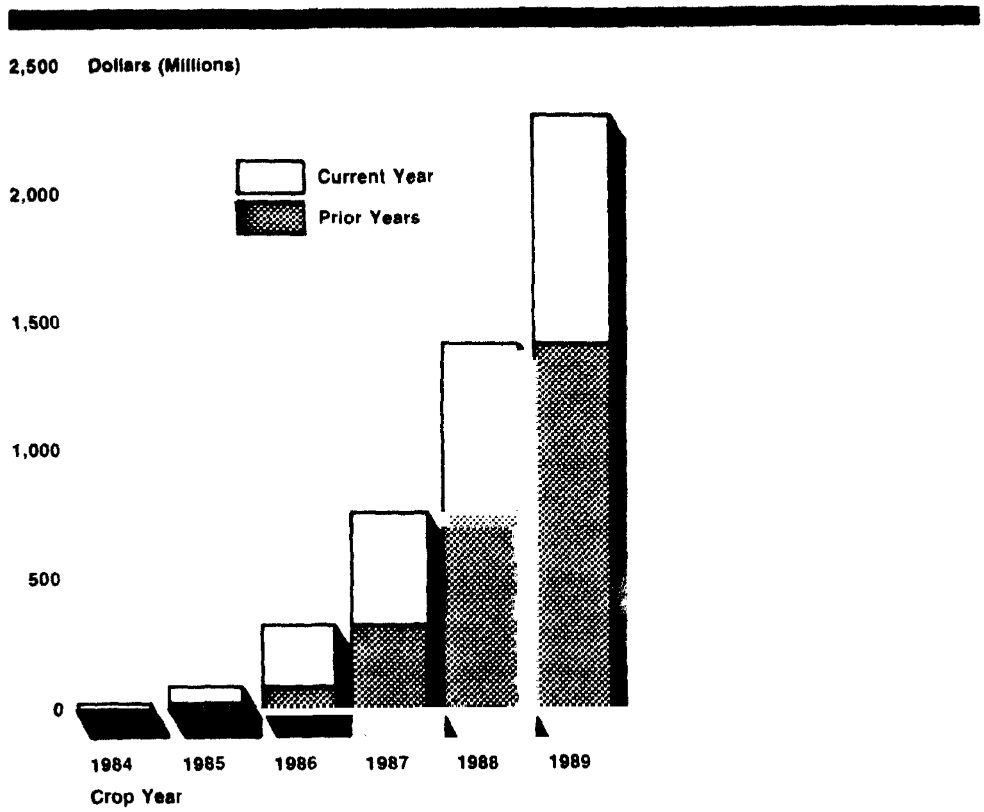


Chart 4: Cumulative Payments to New Producers Resulting From Farm Reorganizations



Case Study #1

Reorganization Using Multiple Corporations

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

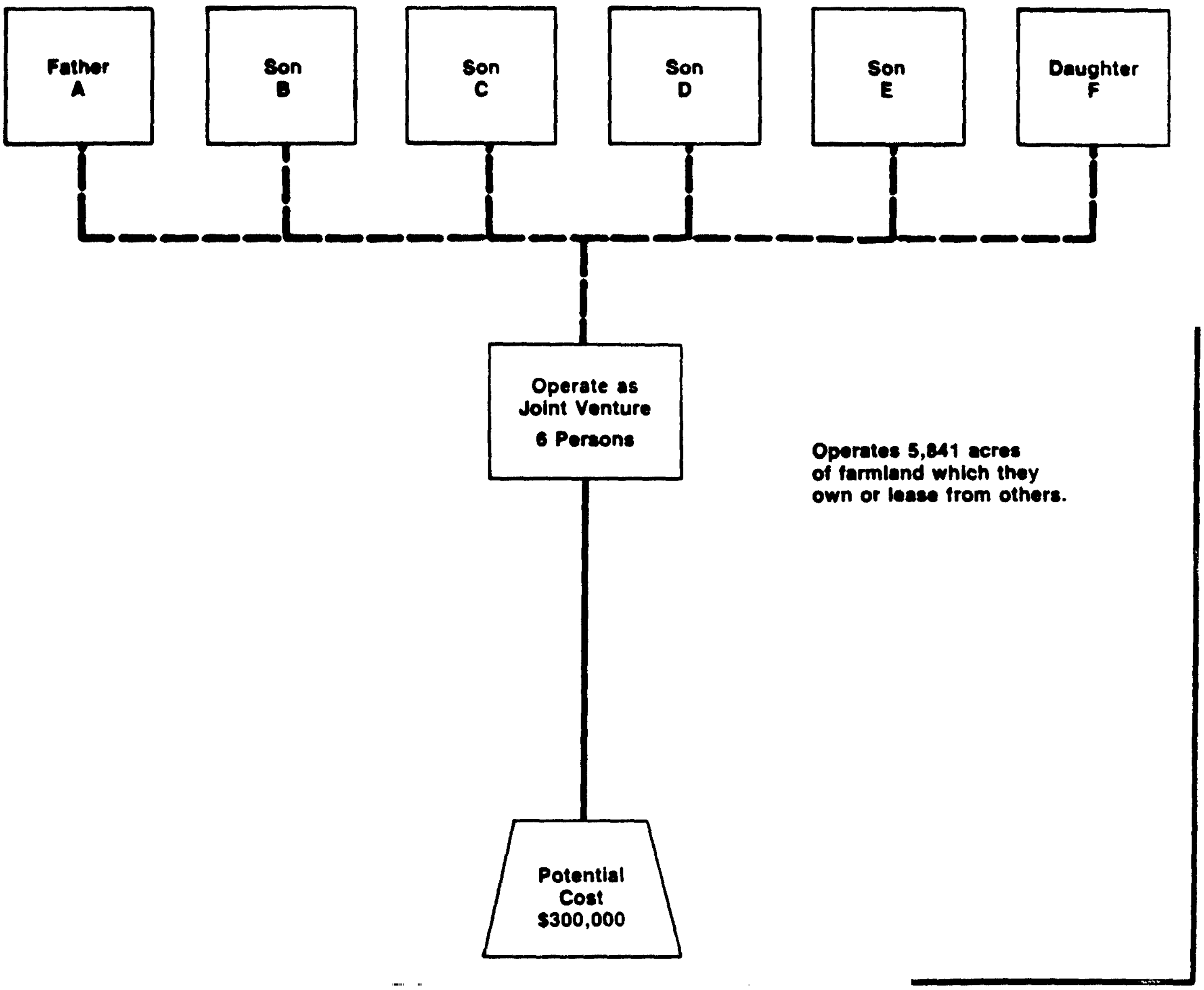
In 1985, a six member joint venture operated 5,841 acres of farm land which the participants in the venture either owned or cash leased from others. The joint venture comprised a father, his four adult sons, and an adult daughter. USDA officials determined that each individual member in the venture qualified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

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

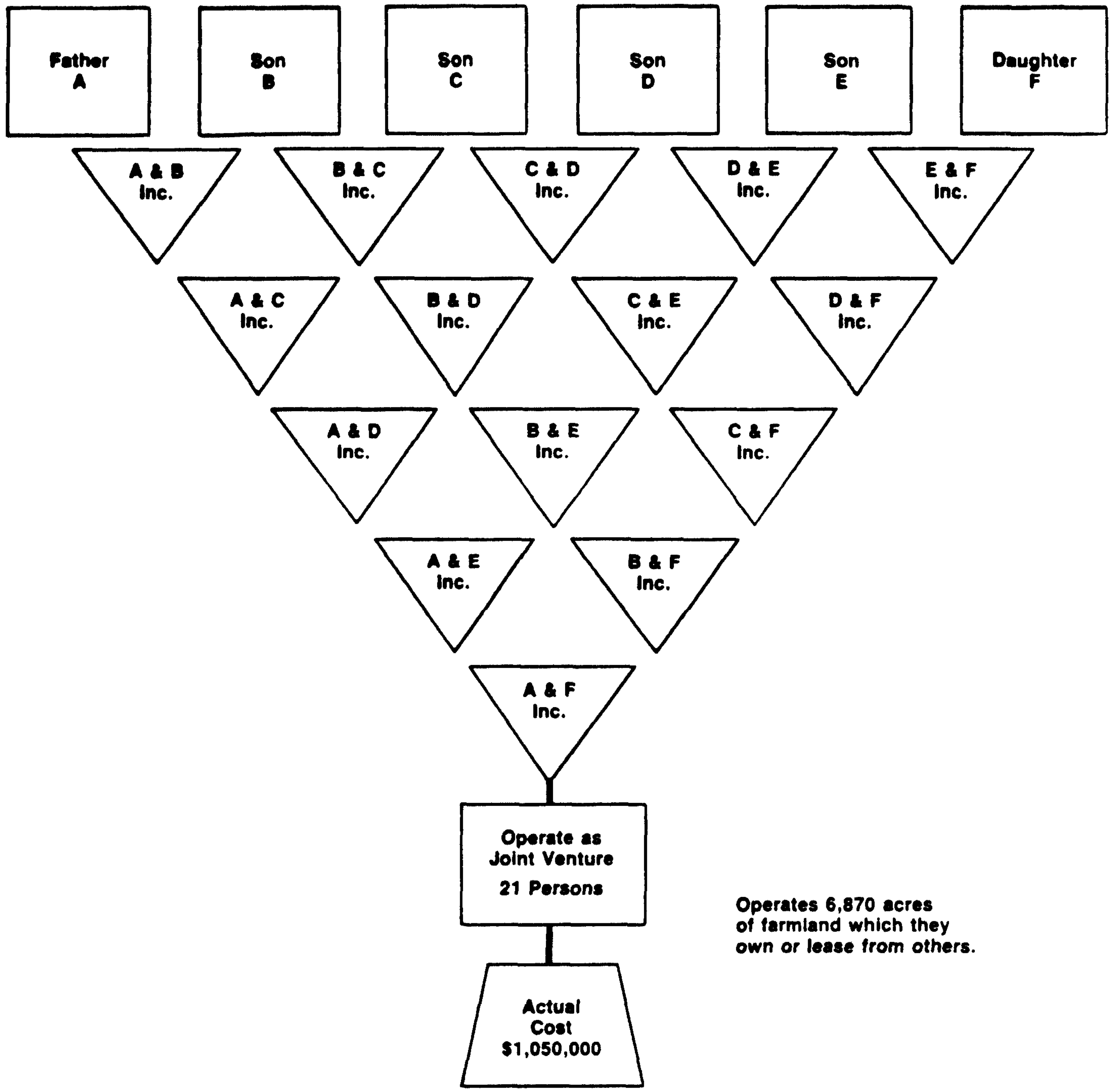
For 1986, the operation was reorganized by the father and his children into a new joint venture that comprises the same six persons as in 1985 plus 15 new corporations they formed. Each corporation is owned on a 50/50 basis by two individuals, each of whom was a member of the 1985 joint venture. The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

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

Corporate Case Study — 1985 Organizational Structure



Corporate Case Study — 1986 Organizational Structure



Case Study #2

Reorganization Showing Investors That Cash Rent Farms

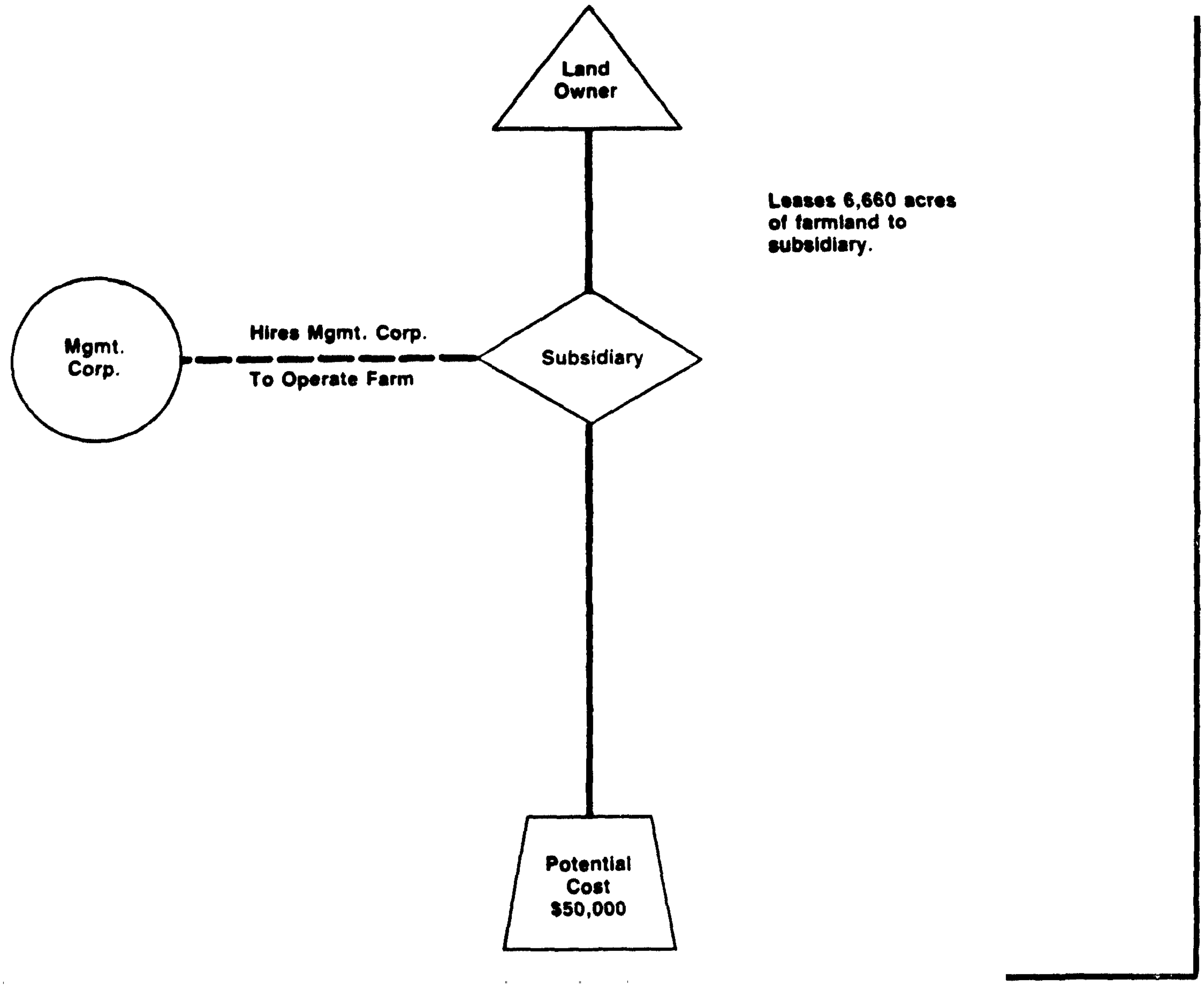
This case study shows how investors with little or no active farming interests of their own can take advantage of USDA's definition of what constitutes a person actively engaged in farming. Under the regulations, a person is someone who has a separate and distinct interest in the land or crop, exercises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

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

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

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

Cash Rent Case Study — 1985 Organizational Structure



Cash Rent Case Study — 1986 Organizational Structure