United States General Accounting Office

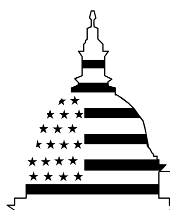
GAO

Report to the Chairman, Committee on Finance, U.S. Senate

April 2004

FARM PROGRAM PAYMENTS

USDA Needs to Strengthen Regulations and Oversight to Better Ensure Recipients Do Not Circumvent Payment Limitations



G A O

Accountability ★ Integrity ★ Reliability

GAO-04-407

Highlights of GAO-04-407, a report to the Chairman, Committee on Finance, U.S. Senate

Why GAO Did This Study

Farmers receive about $15 billion annually in federal farm program payments to help produce major commodities, including corn, cotton, rice, and wheat. The Farm Program Payments Integrity Act of 1987 (1987 Act) limits payments to individuals and entities—such as corporations and partnerships—that are "actively engaged in farming." GAO (1) determined how well USDA's regulations limit payments, (2) assessed USDA's oversight of the act, and (3) summarized the distribution of farm payments by type of entity.

What GAO Recommends

GAO recommends that USDA (1) develop measurable requirements defining a significant contribution of active personal management; (2) clarify regulations and guidance as to what constitutes a scheme or device to effectively evade payment limitations; (3) improve its sampling method for selecting farming operations for review; and (4) develop controls to ensure all available tools are used to assess compliance with the act.

In commenting on this report, USDA agreed to act on most of our recommendations. However, USDA stated that its current regulations are sufficient for determining active engagement in farming and assessing whether operations are schemes or devices to evade payment limitations. We still believe measurable standards and clarified regulations would better assure the act's goals are realized.

www.gao.gov/cgi-bin/getrpt?GAO-04-407

To view the full product, including the scope and methodology, click on the link above. For more information, contact Lawrence J. Dyckman, (202) 512-3841 or dyckmanl@gao.gov..

April 2004

FARM PROGRAM PAYMENTS

USDA Needs to Strengthen Regulations and Oversight to Better Ensure Recipients Do Not Circumvent Payment Limitations

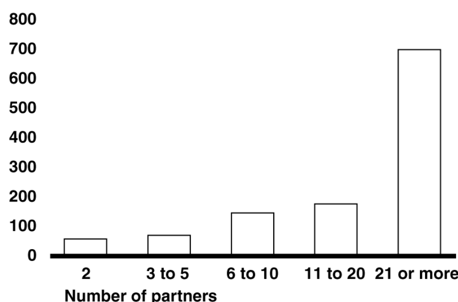
What GAO Found

USDA's regulations to ensure recipients are actively engaged in farming do not specify a measurable standard for what constitutes a significant contribution of active personal management. By not specifying such a measurable standard, USDA allows individuals who may have limited involvement with the farming operation to qualify for payments. According to GAO's survey of USDA's compliance reviews, about 99 percent of payment recipients asserted they met eligibility requirements through active personal management. USDA's regulations lack clarity as to whether certain transactions and farming operation structures that GAO found could be considered schemes or devices to evade, or that have the effect of evading, payment limitations. Under the 1987 Act, if a person has adopted such a scheme or device, then that person is not eligible to receive payments for the year in which the scheme or device was adopted or the following year. Because it is not clear whether fraudulent intent must be shown in order to find that a person has adopted a scheme or device, USDA may be reluctant to pursue the question of whether certain farming operations, such as the ones GAO found, are schemes or devices.

According to GAO's survey and review of case files, USDA is not effectively overseeing farm program payments. That is, USDA does not review a valid sample of farm operation plans to determine compliance and thus does not ensure that only eligible recipients receive payments, and compliance reviews are often completed late. As a result, USDA may be missing opportunities to recoup ineligible payments. For about one-half of the farming operations GAO reviewed for 2001, field offices did not use available tools to determine whether persons were actively engaged in farming.

Of the $17 billion in payments USDA distributed to recipients in 2001, $5.9 billion went to about 140,000 entities. According to GAO's analysis of USDA's data, corporations and general partnerships represented 39 and 26 percent of these entities, respectively. General partnerships received 45 percent of the payments to entities, or $2.7 billion; these entities receive more payments if they have more partners.

Average Farm Program Payments to General Partnerships, by Number of Partners, 2001



Source: GAO analysis of FSA data.

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Abbreviations

FSA Farm Service Agency
USDA U.S. Department of Agriculture

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

April 30, 2004

The Honorable Charles E. Grassley
Chairman, Committee on Finance
United States Senate

Dear Mr. Chairman:

Between 1999 and 2002, farmers received about $60 billion in federal farm program payments—averaging $15 billion annually—from the U.S. Department of Agriculture (USDA) to help support the production of major commodities, including corn, cotton, rice, soybeans, and wheat. These payments go to 1.3 million producers: individuals and entities such as corporations, partnerships, and trusts.[1] Annually, almost two-thirds of these payments go to about 10 percent of the producers. Large farming operations get the most payments because the payments are based primarily on the amount of crop produced and/or the historical acres farmed.

After hearing several concerns about farm payments going to individuals not involved in farming, the Congress enacted the Agricultural Reconciliation Act of 1987 (1987 Act), commonly referred to as the Farm Program Payments Integrity Act, which among other things, set eligibility conditions to limit the number of payments going to recipients and to ensure that only individuals and entities "actively engaged in farming" received payments.[2] To be considered actively engaged in farming, an individual recipient must make significant contributions to the farming operation in two areas: (1) capital, land, or equipment and (2) personal labor, or active personal management. An entity is considered actively

[1]According to the U.S. Census of Agriculture, in 2002, 2.1 million farms produced and sold agricultural products. Approximately 1.3 million individuals and entities receive federal farm program payments on major commodities. Entities also include other legal organizations such as joint ventures, limited liability companies, limited partnerships, limited liability partnerships, estates, and charitable organizations. Additionally, for federal farm program purposes, entities include states, political subdivisions, or agencies thereof. USDA's Farm Service Agency uses the term "persons" to refer to individuals or entities that receive farm program payments. See appendix I for more information on the most common ways farmers organize their farming operations, including the types of legal entities used.

[2]Most of its provisions became effective in the 1989 crop year. Agricultural Reconciliation Act of 1987, as enacted by the Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, §§ 1301-1307, 101 Stat. 1330, 1330-12-1330-19.

engaged in farming if the entity separately makes a significant contribution of capital, land, or equipment, and its members collectively make a significant contribution of personal labor or active personal management to the farming operation. USDA's Farm Service Agency's (FSA) regulations define active personal management to include such tasks as arranging financing for the operation, supervising the planting and harvesting of crops, and marketing the crops. For both individuals and entities, their share of the farming operation's profits or losses must also be commensurate with their contributions to the farming operation and those contributions must be at risk. The 1987 Act also limits the number of entities through which a person can receive program payments. Under the act, a person can receive payments as an individual and through no more than two entities, or through three entities and not as an individual. The statutory provision imposing this limit is commonly known as the three-entity rule. Under the Farm Security and Rural Investment Act of 2002, "persons"—individuals or entities—are generally limited to a total of $180,000 annually in farm program payments, or $360,000 if they are members of up to three entities.[3]

While one of the purposes of the 1987 Act was to prevent the use of multiple legal entities to avoid the effective application of the payment limitations, individuals can still pool resources within certain entities to receive farm program payments and significantly increase payments to a single farming operation. For example, individuals who on their own would generally be limited to $180,000 for their farming operation can instead set up a partnership composed of three partners, each of whom is qualified to receive up to $180,000 in farm program payments, and thereby triple the total amount of payments to the farming operation, assuming the land qualifies for additional payments. This partnership could include (1) individual A, (2) a corporation with individuals A and B, and (3) a corporation with individuals A and C. In this example, the partnership could receive up to $540,000 annually in the following way: individual A receives up to $180,000; the corporation with individuals A and B receives up to $180,000; and the corporation with individuals A and C receives up to $180,000. Under this arrangement, individual A could receive $360,000 ($180,000 as an individual and $90,000 from each of the two corporations).

FSA is responsible for administering the 1987 Act and ensuring that recipients meet the eligibility criteria and do not receive payments that

[3]Farm Security and Rural Investment Act of 2002, Pub. L. No. 107-171, 116 Stat. 134, 213.

exceed those allowed. It carries out this responsibility through its headquarters office, 50 state offices, and over 2,500 field offices.[4] Before applying for farm program payments, farming operations file a farm operating plan with the local FSA field office.[5] The plan documents the name of each recipient, the number of recipients that qualify for payments, and the recipients' share of profits and losses. FSA reviews the plan to determine the number of recipients that qualify for payments and whether the recipients are actively engaged in farming. At the end of the year, FSA field offices review a sample of these plans to help monitor whether farming operations were conducted in accordance with these approved plans. These reviews include an assessment of whether payment recipients met the requirement for active engagement in farming and whether the farming operations have the documents to demonstrate that each individual or entity receiving payments is separate and distinct from other individuals or entities. FSA's state offices review plans for farming operations with more than five recipients. After the state offices review these plans, they send them to the county where the farming operation is located. FSA selects its sample of farming operations based on, among other criteria, (1) whether the operation has undergone an organizational change in the past year by, for example, adding another recipient to the operation and (2) whether the operation receives payments above a certain dollar threshold. These criteria have principally resulted in sampling large farming operations in areas that produce cotton and rice—Arkansas, California, Louisiana, Mississippi, and Texas. Cotton and rice typically receive higher payments per acre than other commodity crops.

You asked us to examine FSA's implementation of the 1987 Act. As agreed with your office, we (1) determined how well FSA's regulations for active engagement in farming help limit farm program payments; (2) assessed the effectiveness of FSA's oversight of farm program payments' requirements for active engagement in farming; and (3) summarized the distribution of farm payments by type of entity, such as a corporation, partnership, and trust.

To address these issues, we reviewed FSA's regulations and guidelines implementing the provisions of the 1987 Act and spoke with FSA officials in

[4]FSA offices are also located in Guam, Puerto Rico, and the Virgin Islands.

[5]Farming operations are only required to update the plan when there is a change in the operation.

headquarters, state offices, and field offices who are responsible for ensuring that recipients are actively engaged in farming. To evaluate FSA's application of procedures and standards and to assess the overall effectiveness of its review process for deciding whether recipients are actively engaged in farming, we reviewed selected participant files and conducted a two-part, nonprobability, Web-based survey of all 535 field offices responsible for 1 or more of the 1,573 operations selected for review in FSA's sample for 2001, the latest year for which data are available. The first part of the survey solicited detailed information about specific farming operations selected for review in the 535 field offices; the second part was designed to obtain the views of field staff on issues about the actively engaged in farming requirements and payment limitation rules. We received responses for 96 percent of the farming operations under review in part 1 of the survey, and we received responses from 89 percent of the 535 field offices queried in part 2 of our survey. FSA participant files with the needed information—farm operation documents, including leases, contracts, partnership agreements, accounting records, bank statements, and tax statements—were readily available only for 523 of the 1,573 farming operations FSA field offices selected for review. Of the remaining farming operations, 966 had their compliance reviews waived by FSA and therefore were not reviewed.[6] If FSA does not review a farming operation, that operation does not have to provide supporting documentation. As such, it was difficult and impractical for us to obtain the documents needed for a reliably projectable sample from the total population of farming operations. At the time we began our field work, FSA had not completed its examination of the 523 farming operations.[7] Five states had the largest number of farming operations selected for review—Arkansas, California, Louisiana, Mississippi, and Texas—and in these states, the reviews were generally concentrated in a small percentage of counties.[8] In these 5 states, we examined 64 reviews in the counties with the largest number of completed reviews. For comparative purposes, we also reviewed 22 files FSA selected for review in several counties in Nebraska, which is a large

[6]For the remaining 84 operations selected for review, in 72 cases, survey respondents did not provide information on whether the reviews for these entities were waived or will be conducted in the future; in 12 cases, we were unable to determine the field office responsible for reviewing the entities because of inconsistencies in FSA's data files.

[7]During our field office visits, FSA had completed reviews on 250 farming operations. As of January 2004, FSA completed an additional 97 reviews for a total of 347 reviews.

[8]At the time of our study, Arkansas had not begun conducting the reviews of its farming operations.

producer of corn and soybeans. To summarize the distribution of farm payments by type of farming operation, we obtained and analyzed FSA's computer databases for program payments and the individuals or entities receiving these payments. For the entities, the databases contain detailed information on the individuals that are members or beneficiaries, their share of payments, and additional organizational details, allowing us to determine the total number and type of entities receiving payments. We assessed the reliability of FSA's data by (1) performing electronic testing of required data elements, (2) reviewing existing information about the data and the system that produced them, and (3) interviewing agency officials knowledgeable about the data. We determined that the data were sufficiently reliable for the purposes of this report. Appendix II contains more detailed information on our scope and methodology, and appendix IV contains detailed results on our survey.

We conducted our review from May 2003 through March 2004 in accordance with generally accepted government auditing standards.

Results in Brief

Individuals may circumvent the farm payment limitations because of weaknesses in FSA's regulations. FSA's regulations do not provide a measurable standard for what constitutes a "significant contribution" of active personal management, defining it as "activities that are critical to the profitability of the farming operation, taking into consideration the individual's or entity's commensurate share in the farming operation."[9] In contrast, the regulations provide specific standards for what constitutes a significant contribution of capital, land, equipment, and active personal labor. For example, the regulations define a significant contribution of personal labor as the lesser of 1,000 hours of work per calendar year or 50 percent of the hours necessary to conduct a farming operation comparable in size to the individual's or entity's share in the farming operation. By not specifying quantitative standards for a significant contribution of active personal management, FSA allows individuals and entities who may have had limited involvement in the farming operation to qualify for payments. According to our survey of FSA field offices and our review of large farming operations, nearly all recipients meet one of the actively engaged in farming requirements by asserting that they have made a significant contribution of active personal management. Survey respondents indicated

[9] 7 C.F.R. § 1400.3(b).

that 99 percent of about 1,000 recipients who were members of partnerships and joint ventures for which FSA completed compliance reviews in 2001, asserted that they contributed active personal management solely or in combination with personal labor to meet the requirements for actively engaged in farming.

In addition to not providing a measurable standard for what constitutes a significant contribution of active personal management, FSA's regulations and guidance lack clarity as to whether certain transactions that we found could be considered schemes or devices. We found examples of farming operations where recipients may circumvent the payment limits by organizing large farming operations to maximize program payments and then channeling the payments to affiliated nonfarming operations, such as financial services companies or crop processing companies that are owned by one or a few individuals. These individuals are either partners in the farming operation or have close ties to the farming operation's partners. The farming operation's partners are employees of, or have close ties to, the owners of the nonfarming operations. With these types of legal structures, the farming operation receiving farm payments usually has only minimal assets and comprises many partners, each qualifying the farming operation for an additional $180,000 in payments. The nonfarming operations control significant assets—land, equipment, and capital—and are owned by one or a few individuals who were instrumental in setting up the legal structure for the farming operation. The nonfarming operations engage in transactions that do not appear to be at arm's length with the farming operations to provide goods and services, including land, equipment, and capital, and to purchase the crops. The net effect of these transactions between the nonfarming operations and the farming operations is to channel the farm payments to owners of the nonfarming operations. These payments to the owners of the nonfarming operations may significantly exceed the limit that would have applied to these individuals had they received the payments directly as sole owners of the farming operation. Depending on how the FSA's regulations are interpreted, these types of cases might be considered schemes or devices to evade, or that have the effect of evading, payment limitations. Under the 1987 Act, as amended, if the Secretary of Agriculture determines that any person has adopted a "scheme or device" to evade, or that has the purpose of evading, the act's provisions—in other words, the payment limitations—then that person is not eligible to receive farm program payments for the year the

scheme or device was adopted and the following crop year.[10] Some FSA officials believe that fraudulent intent is necessary to prove adoption of a scheme or device; however, it is not clear whether either the statutory provision or FSA's regulations require a demonstration of fraudulent intent in order to find that someone has adopted a scheme or device. Moreover, FSA's guidance contained in its payment limitations handbook does not clarify the matter, as it does not provide any additional examples, beyond those contained in the regulations. This lack of clarity over whether fraudulent intent must be shown in order for FSA to deny payments under the scheme or device provision of the law may be inhibiting FSA from finding that some questionable operations are schemes or devices. In light of the problems we identified, we are recommending that the Secretary of Agriculture revise FSA's regulations to better define active personal management and to clarify whether schemes and devices require fraudulent intent. We are also recommending that FSA issue more detailed guidance on the kinds of arrangements that may constitute a scheme or device under its regulations.

Moreover, FSA is not effectively overseeing farm program payments, according to our analysis of FSA's compliance reviews and our survey of FSA field offices. In 2001, FSA reviewed 347 farming operations and identified 18 operations that had members who did not comply with the actively engaged in farming requirements. While FSA's reviews found cases of noncompliance, the overall level of compliance with the actively engaged in farming and payment limitation provisions is unknown because of shortcomings in key areas. Specifically:

- FSA is not reviewing a valid sample of farm operation plans to reasonably assess the overall level of compliance because its selection methodology does not incorporate additional cases to replace cases where compliance reviews have been waived, resulting in a smaller final sample size that may affect the validity of the sample results. As a result, FSA does not have reasonable assurance that only eligible recipients are receiving payments. In particular, for 2001, FSA developed a judgmental sample of 1,573 farm operation plans from the 247,831 entities that received federal farm payments. The sample selection included 966 farming operations that were waived for various reasons, primarily because they were previously reviewed, leaving 523 farming operations to be reviewed. As of January 2004, FSA had only completed reviews for

[10] 7 U.S.C. § 1308-2.

347 plans, but expects to complete reviews for another 176 plans. Consequently, only about one-third of the 1,573 operations will be reviewed, providing FSA only a limited assessment of recipients' compliance with the actively engaged in farming and payment limitation requirements.

- Six FSA state offices responsible for conducting more than 400 year-end reviews for 2001 did not require their field offices to conduct these reviews within 12 months, as FSA's policy requires. Officials told us other priorities took precedence, including implementing the 2002 farm bill. As of summer 2003, the field offices had not yet begun these reviews. As a result, FSA is not in a position to comment on the likely extent of compliance with the 1987 Act or to correct problems; it may also be missing opportunities to recapture payments that were made to ineligible recipients who were part of a farming operation that reorganized or ceased operations.

- Our field office visits revealed that for one-half of the farming operations we reviewed for 2001, field offices did not use all available tools to determine whether individuals and entities are actively engaged in farming and eligible to receive farm program payments by, among other things, conducting interviews to substantiate management contributions or obtaining key financial information to verify that farm program payments are going to separate and distinct entities.

- FSA has provided only limited training on how to examine legal and financial documents to staff we surveyed. Nearly 90 percent of these field staff said that training would help them conduct compliance reviews more effectively.

We are making a number of recommendations to the Secretary of Agriculture for improving FSA's oversight of compliance with the 1987 Act, including improving its sampling method for selecting farming operations for review, developing management controls to ensure that FSA field staff make use of all available tools to assess payment recipients' compliance with the act, and providing training that emphasizes the financial and legal aspects of compliance reviews.

In 2001, USDA distributed about $17 billion in federal farm program payments to 1.3 million recipients—individuals and entities. Over one-third of these payments, or $5.9 billion, went to about 140,000 entities. Corporations and general partnerships represented 39 and 26 percent of

these entities, respectively, followed by joint ventures, and other entities, according to our analysis of FSA's databases. General partnerships received 45 percent of the program payments going to entities, or $2.7 billion. Partnerships with 2 partners collected an average of $57,890 in farm program payments in 2001, while partnerships with more than 20 partners collected an average of $698,235. Corporations collected about 38 percent of the program payments entities received, or $2.2 billion. Joint ventures, and other entities—such as limited partnerships, trusts, and charitable organizations—received the remaining $1.0 billion in program payments going to entities.

We provided a draft of this report to USDA for its review and comment. USDA agreed to act on most of our recommendations, but it disagreed with two of them. For example, USDA agreed it would consider whether its guidance on what constitutes a scheme or device can be improved and whether it can develop a better methodology for selecting farms for review. However, it disagreed with our recommendation for developing a measurable standard for assessing a recipient's contribution of active personal management and with our recommendation for clarifying whether fraudulent intent must be demonstrated to establish a scheme or device under its regulations. For both recommendations, USDA believes that its implementation of the 1987 Act is consistent with the intent of Congress. However, we continue to believe that USDA's current implementation of the payment limitation requirements may allow some individuals to circumvent the established payment limitations and that our recommendations would better assure that the goals of the 1987 Act are realized. Our detailed response to USDA's comments appears at the end of this letter and following USDA's written comments in appendix V.

Background

In 1987, Congress enacted what is commonly known as the Farm Program Payments Integrity Act, requiring that an individual or entity be actively engaged in farming in order to receive farm program payments. To be considered actively engaged in farming, the act requires an individual or entity to provide a significant contribution of inputs of capital, land, or equipment, as well as a significant contribution of services of personal labor or active personal management to the farming operation. Hired labor or hired management may not be used to meet the service contribution requirement. The act's definition of a "person" eligible to receive farm program payments includes an individual, as well as certain kinds of corporations, partnerships, trusts, or similar entities. Table 1 shows the input and service requirements that recipients must meet. In addition to

meeting the input and service requirements, recipients must demonstrate that their contributions to the farming operation are in proportion to their share of the operation's profits and losses and that these contributions are at risk.

Table 1: Contribution Requirements for Recipients to Be Considered Actively Engaged in Farming

Input contribution	Service contribution
Significant contribution to the farming operation of one or a combination of the following: • capital • land, or • equipment	Significant contribution to the farming operation of one or a combination of the following: • personal labor, or • active personal management

Source: GAO.

Note: Recipients' contributions must be considered "at risk," that is, there must be a possibility that the recipient could suffer a loss.

Congress has established limitations on how much money recipients can receive annually through the various programs. Farmers can receive federal farm payments for major commodity crops, including corn, cotton, rice, soybeans, and wheat, through the following income support programs under the Farm Security and Rural Investment Act of 2002.

- *Direct payments* to farmers are tied to a fixed payment rate for each covered commodity crop and are not dependent on current production or current market prices. Direct payments are based on the farm's historical acreage and on historical yields. They are similar to production flexibility contract payments of the Federal Agriculture Improvement and Reform Act of 1996.[11]

- *Counter-cyclical payments* provide price-dependent benefits for covered commodities whenever the effective price for the commodity is less than a pre-determined price (called the target price). Counter-cyclical payments are based on the farm's historical acreage and yields, and are not tied to current production of the covered

[11] Pub. L. No. 104-127, 110 Stat. 888 (1996).

commodity. These payments were developed to replace most ad hoc market loss assistance payments that were provided to farmers during 1998 through 2001.

- *Marketing assistance loan gains*, *marketing assistance loan forfeitures*, *loan deficiency payments*, *and commodity certificate gains* also provide benefits for covered commodities when market prices are low. Specifically, under USDA's marketing assistance loan program, the federal government accepts harvested crops as collateral for interest-bearing loans (marketing assistance loans) that are due in 9 months. When market prices drop below the loan rate (the loan price per pound or bushel), the government allows farmers to repay the loan at a lower rate and retain ownership of their commodity for eventual sale. The difference between the loan rate and the lower repayment rate is called the marketing assistance loan gain. In lieu of repaying the loan, farmers may forfeit their crops to the government when the loan matures and keep the loan principal. Conversely, farmers who do not have marketing assistance loans can also receive a benefit when prices are low, which is called a loan deficiency payment. The loan deficiency payment is equal to the marketing assistance loan gain that the farmer would have received if the farmer had a loan. Finally, commodity certificate exchanges allow farmers to redeem their marketing assistance loan at a lower repayment rate. By purchasing these certificates, farmers can immediately reclaim their commodities under loan. The difference between the loan rate and the lower repayment rate is called the commodity certificate gain. Benefits under the marketing assistance loan program are similar to those benefits provided under the Federal Agriculture Improvement and Reform Act of 1996.

Each of the income support programs has a separate payment limit. For example, under the Farm Security and Rural Investment Act of 2002, a recipient generally may only receive up to $40,000 in direct payments, up to $65,000 in counter-cyclical payments, and up to $75,000 in loan deficiency payments, and marketing assistance loan gains, for a total of $180,000 per

year.[12] Under the three-entity rule, an individual may receive up to twice the payment per year from three entities, that is, a full payment on the first entity and up to a half payment for each of two additional entities for a total of $360,000. Benefits received through commodity certificate gains and marketing loan forfeitures do not count against the payment limitations. In addition, effective for 2003 through 2007, under FSA's regulations, a recipient—an individual or entity—is ineligible for farm program payments if (1) the 3-year average of the adjusted gross income for the recipient exceeds $2.5 million and (2) less than 75 percent of the recipient's average adjusted gross income is derived from farming, ranching, or forestry operations.

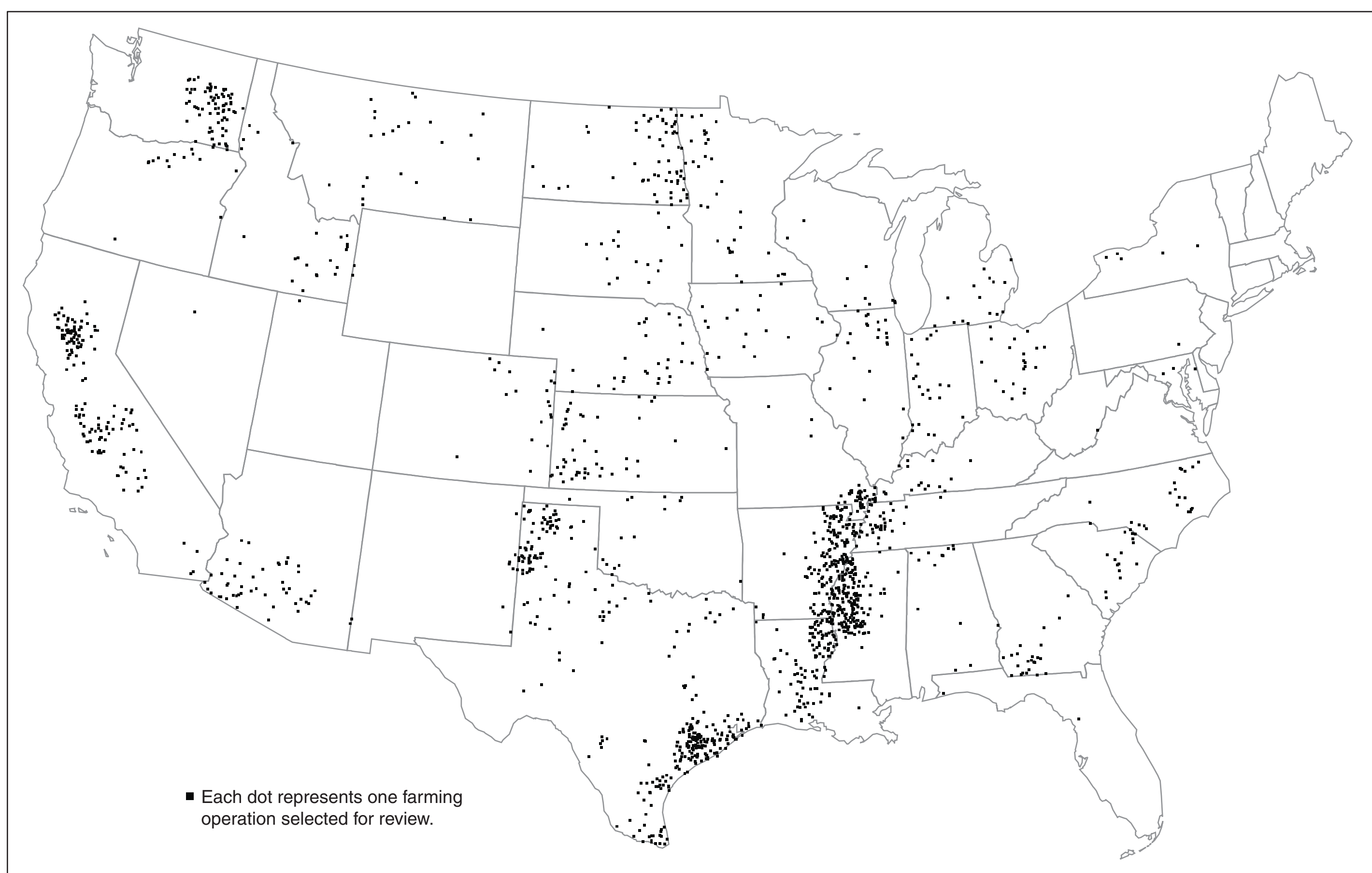
Some farming operations may reorganize to overcome payment limits to maximize their farm program benefits. Larger farming operations and farming operations producing crops with high payment rates such as rice and cotton may establish several related entities that are eligible to receive payments. However, each entity must be separate and distinct and is required to demonstrate that it is actively engaged in farming by providing a significant contribution of capital, land, or equipment, as well as a significant contribution of personal labor or active personal management to the farming operation.

USDA is responsible for enforcing the actively engaged in farming and payment limitation rules and has delegated this specific responsibility to its FSA. FSA field offices review a sample of farming plans at the end of the year to help monitor whether farming operations were conducted in accordance with approved plans, including whether payment recipients met the requirement for active engagement in farming and whether the farming operations have the documents to demonstrate that the entities receiving payments are in fact separate and distinct legal entities. FSA selects its sample of farming operations based on, among other criteria, (1) whether the operation has undergone an organizational change in the past year by, for example, adding another entity or partner to the operation and (2) whether the operation receives payments above a certain threshold.

[12]Recipients who also produce peanuts may receive up to an additional $40,000 in direct payments, $65,000 in counter-cyclical payments, and $75,000 in loan deficiency payments and marketing assistance loan gains, for a total of up to an additional $180,000 per year. Also recipients of Conservation Reserve Program payments, to retire environmentally sensitive land, may receive up to an additional $50,000 per year. Under the three-entity rule, recipients who produce peanuts may receive up to $360,000 in payments, and recipients who receive Conservation Reserve Program payments may receive up to $100,000 in payments.

These criteria have principally resulted in sampling farming operations in areas that produce cotton and rice—Arkansas, California, Louisiana, Mississippi, and Texas. Figure 1 shows the location of farming operations selected by FSA for review.

Figure 1: Compliance Reviews Selected by FSA for 2001



Source: GAO analysis of FSA data.

Individuals May Circumvent Farm Payment Limitations Because of Weaknesses in FSA's Regulations

Weaknesses in FSA's regulations may enable some individuals to circumvent farm payment limitations. FSA's regulations do not provide a measurable standard for what constitutes a significant contribution of active personal management. As a result, individuals and entities that have little involvement in a farming operation can assert a significant contribution of active personal management and receive farm payments. In addition, FSA's regulations and guidance lack clarity as to whether certain transactions and farming operation structures that we found could be considered schemes or devices. We found several examples of recipients that may be circumventing the payment limits by organizing large farming operations to maximize program payments and then channeling the payments to affiliated nonfarming operations, such as financial services companies or crop processing companies that are owned by one or a few individuals. These individuals are either partners in the farming operation or have close ties to the farming operation's partners. Under the 1987 Act, as amended, if the Secretary of Agriculture determines that any person has adopted a "scheme or device" to evade, or that has the purpose of evading, the act's provisions—in other words, the payment limitations—then that person is not eligible to receive farm program payments for the year the scheme or device was adopted and the following crop year.[13] Some FSA officials believe that fraudulent intent is necessary to prove adoption of a scheme or device, but it is not clear whether either the statutory provision or FSA's regulations require a demonstration of fraudulent intent in order to find that someone has adopted a scheme or device. Moreover, guidance contained in *FSA Handbook Payment Limitations, 1-PL (Revision 1), Amendment 40*, does not clarify the matter, as it does not provide any additional examples, beyond those contained in the regulations, for FSA officials of the types of arrangements that might be considered schemes or devices. This lack of clarity over whether fraudulent intent must be shown in order for FSA to deny payments under the scheme or device provision of the law may be inhibiting FSA from finding that some questionable operations are schemes or devices.

[13] 7 U.S.C. § 1308-2.

Lack of a Measurable Standard for What Constitutes a Significant Management Contribution Allows Individuals and Entities Who May Have Had Limited Involvement in the Farming Operation to Qualify for Payments

Many recipients meet one of the farm program payments' eligibility requirements by asserting that they have made a significant contribution of active personal management. As we noted before, in order to be considered actively engaged in farming, a person must make a significant contribution of land, equipment, or capital, and a significant contribution of personal labor or active personal management. Because FSA's regulations do not provide a measurable, quantifiable standard for what constitutes a significant management contribution, people who appear to have little involvement, according to our survey of FSA field offices and our review of 86 case files, are receiving farm program payments. Indeed, most large farming operations meet the requirement for personal labor or active personal management by asserting a significant contribution of management. Survey respondents provided information on 347 partnerships and joint ventures for which FSA completed compliance reviews in 2001; these entities comprised 992 recipients, such as individuals and corporations who were members of these farming operations. Of these 992 recipients, 46 percent, or 455, asserted that they contributed active personal management; 1 percent, or 7, asserted that they contributed personal labor; and the remaining 530 asserted they provided a combination of active personal management and personal labor, to meet the actively engaged in farming requirement.

While FSA's regulations define active personal management more specifically to include such things as arranging financing for the operation, supervising the planting and harvesting of crops, and marketing the crops, the regulations lack measurable criteria for what constitutes a significant contribution of active personal management. FSA regulations define a "significant contribution" of active personal management as "activities that are critical to the profitability of the farming operation, taking into consideration the individual's or entity's commensurate share in the farming operation." In contrast, FSA provides quantitative standards for what constitutes a significant contribution of active personal labor, capital, land, and equipment. For example, FSA's regulations define a significant contribution of active personal labor as the lesser of 1,000 hours of work annually, or 50 percent of the total hours necessary to conduct a farming operation that is comparable in size to such individual's or entity's commensurate share in the farming operation. By not specifying quantifiable standards for what constitutes a significant contribution of active personal management, FSA allows recipients who may have had limited involvement in the farming operation to qualify for payments.

In FSA's 1988 proposed regulations to implement the 1987 Act, it defined a significant contribution of active personal management as the lesser of 1,000 hours annually, or 50 percent of the hours necessary to conduct a farming operation of comparable size to the person's share in the farming operation.[14] During the public comment period, some commentators expressed a concern that in determining a significant contribution of personal management, time was not a good measure of such a contribution; they believed that the type of decisions an individual made about a farming operation was far more important than the number of hours the individual took to make the decision. Other commentators said that the 1,000-hour requirement was too high a standard and that it should be changed to 500 hours, which was the amount of hours the U.S. Internal Revenue Service used to determine material participation in a business enterprise. After considering the public comments, FSA removed the requirement that an individual must provide a specific number of management hours; instead, the final regulations discuss a significant contribution with respect to active personal management in terms of the relative worth of the individual's contribution to the farming operation. Specifically, the regulations define a significant contribution as activities that are critical to the overall profitability of the farming operation, taking into consideration the person's commensurate share in the farming operation. These management activities include arranging financing for the operation, supervising the planting and harvesting of crops, and marketing crops. However, this broad definition has allowed a substantial number of recipients to qualify for farm payments and may not have served to limit payments to those recipients whose contributions to the farming operation are significant. According to our survey, of 347 completed reviews of farming operations for 2001, FSA found 18 operations with members, asserting a management contribution, that were not in compliance with the actively engaged in farming requirements.

Our survey and our review of case files show that the largest farming operations usually are structured as general partnerships or joint ventures with individuals, corporations, or trusts, as partners. One individual often fulfills the management contribution requirement for multiple entities within the partnership or joint venture. Through the three-entity rule, persons can collect farm program payments as members of up to three

[14]In 1995, FSA assumed responsibility for programs previously under the jurisdiction of the Agricultural Stabilization and Conservation Service.

entities.[15] These entities are generally corporations or limited liability companies comprised of two shareholders, each with 50 percent ownership. Often, one individual fulfills the actively engaged in farming requirement for three entities by contributing active personal management for all three entities at once. Essentially, when an individual contributes management activities for one entity, that individual is also contributing the same management activities for the other two entities. In 24 of the 31 files we reviewed, where the partnership or joint venture included corporations or limited liability companies, a single individual claimed to fulfill the management contribution requirement for multiple recipients.

For 26 of the 86 FSA compliance review files we examined in which the recipients asserted they made a significant contribution of active personal management to the farming operation, some recipients appeared to have little involvement with the farming operation. For example, in 2001, 11 partners in a general partnership operated a farm of 11,900 cropland acres. These partners asserted they met the actively engaged in farming requirement by making a significant contribution of equipment and active personal management. FSA's compliance review found that all partners of the farming operation were actively engaged in farming and met all requirements for the approximately $1 million the partnership collected in farm program payments in 2001. Our review found that the partnership held five management meetings during the year, three in a state other than the state where the farm was located, and two on-site meetings at the farm. Some of the partners attended the meetings in person while others joined the meetings by telephone conference. Although all 11 partners claimed an equal contribution of management, minutes of the management meetings indicated seven partners participated in all five meetings, two participated in four meetings, and two participated in three meetings. All partners resided in states other than the state where the farm was located and only one partner attended all five meetings in person. Based on our review of minutes documenting the meetings, it is unclear whether some of the partners contributed significant active personal management. If FSA had found that some of the partners had not contributed active personal management, the partnership's total farm program payments would have been reduced by about 9 percent, or $90,000, for each partner that FSA

[15]Alternatively, individuals can collect farm program payments as an individual and as a member in two entities. Individuals with an ownership interest in an entity that exceeds 50 percent lose eligibility for their share of program payments for that entity.

determined was ineligible.[16] State FSA officials agreed that the evidence to support the management contribution for some partners was questionable and that FSA reviewers could have taken additional steps to confirm the contributions for these partners. However, the officials also stated they do not have any plans to revisit the review of this farming operation.

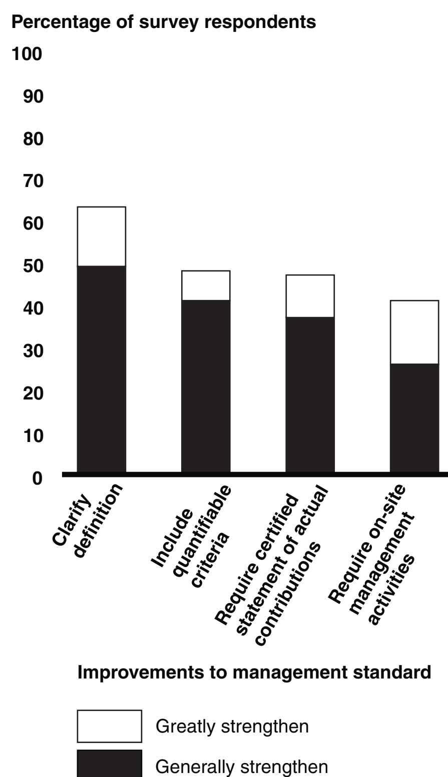
In another example, in 2001, six partners in a general partnership operated a farm of about 6,400 cropland acres. All six partners asserted they met the actively engaged in farming requirement by making a significant contribution of equipment and providing active personal management. FSA's compliance review found that all partners of the farming operation were actively engaged in farming and met all requirements for the approximately $700,000 the partnership collected in farm program benefits in 2001. FSA's review documentation noted that all management was provided on-site on a "daily" basis. However, our review found that two of the six partners resided in a state several hundred miles away from the farm, raising questions about how these two partners could have provided this level of management. Moreover, the FSA field staff conducting the review did not interview any of the partners to determine the management duties each partner actually performed and how these duties helped the profitability of the farming operation. A state FSA official agreed that they could have conducted interviews with the partners to confirm the contributions for these partners. However, the official also stated FSA does not have any plans to revisit the review of this farming operation.

According to our survey of 535 FSA field offices, FSA could make key improvements to strengthen the management contribution standard. These offices reported that the management standard can be strengthened by clarifying the standard, including providing quantifiable criteria, certifying

[16]Each partner's share in the farming operation is about 9 percent. Nine percent of $1 million is $90,000.

actual contributions, and requiring management to be on-site.[17] As figure 2 shows, the percentage of respondents supporting these changes ranged from 41 to 63.

Figure 2: Percentage of FSA Field Offices Indicating Specific Improvements Would Strengthen the Active Personal Management Contribution



Source: GAO survey results.

Moreover, in 2003, a USDA commission established to look at the impact of changes to payment limitations concluded that determining what constitutes a significant contribution of active management is difficult and lack of clear criteria likely makes it easier for farming operations to add

[17]Certifying actual contributions could include requiring an affidavit from each recipient delineating management activities performed.

recipients in order to avoid payment limitations.[18] In discussing the management contribution issue in February 2004, FSA officials acknowledged that under current regulations, only land, equipment, capital, and labor are measurable, and that enforcing the current management contribution standard is difficult because of its subjective nature.

Lack of Clarity in FSA's Regulations and Guidance Concerning Schemes and Devices May Reduce Effectiveness of Payment Limitations

Our review found that some individuals or entities have engaged in transactions that might constitute schemes or devices to evade payment limitations, but neither FSA's regulations nor its guidance address whether such transactions could constitute schemes or devices. Under the 1987 Act, as amended, if the Secretary of Agriculture determines that any person has adopted a "scheme or device" to evade, or that has the purpose of evading, the act's provisions—in other words, the payment limitations—then that person is not eligible to receive farm program payments for the year the scheme or device was adopted and the following crop year.[19] FSA's regulations implementing this statutory provision provide that it (1) includes persons who adopt or participate in adopting a scheme or device and (2) includes schemes or devices that are designed to evade or have "the effect of evading" payment limitation rules. The regulations state that a scheme or device shall include concealing information that affects a farm program payment application, submitting false or erroneous information, or creating fictitious entities for the purpose of concealing the interest of a person in a farming operation.[20] As one court has noted, the regulations "seek to identify sham transactions" to obtain more farm program payments.[21]

We found several large farming operations that were structured as one or more partnerships, each consisting of multiple corporations that increased farm program payments in a questionable manner. The farming operations engage in transactions with nonfarming operations that may be owned by

[18]See U.S. Department of Agriculture, Office of the Chief Economist, Commission on the Application of Payment Limitations for Agriculture, *Report of the Commission on the Application of Payment Limitations for Agriculture* (Washington, D.C.: August 2003).

[19]7 U.S.C. § 1308-2.

[20]7 C.F.R. § 1400.5.

[21]Stegall v. United States, 19 Cl. Ct. 765, 769 (1990).

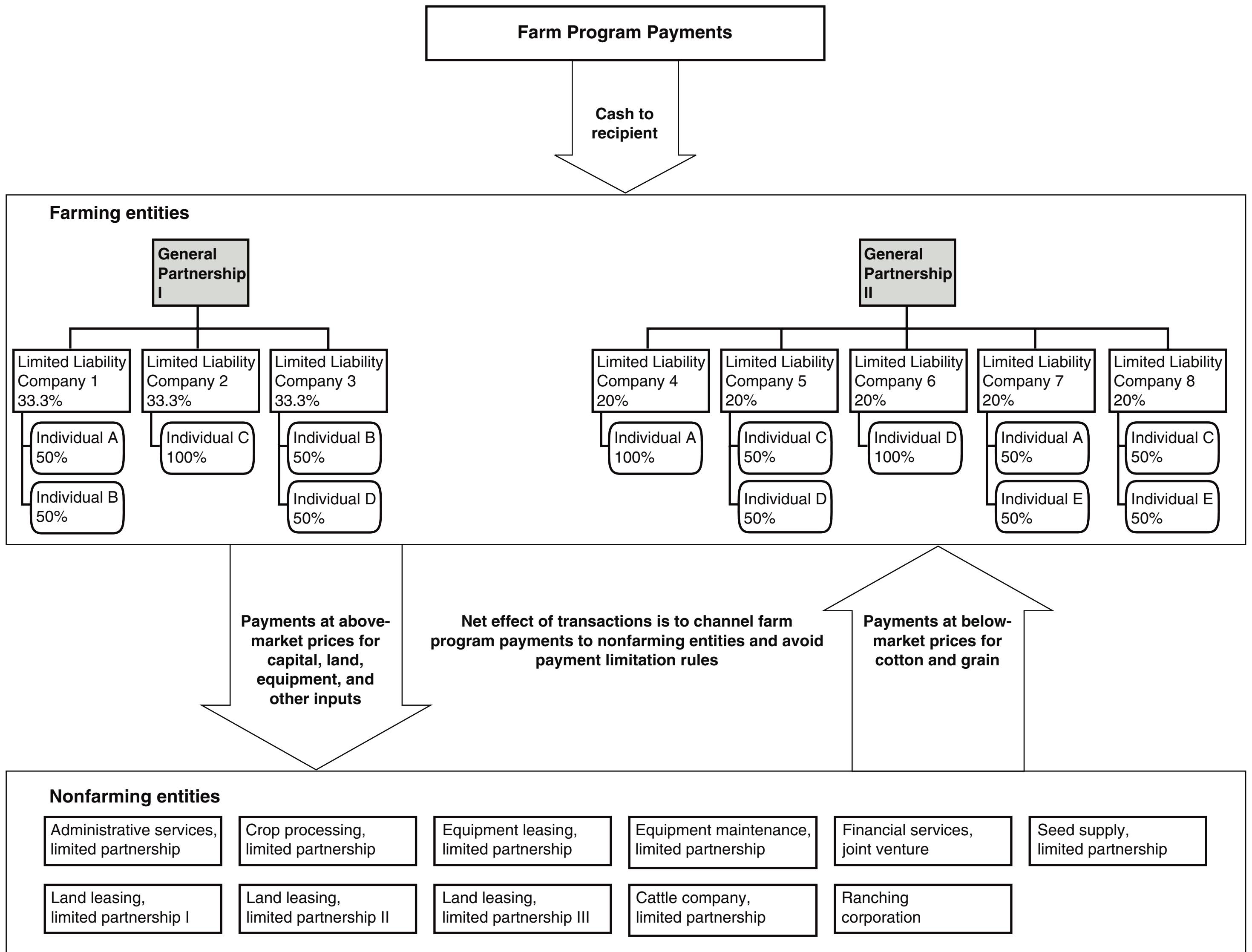
or have close ties to the farming operation's partners who were instrumental in setting up the legal structure for the farming operation. These transactions include activities such as purchasing the farming operation's goods and services—including land, equipment, and capital—and also selling the farming operation's crops. According to our review of farming operation files and interviews with FSA officials, these transactions may not be at arm's length and the farming operation often loses money because apparently it pays above-market prices for the goods and services and receives net returns for its crops that are below-market prices. The net effect of these transactions between the nonfarming and farming operations is that farm program payments are not distributed as profits to the partners or corporations that comprise the farming operation, but rather are channeled to the owners of the nonfarming operations. In this manner, the owners of the nonfarming operations—who set up the legal structure for the farming operation—often receive funds significantly in excess of the amount they would have received as a member of the farming operation.

The following two examples illustrate how farming operations, depending on how the FSA regulations are interpreted, might be considered to evade, or have the effect of evading, payment limitations. In one case, we found a family set up the legal structures for its farming operation and also owned the affiliated nonfarming entities. This operation included two farming partnerships comprised of eight limited liability companies.[22] The two partnerships operated about 6,000 acres and collected more than $800,000 in farm program payments in 2001. The limited liability companies included family and nonfamily members, although power of attorney for all of the companies was granted to one family member to act on behalf of the companies, and ultimately the farming partnerships. The operation also included nonfarming entities—nine partnerships, a joint venture, and a corporation—that were owned by family members. The affiliated nonfarming entities provided the farming entities with goods and services, such as capital, land, equipment, and administrative services. The operation also included a crop processing entity to purchase and process the farming operation's crop. According to our review of accounting records for the farming operation, both farming partnerships incurred a small net loss in 2001, even though they had received more than $800,000 in farm program payments. In contrast, average net income for similar-sized farming operations in 2001 was $298,000, according to USDA's Economic

[22]See appendix I for more information on limited liability companies.

Research Service. The records we reviewed showed that the loss occurred, in part, because the farming operations paid above-market prices for goods and services and received a net return from the sale of the crop to the nonfarming entities that appeared to be lower than market prices because of apparent excessive charges. The structure of this operation allowed the farming operation to maximize farm program payments, but because the farm operated at a loss these payments were not distributed to the members of the operation. In effect, these payments were channeled to the family-held nonfarming entities. Figure 3 shows the organizational structure of this operation and the typical flow of transactions between farming and nonfarming entities.

Figure 3: Large Operation Containing Farming and Nonfarming Entities



Source: GAO analysis of FSA compliance files.

Note: Percentages shown are share of ownership.

Similarly, we found another general partnership that farmed more than 50,000 acres in 2001 conducted business with nonfarming entities including a land leasing company, an equipment dealership, a petroleum distributorship, and crop processing companies with close ties to the

farming partnership. The partnership, which comprised more than 30 corporations, collected more than $5 million in farm program payments in 2001.[23] The shareholders who contributed the active personal management for these corporations were officers of the corporations. Each officer provided the active personal management for 3 corporations. Some of these officers were also officers of the nonfarming entities—the entities that provided the farming partnership goods and services such as the capital, land, equipment, and fuel. The nonfarming entities also included a gin and grain elevators to purchase and process the farming partnership's crops. Our review of accounting records showed that even though the farming partnership received more than $5 million in farm payments, it incurred a net loss in 2001, which was distributed among the corporations that comprised the partnership.[24]

Factors contributing to the loss included the above-market prices for goods and services charged by the nonfarming entities and the net return from the sale of crops to nonfarming entities that appeared to be lower than market prices because of apparent excessive charges for storage and processing. For example, one loan made by the nonfarming financial services entity to the farming partnership for $6 million had an interest rate of 10 percent while the prevailing interest rate for similar loans at the time was 8 percent. Similarly, the net receipts from the sale of the harvested crop, which were sold almost exclusively to the nonfarming entities, were below market. For example, in one transaction the gross receipt was about $1 million but after the grain elevators deducted fees such as for drying, storage, and grain quality, the net proceeds to the farming entity were only about $500,000. In this particular operation, all of the nonfarming entities had common ownership linked to one individual. This individual had also set up the

[23]In 2003, the operation divided into six new farming partnerships comprised of the same corporations.

[24]The accounting records also showed that the capital (equity) account for each of the corporations carried a negative balance indicating multiple years of net losses.

legal structure for the farming entities but had no direct ownership interest in the farming entities.[25]

It is unclear whether either of these operations falls within the statutory definition of a scheme or device or whether they otherwise circumvent the payment limitation rules. State FSA officials in Arkansas, Louisiana, Mississippi, and Texas, where many of the large farming operations are located, believed that some large operations with relationships between the farming and nonfarming entities were organized primarily to circumvent payment limitations.[26] In this manner, these farming operations may be reflective of the organizational structures that some members of Congress indicated were problematic when enacting the 1987 Act and the scheme or device provision. The House of Representatives report for the 1987 Act states: "A small percentage of producers of program crops have developed methods to legally circumvent these limitations to maximize their receipt of benefits for which they are eligible. In addition to such reorganizations, other *schemes* have been developed that allow passive investors to qualify for benefits intended for legitimate farming operations."[27] In discussing the issue of farming operations that circumvent the payment limitation rules with FSA headquarters officials in February 2004, they noted that while an operation may be legally organized, the operation may be misrepresenting who in effect receives the farm program payments. FSA has no data on how many of the types of operations that we identified exist. However, FSA is reluctant to question these operations because it does not believe current regulations provide a sufficient basis to take action.

[25]In addition, this individual also set up the legal structure for a separate farming operation that collected about $2 million in farm program payments in 2001. The operation is set up as a general partnership and is comprised of more than 20 corporations. According to FSA field staff, this farming operation also conducts transactions with the individual's nonfarming operations. We did not review this operation because FSA did not select this operation for review in 2001.

[26]FSA officials noted that as part of the actively engaged in farming compliance review, FSA checks whether rates for land or equipment leased from an individual or nonfarming entity with an interest in the farming operation are consistent with prevailing rates. However, when an individual or nonfarming entity does not have an ownership interest in the farming operation, FSA's regulations and policy do not require that the lease rates be at prevailing rates even in situations such as we identified above where family members do have such an interest in the farming operation.

[27]H.R. Rep. No. 100-391 (1987) (emphasis added).

Other officials said that USDA could review such an operation under the 1987 Act's scheme or device provision if it becomes aware that the operation is using a scheme or device for the purpose of evading the payment limitation rules. However, these FSA officials stated it is difficult to prove fraudulent intent—which they believe is a key element in proving scheme or device—and requires significant resources to pursue such cases. In addition, they stated that even if a recipient is found ineligible to receive payments this decision might be overturned on appeal within USDA. The FSA officials noted that when FSA loses these cases, it tends to discourage other field offices from aggressively pursuing these types of cases.

It is not clear whether either the statutory provision or FSA's regulations require a demonstration of fraudulent intent in order to find that someone has adopted a scheme or device. As discussed above, the statute limits payments if the Secretary of Agriculture determines that any person has adopted a scheme or device "to evade, or that has the purpose of evading," the farm payment limitation provisions. The regulations state that payments may be withheld if a person "adopts or participates in adopting a scheme or device designed to evade . . . or that has the effect of evading" the farm payment limitations. The regulations note that schemes or devices shall include, for example, creating fictitious entities for the purpose of concealing the interest of a person in a farming operation. Some have interpreted this as appearing to require intentionally fraudulent or deceitful conduct.[28] On the other hand, FSA regulations only provide this as one example of what FSA considers to be a scheme or device. They do not specify that all covered schemes or devices must involve fraudulent intent. As previously stated, covered schemes or devices under FSA regulations include those that have "the effect of evading" payment limitation rules.[29]

[28]*See* Alan R. Malasky, *ASCS Appeals and Payment Limitation Revisions in the 1990 Farm Bill: What Did the American Farmer Really Gain (or Lose)?*, North Dakota Law Review 365, 385 and n. 72 (1992) (noting that the regulatory examples of schemes and devices support the interpretation that some form of fraud or misrepresentation was necessary). *See also* Vandervelde v. Espy, 908 F. Supp. 11, 16 (D.D.C. 1995) (implying in *dicta* that to find a scheme or device there is a necessary inference that a person acted in bad faith).

[29]*See* Christopher R. Kelley, *Introduction to Federal Farm Program Payment Legislation and Payment Eligibility Law*, Arkansas Law Notes 11, 37 (2002) ("Although the regulations appear to require a 'scheme or device' to involve intentionally fraudulent or deceitful conduct, the meaning of the phrase is the subject of disagreement. By including actions that merely have the 'effect' of evading the rules in its regulations, the FSA seems to take the position that a producer's unintentional oversight in completing his, her, or its farm operating plan can constitute a 'scheme or device.' Whether this is what Congress intended is open to debate.").

Finally, guidance contained in *FSA Handbook Payment Limitations, 1-PL (Revision 1), Amendment 40*, does not clarify the matter, as it does not provide any additional examples for FSA officials of the types of arrangements that might be considered schemes or devices. This lack of clarity over whether fraudulent intent must be shown in order for FSA to deny payments under the scheme or device provision of the law may be inhibiting FSA from finding that some questionable operations are schemes or devices.

We have referred the two cited operations to USDA's Office of Inspector General for further investigation.

Weaknesses in FSA's Oversight May Enable Ineligible Farmers to Receive Program Payments

In addition to weaknesses in the regulations cited above, FSA does not effectively oversee farm program payments in five key areas, according to our analysis of FSA compliance reviews and our survey of FSA field offices. First, FSA does not review a valid sample of farm operation plans for compliance in order to have greater assurance that only eligible recipients receive payments. Second, field offices in 29 states did not conduct compliance reviews in a timely manner. Third, according to our review of case files, for one-half of the farming operations we reviewed for 2001, field offices did not use all available tools, such as interviews and key financial information, to determine whether persons were actively engaged in farming. Fourth, FSA has not established a methodology for collecting and summarizing compliance review data for comparison from year to year and assessing field offices' performance to be assured that its state and field offices are consistently and accurately applying payment eligibility requirements. Finally, these problems are exacerbated by a lack of periodic training for FSA staff on the payment limitation and eligibility rules. As a result, FSA's finding that virtually all individuals receiving farm payments in large farming operations were actively engaged in farming in 2001 is questionable.

FSA Does Not Review a Valid Sample of Recipients to Be Reasonably Assured of Compliance with the Payment Limitations

FSA is not reviewing a valid sample of farm operation plans to determine compliance because its methodology does not incorporate additional cases to replace cases where compliance reviews are later waived, resulting in a smaller final sample size that may affect the validity of the sample results. In 2001, about two-thirds of farming operations selected for review were waived because they were previously reviewed or the farming operation involved only a husband and wife. Consequently, FSA does not have

reasonable assurance that only eligible recipients are receiving payments. To conduct the compliance reviews, FSA annually selects a judgmental sample of farming operations. Specifically, in 2001, FSA selected 1,573 farming operations from its file of 247,831 entities to review producers' compliance with actively engaged in farming requirements. FSA's sample selection focuses on entities that have undergone an organizational change during the year or received large farm program payments.[30] When the state offices receive the selections and forward them to the field locations, field staff seek waivers for farming operations reviewed within the last 3 to 5 years—the time frame varies by state. As a result, according to FSA officials, of the farming operations selected for review each year, more than half are waived and therefore not actually reviewed. According to these officials, many of the waived cases show up year after year because FSA's sampling methodology does not take into consideration when an operation was last reviewed. According to survey respondents who provided written comments on FSA's sampling method, the repetitive selection of operations recently reviewed is one of the reasons they seek waivers. For example, one respondent commented that some farming operations must be waived every year because FSA headquarters does not monitor the sample selection process and the farming operations are selected repeatedly. Another respondent noted many of the same farming operations in his county were selected for review for 5 consecutive years and suggested using other selection methods. In 2001, the latest year for which data are available, only 523 of 1,573 sampled entities were to be reviewed.[31] Field offices sought and received waivers for 966 entities for various reasons, but primarily because the entities were previously reviewed or the farming operation involved only a husband and wife.[32] As of January 2004, FSA had only completed reviews for 347 of the 523 entities and expects to complete reviews for the remaining 176 entities. FSA's selection methodology does

[30]Under the 1987 Act, the Secretary of Agriculture is prohibited from approving, for farm program payment purposes, any change in a farming operation that will increase the number of persons to which the payment limitations apply unless the change is bona fide and substantive. 7 U.S.C. § 1308.

[31]For 72 of the 1,573 sampled entities, survey respondents did not provide information on whether the reviews for these entities were waived or will be conducted in the future. In addition, we were unable to determine the field offices responsible for reviewing 12 of the 1,573 sampled entities.

[32]State offices may waive selected compliance reviews for farming operations that were previously reviewed, did not receive an adverse determination, and for which the reviewing authority has no reason to believe there have been changes that affect the original eligibility decision.

not take into consideration how review waivers result in a smaller final sample size that may affect the validity of the sample results. Consequently, the results from the review of these 523 entities provide only a limited assessment of the population of all 247,831 entities. In discussing this issue with FSA headquarters officials in February 2004, they said the sampling process was developed in the mid-1990s and acknowledged that it can be improved and better targeted. In responding to a draft of this report, FSA noted that it is currently discussing changes to the current selection process with USDA's Office of Inspector General.

Although a smaller sample size of operations can produce reliable results for assessing compliance nationwide, certain statistical methods have to be used to provide that level of assurance.[33] However, FSA is not using these methods.

Field Offices Do Not Always Conduct Compliance Reviews in a Timely Manner

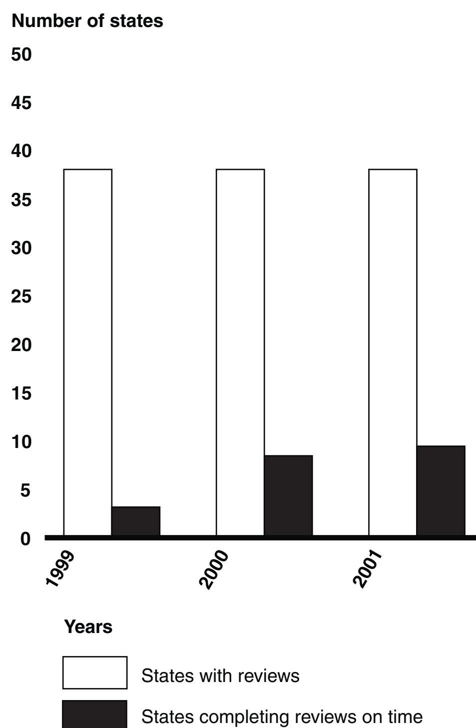
Only 9 of 38 FSA state offices responsible for conducting compliance reviews for 2001 completed the reviews and reported the results to FSA headquarters within 12 months, as FSA policy requires.[34] FSA headquarters selected the 2001 sample on March 27, 2002, and forwarded the selections to its state offices on April 4, 2002. FSA headquarters required the state offices to conduct the compliance reviews and report the results by March 31, 2003. Six of the 26 FSA state offices that failed to report the results to headquarters had not yet begun these reviews for 470 farming operations as of summer 2003: Arkansas, California, Colorado, Louisiana, Ohio, and South Carolina. Until we brought this matter to their attention in July 2003, FSA headquarters staff were unaware that these six states had not conducted compliance reviews for 2001. Similarly, they did not know the status of the remaining 20 states that were required to report the results of their compliance reviews. Because of this long delay, FSA cannot reasonably assess the level of recipients' compliance with the act and may be missing opportunities to recapture payments that were made to ineligible recipients if a farming operation reorganizes or ceases operations. FSA officials in the six states told us that implementing various provisions of the Farm Security and Rural Investment Act of 2002, which

[33]The smaller sample size would be sufficient if FSA used a probability sample design to select a representative sample of farm entities. In this case, a desired precision and level of confidence could be used to determine the sample size. Use of a probability sample allows the projection of results from the sample to the population as a whole.

[34]Three additional FSA state offices submitted the required report after the due date.

was enacted in May 2002, took precedence over conducting the 2001 compliance reviews. Figure 4 shows, for 1999 through 2001, that few states annually complete the compliance reviews within 12 months, as required by FSA.

Figure 4: Number of States with Farming Operations Selected for Compliance Reviews and Number of States that Completed the Reviews within 12 Months, 1999 to 2001



Source: FSA.

Note: GAO analysis of FSA data.

FSA Staff Do Not Use All Available Tools in Assessing Compliance and Do Not Maintain Documents to Support Their Decisions

Our review of case files indicate that for one-half of the farming operations we reviewed in 2001, field offices did not use all available tools to determine whether persons are actively engaged in farming, such as conducting interviews, to substantiate management contributions or obtaining key financial information to verify that farm program payments are going to separate and distinct entities. FSA policy requires field staff

conducting the compliance reviews to interview persons asserting that they are actively engaged in farming before making a final eligibility decision, unless the reason for not interviewing the person is obvious and adequately justified in writing.[35] Indeed, 83 percent of field offices responding to our survey indicated that interviews are helpful in conducting compliance reviews. However, in 27 of the 86 case files we reviewed in six states, field staff did not interview persons asserting that they met the active engagement in farming requirement and did not adequately document why they had not conducted interviews. In one of the states we visited, field staff had not conducted any interviews.

We also found that some field offices do not obtain and review certain key financial information regarding the farming operation before making final eligibility decisions. For example, our review of case files indicate that for one-half of the farming operations, field staff did not use financial records, such as bank statements, cancelled checks, or accounting records, to substantiate that capital was contributed directly to the farming operation from a fund or account separate and distinct from that of any other individual or entity with an interest in the farming operation, as required by FSA's policy.[36] Instead, FSA staff often rely on their personal knowledge of the individuals associated with the farming operation to determine whether these individuals meet the requirement for active engagement in farming. Furthermore, during our field office visits, we identified at least one state FSA office that requires its field staff to obtain only 3 months of bank statements to conduct the compliance reviews. Because the field staff obtained only 3 months of bank statements, we were unable to determine whether an individual's or entity's capital contributions to the farming operation were from a fund or account separate and distinct from any other individual or entity with an interest in the farming operation. According to FSA staff in field offices in other states that we visited, 12 months of bank statements are critical to gain complete and accurate understanding of transactions among individuals and entities within a farming operation. Similarly, 77 percent of field offices responding to our survey indicated that obtaining 12 months of bank statements is helpful in conducting compliance reviews.

[35]*FSA Handbook Payment Limitations, 1-PL (Revision 1), Amendment 40.*

[36]*FSA Handbook Payment Limitations, 1-PL (Revision 1), Amendment 40.*

Finally, FSA field staff do not always maintain documentation supporting their decisions on the results of their compliance reviews, as required by FSA policy.[37] For example, in 31 of 86 compliance review cases we examined, the files contained a worksheet documenting the decision but no evidence to show how FSA verified the recipient's input contributions—capital, land, or equipment—to the farming operation. That is, FSA could not document whether (1) the recipient's contribution of inputs to the farming operation were significant and (2) these inputs were at risk.

FSA Does Not Consistently Collect and Analyze Monitoring Data

FSA has not established a methodology for collecting and summarizing compliance review data so that it can (1) reliably compare farming operations' compliance with the actively engaged in farming requirements from year to year and (2) assess its field offices' conduct of compliance reviews. Under Office of Management and Budget Circular A-123, agencies are required to develop and implement management controls to reasonably ensure that they obtain, maintain, report, and use reliable and timely information for decision-making. Because FSA has not instituted these controls, it cannot determine whether its staff are consistently applying the payment eligibility requirements across states and over time. For example, as discussed above, until we brought it to their attention, FSA headquarters staff were unaware that 6 of 38 states responsible for conducting compliance reviews, had not begun the reviews for 2001, even though state compliance review results were due to headquarters by March 31, 2003. As of July 2003, another 20 states had not submitted their compliance review results to headquarters for 2001. In addition, 8 of these 20 states had not submitted any compliance review results for 1998 through 2001. Until we began this review, FSA had not examined the data it had collected to identify potential problem areas and develop strategies for addressing them. Since we brought this issue to its attention, however, FSA has begun to consider how it can obtain and systematically review the data.

As of January 2004, FSA had completed only 347 of the 523 farming operations scheduled for review for 2001. Of the 347 farming operations that were reviewed, FSA found 18 operations with members that were not in compliance with the actively engaged in farming requirements. According to FSA, debt collection procedures may be taken against these

[37] *FSA Handbook Payment Limitations, 1-PL (Revision 1), Amendment 40.*

18 operations because they received farm program payments that they were ineligible to receive.[38]

FSA Staff Responsible for Compliance Reviews Have Not Received Training

The implementation problems we have identified are exacerbated by a lack of training for FSA staff on the actively engaged in farming requirements and payment limitations. Training has generally not been available since the mid-1990s, which has led to difficulty in assessing compliance with the payment limitation and eligibility rules. For example, in 8 of the 16 field offices we visited, staff had not received updated training on how to conduct these reviews, which may have contributed to some of the problems we identified in making eligibility determinations. In one field office in California, FSA staff conducting the compliance reviews found errors in the initial eligibility determination for four farming operations reviewed.[39] For example, in one case, the review found the original eligibility determination was incorrect because a farming operation did not have separate contracts reflecting the fair market value of both leased equipment and hired labor, as required by FSA policy when the equipment and labor are provided by one individual.

In another field office, in Texas, FSA staff found that one of three members of a joint venture was not actively engaged in farming for 2001 and therefore was ineligible to receive $65,541 in farm program payments. The member had asserted he contributed active personal management to the joint venture, but the review found that the individual had received several checks totaling $104,000 for management fees. However, according to FSA's regulations, individuals cannot receive compensation for their contribution of active personal management. The member appealed the decisions to FSA, stating he was not skilled in bookkeeping and simply miscoded the checks issued to him by the joint venture as management fees. The member was allowed to amend his paperwork to be in compliance with active engagement requirements. He retained his $65,541 in program payments and repaid the $104,000 to the farming operation as repayment of a loan with interest. According to FSA staff, they were not

[38]Noncompliance decisions are not final; payment recipients may appeal the decisions within USDA.

[39]At the beginning of the planting season, FSA field offices review each recipient's farm operating plan to determine whether the recipient's plan meets the requirement for active engagement in farming.

aware that FSA's policy prevented such amendments and they believe that training would help to avoid such problems in the future.

Similarly, over one-third of survey respondents noted that they had never received formal training or that it had been at least 5 years since they received training on the payment limitation and eligibility rules, and 85 percent indicated that training is helpful in conducting compliance reviews. Additionally, 132 respondents in 535 field offices surveyed provided written comments regarding the need to receive training. For example, one respondent noted that FSA staff in one state received limited training on payment limitation and eligibility rules and are either not comfortable making compliance decisions or are making inaccurate decisions. Other respondents commented that more training, specifically on accounting and legal issues, is needed to better understand how to apply the eligibility requirements to complex legal entities. In discussing this issue with FSA headquarters officials in February 2004, they acknowledged that they have not provided updated training in recent years and agreed that this lack of training is a problem. They said that although budgetary and resource constraints limit training, FSA intends to offer some training to staff in its state offices in 2004. However, decisions to provide training to staff in field offices are made by FSA's state offices.

General Partnerships Received Almost One-Half of Farm Program Payments Made to Entities

Of the approximately $17 billion in federal farm program payments in 2001 to 1.3 million recipients—individuals and entities—over one-third of these payments, or $5.9 billion, went to 141,884 entities.[40] Corporations and general partnerships represented 39 and 26 percent of these entities, respectively, followed by joint ventures, and other types of farming operations, according to our analysis of FSA's databases. Corporations received 38 percent of the program payments to entities, or $2.2 billion, while general partnerships received 45 percent of the payments, or $2.7 billion. Joint ventures, and other entities—such as limited partnerships, trusts, and charitable organizations—received the remaining 17 percent of program payments going to entities, or $1.0 billion. Table 2 shows the types of entities and the farm program payments they received in 2001.

[40]The total for entities does not include 17,964 entities that received $938 million because FSA's files were incomplete and we were unable to identify the type of entity.

Table 2: Types of Entities and Total Farm Program Payments, 2001

Dollars in millions

Type	Entities		Payments	
	Number	Percent	Total	Percent
Corporations	54,637	38.5	$2,248	37.9
General partnerships	37,193	26.2	2,684	45.2
Joint ventures	8,888	6.3	583	9.8
Other[a]	41,166	29.0	419	7.1
Total	**141,884**	**100.0**	**$5,934**	**100.0**

Source: GAO analysis of FSA data.

Notes:

Data include production flexibility contract payments, market loss assistance payments, loan deficiency payments, and marketing assistance loan gains. In 2001, recipients were limited to $40,000 for production flexibility contract payments, $40,000 for market loss assistance payments, and $150,000 for loan deficiency payments and marketing assistance loan gains. Recipients in three entities could receive up to double the amount for each of these types of payments.

Data do not include 17,964 entities that received $938 million because we were unable to identify the type of entity.

[a]Includes limited partnerships, estates, trusts, charitable organizations, and federal agencies.

General partnerships receive more farm program payments as the number of partners in partnerships increase. General partnerships with 2 partners collected an average of $57,890 in farm program payments in 2001, while partnerships with more than 20 partners collected an average of $698,235. Table 3 shows the type and number of entities receiving federal farm program payments in 2001.

Table 3: Type and Number of Entities and Farm Program Payments, Categorized by the Number of Members, 2001

Type	Partners/members	Entities		Payments		
		Number	Percent	Total	Percent	Average
General partnerships	2	19,152	51.5	$1,108,708,233	41.3	$57,890
	3-5	15,459	41.6	1,169,100,368	43.6	75,626
	6-10	2,296	6.2	335,485,915	12.5	146,118
	11-20	252	0.7	46,975,225	1.8	186,410
	21 or more	34	0.1	23,739,989	0.9	698,235
	Total	**37,193**	**100.0**	**$2,684,009,730**	**100.0**	**$72,164**
Joint ventures	2	5,707	64.2	$407,817,751	70.0	$71,459
	3-5	2,523	28.4	123,250,433	21.2	48,851
	6-10	537	6.0	42,432,967	7.3	79,019
	11-20	104	1.2	5,184,475	0.9	49,851
	21 or more	17	0.2	3,893,350	0.7	229,021
	Total	**8,888**	**100.0**	**$582,578,976**	**100.0**	**$65,547**
Total	**2**	**24,859**	**53.9**	**$1,516,525,984**	**46.4**	**$61,005**
	3-5	**17,982**	**39.0**	**1,292,350,801**	**39.6**	**71,869**
	6-10	**2,833**	**6.1**	**377,918,882**	**11.6**	**133,399**
	11-20	**356**	**0.8**	**52,159,700**	**1.6**	**146,516**
	21 or more	**51**	**0.1**	**27,633,339**	**0.8**	**541,830**
	Total	**46,081**	**100.0**	**$3,266,588,706**	**100.0**	**$70,888**

Source: GAO analysis of FSA data.

Notes:

Data include production flexibility contract payments, market loss assistance payments, loan deficiency payments, and marketing assistance loan gains. In 2001, recipients were limited to $40,000 for production flexibility contract payments, $40,000 for market loss assistance payments, and $150,000 for loan deficiency payments and marketing assistance loan gains. Recipients in three entities could receive up to double the amount for each of these types of payments.

Percentages may not total to 100 due to rounding.

More detailed information on farm program payments to general partnerships and joint ventures is contained in appendix III.[41]

[41] In addition, for more detailed information on the distribution of farm program payments to farming entities, see U.S. Department of Agriculture, Office of the Chief Economist, Commission on the Application of Payment Limitations for Agriculture, *Report of the Commission on the Application of Payment Limitations for Agriculture* (Washington, D.C.: August 2003).

Conclusions

The Farm Program Payments Integrity Act of 1987, while enacted to limit payments to individuals and entities actively engaged in farming, allows farming operations to maximize the receipt of federal farm payments as long as all recipients meet eligibility requirements. However, we found cases where payment recipients may have developed methods to circumvent established payment limitations. This seems contrary to the goals of the 1987 Act and was caused by weaknesses in USDA's regulation and oversight. The regulations need to better define what constitutes a significant contribution of active personal management and clarify whether fraudulent intent is necessary to find that someone has adopted a scheme or device. Without specifying measurable standards for what constitutes a significant contribution of active personal management, FSA allows individuals who may have had limited involvement in the farming operation to qualify for payments. By providing more specific requirements for what constitutes a significant contribution of active personal management, as it has for other eligibility requirements, FSA could help ensure that individuals receiving farm program payments are not simply getting paid for allowing their name to be used in a farming operation document. Furthermore, because of a lack of clarity in its regulations, FSA may be reluctant to pursue whether certain farming operations such as those we found are schemes or devices. By acting to resolve these issues, the government could save millions of dollars in farm payments annually.

Moreover, FSA is not providing adequate oversight of farm program payments under its current regulations and policies. First, its sampling methodology does not eliminate from the universe of farming operations those operations recently reviewed for compliance with the payment limits. These operations are therefore included in the sample and then waived for review. In effect, FSA is missing opportunities to review a more representative sample of operations to better determine overall compliance with the payment limitations. Second, FSA's compliance reviews are often completed late. As a result, FSA may be missing opportunities to recoup ineligible payments from farming operations. Third, when FSA's field offices do not use available tools to determine whether recipients are actively engaged in farming, such as interviews to substantiate management contributions, they miss opportunities to better ensure that recipients are eligible for farm payments. Fourth, FSA lacks a system for reviewing compliance reports so it can reliably compare, on a national basis, farming operations' compliance with the actively engaged in farming requirements from year to year and assess its field offices' conduct of compliance reviews. Finally, FSA staff do not receive the periodic training

they need to ensure that they can ascertain whether individuals receiving farm program payments meet the requirements for active engagement in farming.

Recommendations for Executive Action

To better ensure that recipients of farm program payments do not circumvent payment limitations, we recommend that the Secretary of Agriculture direct the Administrator of the Farm Service Agency to take the following eight actions:

- develop and enforce measurable requirements defining a significant contribution of active personal management;
- revise its regulations to clarify whether schemes and devices require fraudulent intent and seek congressional authority if necessary;
- issue more detailed guidance on the kinds of arrangements that may constitute a scheme or device under its regulations;
- improve the sampling methodology for selecting farming operations for review in order to have greater assurance that only eligible recipients receive payments;
- ensure that FSA field offices conduct compliance reviews in a timely manner;
- develop management controls to ensure that FSA field staff make use of all available tools to assess payment recipients' compliance with the act;
- establish and maintain a consistent methodology for collecting, analyzing, and summarizing data to identify patterns and trends in compliance over time and across states; and
- provide training that emphasizes the financial and legal aspects of compliance reviews.

Agency Comments and Our Evaluation

We provided USDA with a draft of this report for its review and comment. We received written comments from USDA's Under Secretary for Farm and Foreign Agricultural Services. The department agreed to act on most of our recommendations, including whether its guidance on what constitutes a

scheme or device can be improved and whether it can develop a better methodology for selecting farms for review. It, however, disagreed with recommendations to develop measurable requirements for defining a significant contribution of active personal management and to revise its regulations to clarify whether schemes and devices require fraudulent intent.

With respect to developing a measurable standard for a significant contribution of active personal management, USDA believes that its implementation of the 1987 Act is consistent with the intent of the Congress. USDA agreed that it would be beneficial to have a measurable standard to help measure active personal management for those recipients required to be actively engaged in farming. It stated that a measure of time was proposed when initial rules were written to implement the 1987 Act. However, based on comments it received, USDA removed the time measure from the proposed regulations and adopted a standard based on the relative worth of the active personal management performed. No measurable standards are provided to assist reviewing authorities in making judgments on whether reported contributions meet the active personal management requirement. While it may be difficult, we believe that it is possible and necessary to develop a measurable standard to better assure that recipients are making a meaningful contribution of active personal management. We note that the U.S. Internal Revenue Service has established time as a measurable standard to determine material participation in a business enterprise. USDA stated that FSA is faced with something of a dilemma in the implementation of the 1987 Act in that the act requires participants to provide significant contributions to the farming operation in order to receive payments, but other, more recent statutes allow recipients to receive certain payments without growing crops. USDA does not suggest that these recent statutes have repealed the actively engaged in farming requirements.

USDA also disagreed with our recommendation to clarify its regulations on whether fraudulent intent is necessary to demonstrate a scheme or device, stating that current regulations are sufficiently clear. By focusing on the difference between avoidance and evasion in its written comments, FSA seems to imply that it is necessary to demonstrate fraudulent intent to show the adoption of a scheme or device. However, as we note in this report, FSA's regulations on the need to demonstrate intent are unclear. In a February 2004 meeting with USDA officials, they agreed the current regulations may deter FSA field officials from challenging the types of cases we identify in our report that may be evading the payment limitation

provisions. They noted that the types of operations we identify in this report as possible schemes or devices are not specifically addressed in the regulations, and they were not sure if these cases would meet the criteria for a scheme or device. However, in its written comments, USDA did agree to review its procedures on scheme or device to determine if it can provide additional guidance, as we recommend.

Regarding our recommendation to improve its methodology for selecting farming operations for compliance reviews, USDA commented it is considering what, if any, actions it could take to improve its methodology. However, USDA also stated that it uses a judgmental sample and that its methodology is valid for the requirements of such a sample. We do not question USDA's use of a judgmental sample. Our recommendation to improve the sampling methodology is based on the concern that USDA annually waives over one-half of its selected sample and does not replace these waived cases with other selections. If USDA intends to use a sample size that is less than one-half of the farming operations initially selected for review, it must use statistical methods to provide reasonable assurance of compliance with the payment limitations.

USDA also commented that the vast majority of payment recipients are eligible under any current eligibility test or restriction imposed by the Congress. Our analysis shows that 90 percent of payment recipients receive about one-third of farm payments, indicating that the vast majority of recipients are not likely to reach the payment limits. However, based on our review of USDA's oversight procedures, we do not have sufficient information to comment on USDA's assertion that a vast majority of payment recipients are eligible under any test or restriction imposed by the Congress.

FSA also provided technical corrections, which we have incorporated into the report as appropriate. FSA's written comments are presented in appendix V.

As arranged with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 30 days from its issue date. At that time we will send copies of this report to appropriate congressional committees, the Secretary of Agriculture; the Director, Office of Management and Budget; and other interested parties. In addition, this report will be available at no charge on GAO's Web site at http://www.gao.gov.

If you have any questions about this report, please contact me at (202) 512-3841. Key contributors to this report are listed in appendix VI.

Sincerely yours,

Lawrence J. Dyckman
Director, Natural Resources
and Environment

Common Ways Farmers Organize Their Farming Operations

Farmers organize their farming operations in various ways to reduce their exposure to farming's financial risks. For example, certain business structures may limit a farmer's liability when the farming operation has legal problems or debt that cannot be paid from farm earnings. These risk-reducing entities may receive up to $180,000 in farm program payments annually under payment limitation rules regardless of how many members, partners, or shareholders they have.[1] Some of the most common ways farmers organize their business and how these business organizations are treated under payment limitation rules are as follows:

- Sole Proprietorship. About 89 percent of farming operations are owned, operated, and managed by a single individual. A sole proprietorship has no legal existence independent of its owner, which means that only the owner, not the farming operation, can be sued. Owners of sole proprietorships are personally liable for all their farm's debts. Individuals running sole proprietorships are limited to $180,000 in payments for their farming operations.

- Joint Ventures. Joint ventures, defined by FSA as two or more individuals who pool resources and share profits or losses, make up about 1 percent of farming operations receiving payments. As with sole proprietorships, joint operations have no legal existence independent of their owners. Members in a joint operation have unlimited personal liability for the farm's debts. Each member in a joint venture is limited to $180,000 in payments. Adding members to the joint venture could qualify the farming operation for an additional $180,000 in payments for each new member.

- General Partnerships. General partnerships are the simplest form of partnership and most states permit their formation with just an oral agreement. FSA makes farm program payments directly to the partnership rather than to the individual partners, which may be individuals or entities. Each partner can qualify the general partnership for $180,000 in payments. The general partnership can qualify for

[1]Recipients who also produce peanuts may receive up to an additional $40,000 in direct payments, $65,000 in counter-cyclical payments, and $75,000 in loan deficiency payments and marketing assistance loan gains, for a total of up to an additional $180,000 per year. Also recipients of Conservation Reserve Program payments, to retire environmentally sensitive land, may receive up to an additional $50,000 per year. Under the three-entity rule, recipients who produce peanuts may receive up to $360,000 in payments, and recipients who receive Conservation Reserve Program payments may receive up to $100,000 in payments.

additional payments by adding more individuals or entities to the partnership. Each partner is personally liable for that partner's own conduct and for the conduct of those under that partner's direct supervision, as well as negligence, wrongful acts, and misconduct of other partners and partnership employees. Partners are personally liable for partnership commercial obligations such as loans or taxes. About 3 percent of farming operations are organized as general partnerships.

- Corporations. Corporations have a separate legal existence from their owners, meaning that the corporation rather than the owners is ordinarily responsible for farm business debts and that the corporation can be sued. As a result, some individuals may choose the corporate form of farm business organization to protect their personal assets in case of farm financial difficulties. About 5 percent of farming operations are organized as corporations.

- Limited Liability Companies. Limited liability companies are a hybrid form of business entity because they have the limited liability feature of a corporation and the income tax treatment of a general partnership. Their owners are called members.

- Limited Liability Partnerships. Limited liability partnerships, another hybrid organizational form, eliminate the liability of an individual partner for negligence, wrongful acts, and misconduct of other partners and partnership employees. Each partner remains personally liable for that partner's own conduct and for the conduct of those under that partner's direct supervision. Partners remain personally liable for partnership commercial obligations such as loans or taxes.

- Limited Partnerships. Limited partners in a limited partnership are investors whose liability for partnership financial obligations is only as great as the amount of their investment. A limited partnership must have at least one general partner who manages the farm business and who is fully liable for partnership financial obligations to be considered eligible for farm program payments.

- Other. Other types of entities that may qualify as one person under current payment limitation rules include an irrevocable trust, a revocable trust combined with the grantor of the trust, an estate, or a charitable organization. States along with their political subdivisions and agencies are considered one person under current payment

limitation rules. Each of these entities is limited to $180,000 in payments.

Under payment limitation rules, spouses jointly operating a farm may be treated as two separate recipients if neither spouse owns a substantial share of another entity that receives farm program payments separately. Spouses can also be treated as two separate recipients for payment limitation purposes if they each operated a farm independently before marriage and continue to do so after marriage. In that case, the spouses would be operating two independent farms, not jointly operating a farm.

Objectives, Scope, and Methodology

At the request of the Chairman of the Senate Committee on Finance, we reviewed the Farm Service Agency's (FSA) implementation of the payment eligibility provisions of the Farm Program Payments Integrity Act of 1987. Specifically, we agreed to (1) determine how well FSA's regulations for active engagement in farming help limit farm program payments; (2) assess the effectiveness of FSA's implementation of the act and the corresponding regulations; and (3) summarize the distribution of farm payments by type of entity, such as a corporation, partnership, and trust.

To determine how well FSA's regulations for active engagement in farming help limit farm program payments to producers actively engaged in farming, and how effectively FSA is implementing the act to achieve this goal, we examined the guidance that FSA's field offices use to monitor farmers' compliance with the payment limitation and eligibility requirements, including relevant laws; the Code of Federal Regulations, title 7, parts 795 and 1400; and agency policy, including the *FSA Handbook Payment Limitations*, *1-PL (Revision 1)*, *Amendment 40*, and related state amendments and notices.

To evaluate FSA's application of procedures and standards and to assess the overall effectiveness of its review process for deciding whether recipients are actively engaged in farming, we reviewed selected participant files and conducted a two-part, Web-based, non-probability survey of all 535 field offices that had farming operations selected for review in FSA's sample for 2001, the latest year for which data are available. Some FSA county directors managed field offices in more than one county. Consequently, our survey sample consists of 522 respondents, or county directors, representing the 535 field offices. The first part of the survey solicited detailed information about 1,561 farming operations selected for review in the 535 field offices; the second part was designed to obtain the views of field staff on issues about the actively engaged in farming requirements and payment limitation rules.[1] In part 1 of the survey, we received responses for 96 percent of the 1,561 farming operations selected for review by FSA for 2001, and we received responses from 89 percent of the 522 respondents queried in part 2 of our survey. FSA's compliance files with the needed information from completed reviews—farm operation documents, including leases, contracts, partnership agreements,

[1]FSA selected 1,573 farming operations for review for 2001. However, due to data inconsistencies, we were unable to determine the field offices responsible for reviewing 12 of the 1,573 farming operations.

accounting records, bank statements, and tax statements—were available only for 347 of the 1,561 farming operations reviewed in part 1 of the survey. The remaining farming operations had no response (72), an incomplete review (58), no review (118), or were waived (966).

In developing the Web-based questionnaire, we met with officials in FSA's headquarters to gain a thorough understanding of payment limitation and eligibility issues. We also shared a draft copy of the questionnaire with these officials who provided us comments including technical corrections. We then pretested the questionnaire with staff in three FSA field offices in Texas, as well as staff in one office in California, Maryland, Mississippi, and Nebraska. During these pretests, we asked the officials to complete the Web-based survey as we observed the process. After completing the survey, we interviewed the respondents to ensure that (1) the questions were clear and unambiguous, (2) the terms we used were precise, (3) the questionnaire did not place an undue burden on the agency officials completing it, and (4) the questionnaire was independent and unbiased. On the basis of the feedback from the pretests, we modified the questions as appropriate.

Information about accessing the questionnaire was provided via e-mail for those FSA staff selected to participate in the survey. The survey was activated, and staff informed of its availability on October 21, 2003; it was available until January 5, 2004. To ensure security and data integrity, we provided each FSA field staff with a password that allowed him or her to access and complete a questionnaire for the local office. No one else could access that questionnaire or edit its data. We also provided these staff with a pledge of confidentiality to ensure their candor in completing the survey. Selected tables from part 1 of the survey, and all responses from part 2 of the survey, are summarized in appendix IV.[2]

We also visited 16 FSA field offices located in six states to discuss implementation of the payment limitation and eligibility requirements and review compliance files in order to evaluate FSA's application of procedures and standards and to assess the overall effectiveness of its review process for deciding whether recipients are actively engaged in

[2]In addition to responding to our survey questions, many of these field staff also provided us with written comments. Because of the volume of these written comments as well as the need to ensure the confidentiality of individual responses, these comments have not been included in appendix IV.

farming. FSA's compliance files with the needed information—farm operation documents, including leases, contracts, partnership agreements, accounting records, bank statements, and tax statements—are available only for those farming operations in the 535 FSA field offices selected for review. FSA does not require entities not selected for review to provide supporting documentation. As such, it was impractical for us to obtain the documents needed for a reliably projectable sample from the total population of entities. During our field office visits, FSA had only completed its examination of 250 of 523 farming operations it planned to review for 2001.[3] Five states had the largest number of reviews—Arkansas, California, Louisiana, Mississippi, and Texas—and in these states, the reviews were generally concentrated in a small percentage of counties in each state.[4] We examined 86 of the 250 completed reviews in the counties with the largest number of completed reviews. For comparative purposes, we also reviewed files in several counties in Nebraska, which is a large producer of corn and soybeans.

To summarize the distribution of farm payments by type of farming operation, we obtained and analyzed FSA's computer databases for program payments and the individuals or entities receiving these payments. For these entities, the databases contain detailed information on the individuals that are members or beneficiaries, their share of payments, and additional organizational details, allowing us to determine the total number and type of entities receiving payments. We assessed the reliability of FSA's data by (1) performing electronic testing of required data elements, (2) reviewing existing information about the data and the system that produced them, and (3) interviewing agency officials knowledgeable about the data. We determined that the data were sufficiently reliable for the purposes of this report.

Finally, we also interviewed members of the Commission on the Application of Payment Limitations for Agriculture and reviewed the Commission's 2003 report.[5] In addition, we spoke with officials from U.S.

[3]As of January 2004, FSA had completed 347 reviews of farming operations.

[4]At the time of our study, Arkansas had not begun conducting the reviews of its farming operations.

[5]See U.S. Department of Agriculture, Office of the Chief Economist, Commission on the Application of Payment Limitations for Agriculture, *Report of the Commission on the Application of Payment Limitations for Agriculture* (Washington, D.C.: August 2003).

Department of Agriculture's (USDA) Office of Inspector General and agriculture experts including attorneys specializing in agriculture law.

We conducted our review from May 2003 through March 2004 in accordance with generally accepted government auditing standards.

Distribution of Farm Program Payments by Type of Entity and Number of Members, Crop Year 2001

Table 4: Number of General Partnerships and Farm Program Payments, Categorized by the Number of Partners, Crop Year 2001

	Partnerships		Payments		
Partners	**Number**	**Percent**	**Total**	**Percent**	**Average**
2	19,152	51.49	**$1,108,708,233**	41.31	$57,890[a]
3	8,761	23.56	**582,729,706**	21.71	66,514
4	4,763	12.81	**397,777,416**	14.82	83,514
5	1,935	5.20	**188,593,246**	7.03	97,464
6	1,145	3.08	**170,981,215**	6.37	149,329
7	474	1.27	**40,233,582**	1.50	84,881
8	338	0.91	**57,999,373**	2.16	171,596
9	204	0.55	**41,491,143**	1.55	203,388
10	135	0.36	**24,780,602**	0.92	183,560
11	80	0.22	**9,405,677**	0.35	117,571
12	58	0.16	**18,557,203**	0.69	319,952
13	30	0.08	**3,553,851**	0.13	118,462
14	26	0.07	**2,405,065**	0.09	92,503
15	19	0.05	**1,383,891**	0.05	72,836
16	11	0.03	**801,281**	0.03	72,844
17	15	0.04	**4,031,603**	0.15	268,774
18	6	0.02	**3,156,810**	0.12	526,135
19	1	0.00	**2,699**	0.00	2,699
20	6	0.02	**3,677,143**	0.14	612,857
21	3	0.01	**1,439,238**	0.05	479,746
22	3	0.01	**715,474**	0.03	238,491
23	3	0.01	**45,587**	0.00	15,196
24	2	0.01	**233,113**	0.01	116,557
25	5	0.01	**400,056**	0.01	80,011
26	2	0.01	**780,961**	0.03	390,481
27	1	0.00	**107,960**	0.00	107,960
28	2	0.01	**744,506**	0.03	372,253
29	2	0.01	**24,168**	0.00	12,084
30	1	0.00	**298,291**	0.01	298,291
More than 30	10	0.02	**18,950,634**	0.71	1,895,063
Total	**37,193**	**100.00**	**$2,684,009,727**	**100.00**	**$72,164**

Source: GAO analysis of FSA data.

Notes:

Data include production flexibility contract payments, market loss assistance payments, loan deficiency payments, and marketing assistance loan gains. In 2001, recipients were limited to $40,000 for production flexibility contract payments, $40,000 for market loss assistance payments, and $150,000 for loan deficiency payments and marketing assistance loan gains. Recipients in three entities could receive up to double the amount for each of these types of payments.

Percentages may not total to 100 due to rounding.

[a]Our analysis of the payments received by 19,152 general partnerships composed of two partners in 2001 showed that 1,118 partnerships exceeded the limit of $40,000 for production flexibility contract payments for one "person," and 2,223 partnerships exceeded the limit of $40,000 for market loss assistance payments for one "person."

Table 5: Number of Joint Ventures and Farm Program Payments, Categorized by the Number of Members, Crop Year 2001

	Joint ventures		Payments		
Members	Number	Percent	Total	Percent	Average
2	5,707	64.21	**$407,817,751**	70.00	$71,459
3	1,346	15.14	**59,035,930**	10.13	43,860
4	755	8.49	**39,433,320**	6.77	52,230
5	422	4.75	**24,781,183**	4.25	58,723
6	246	2.77	**20,021,159**	3.44	81,387
7	110	1.24	**6,868,610**	1.18	62,442
8	78	0.88	**5,250,279**	0.90	67,311
9	68	0.77	**4,970,975**	0.85	73,103
10	35	0.39	**5,321,943**	0.91	152,056
11	28	0.32	**1,064,020**	0.18	38,001
12	25	0.28	**173,127**	0.03	6,925
13	15	0.17	**797,214**	0.14	53,148
14	12	0.14	**2,907,815**	0.50	242,318
15	8	0.09	**49,643**	0.01	6,205
16	4	0.05	**44,361**	0.01	11,090
17	3	0.03	**80,937**	0.01	26,979
18	3	0.03	**4,959**	0.00	1,653
19	3	0.03	**35,507**	0.01	11,836
20	3	0.03	**26,892**	0.00	8,964
21	2	0.02	**2,706,729**	0.46	1,353,365
22	1	0.01	**2,377**	0.00	2,377
23	1	0.01	**1,752**	0.00	1,752
24	2	0.02	**15,373**	0.00	7,687
26	1	0.01	**4,356**	0.00	4,356

(Continued From Previous Page)

	Joint ventures		Payments		
Members	**Number**	**Percent**	**Total**	**Percent**	**Average**
28	1	0.01	**46,104**	0.01	46,104
29	1	0.01	**3,154**	0.00	3,154
32	1	0.01	**3,838**	0.00	3,838
35	1	0.01	**56,379**	0.01	56,379
36	1	0.01	**29,834**	0.01	29,834
37	3	0.03	**956,031**	0.16	318,677
49	1	0.01	**47,357**	0.01	47,357
56	1	0.01	**20,067**	0.00	20,067
Total	**8,888**	**100.00**	**$582,578,976**	**100.00**	**$65,547**

Source: GAO analysis of FSA data.

Notes:

Data include production flexibility contract payments, market loss assistance payments, loan deficiency payments, and marketing assistance loan gains. In 2001, recipients were limited to $40,000 for production flexibility contract payments, $40,000 for market loss assistance payments, and $150,000 for loan deficiency payments and marketing assistance loan gains. Recipients in three entities could receive up to double the amount for each of these types of payments.

Percentages may not total to 100 due to rounding.

Results of Survey on Implementation and Effectiveness of Actively Engaged in Farming Requirements

Part 1—2001 End-of-Year Compliance Reviews

Question 1: What is the status of the 2001 end-of-year review for the farming operation?

Completed and the COC has made its decision	Completed, but not yet presented to COC	Started, but not yet completed	Not started	Waived	Don't know/ No answer/ Not checked/ Not completed
318	29	58	118	966	72

Question 2: Please indicate the reason the review was waived.

Farming operation involves only a husband and wife	Farming operation has all land meeting the landowner exemption	Farming operation was previously reviewed and did not receive adverse determination and no changes have occurred since the review	Farming operation is an entity (not a joint operation) with no embedded entities and the members do not have other farming interests receiving program payments	Other	Don't know/ No answer/ Not checked/ Not completed
415	38	467	18	26	2

Question 3: What type of operation is the farm?

Individual	General partnership	Joint venture	Limited liability company	Other	Don't know/ No answer/ Not checked/ Not completed
1	225	105	1	2	13

Question 10: Was the member determined to be actively engaged in the farming operation?

Yes	No- did not meet the left hand requirement	No- did not meet the right hand requirement	Don't know/ No answer/ Not checked/ Not completed
920	10	11	51

Question 12: Did the farming operation contribute capital, land, or equipment on behalf of the member to meet the left-hand requirement?

Yes	No	Don't know/ No answer/ Not checked/ Not completed
826	111	55

Question 13: Did the member contribute capital to meet the left-hand requirement?

Yes	No	Skipped from question 12	Don't know/ No answer/ Not checked/ Not completed
59	52	826	55

Question 17: Did the member contribute equipment to meet the left-hand requirement?

Yes	No	Skipped from question 12	Don't know/ No answer/ Not checked/ Not completed
49	62	826	55

Question 23: Did the member contribute land to meet the left-hand requirement?

Yes	No	Skipped from question 12	Don't know/ No answer/ Not checked/ Not completed
39	70	826	57

Question 30: Did the member contribute active personal labor to meet the right-hand requirement?

Yes	No	Don't know/ No answer/ Not checked/ Not completed
489	446	57

Question 33: Did the member contribute active personal management to meet the right-hand requirement?

Yes	No	Don't know/ No answer/ Not checked/ Not completed
851	75	66

Part 2—Payment Eligibility and Limitation Issues

Question 1: For calendar year 2001, in addition to the judgmental sample selected by the Deputy Administrator for Farm Programs (DAFP), how many other end-of-year reviews were conducted for your county?

0	1	2	3	4	5	12	No answer
397	27	12	7	4	3	1	15

Question 2: When producers claim to provide active personal management, in general, how confident are you that their activities actually meet the right-hand requirements?

Very confident	Confident	Moderately confident	Somewhat confident	Not at all confident	Don't know/ No answer/ Not checked
138	241	56	20	7	4

Question 3: In your opinion, would the following actions strengthen or weaken the application of the claimed contributions of active personal management requirement?

	Greatly strengthen	Generally strengthen	Have no effect	Generally weaken	Greatly weaken	Don't know/ No answer/ Not checked
FSA clarifications of the definition of management	63	220	161	5	0	17
Require the producer to perform specific amounts of management	32	177	185	32	1	39
Require management activities be on-site	63	109	176	47	24	47
Require a certified statement of actual management contributions from the producers (other than the farm operating plan)	43	164	192	26	13	28
Other actions	9	10	12	2	1	432

Question 4: To what extent do the following factors help or hinder you in carrying out end-of-year reviews?

	Greatly helps	Generally helps	Neither helps nor hinders	Generally hinders	Greatly hinders	Don't know/ No answer/ Not checked
Guidance from FSA	100	259	76	13	3	15
Emphasis within FSA on doing end-of-year reviews	60	215	147	14	3	27
State office oversight	76	219	112	25	7	27
Inter-county cooperation	126	239	66	4	2	29

	Greatly helps	Generally helps	Neither helps nor hinders	Generally hinders	Greatly hinders	Don't know/ No answer/ Not checked
Time of year in which end-of-year review lists are received (April)	24	84	192	106	32	28
Time frame in which reviews are to be conducted (April-December)	23	105	196	88	27	27
Having complete federal income tax returns for all relevant producers	185	195	46	13	5	22
Having 12 months of bank statements for all relevant producers	147	213	66	12	7	21
Having supporting documents (other than tax and bank records) from producers	179	247	20	2	4	14
Interviewing producers	135	252	58	7	1	13
Training in conducting end-of-year reviews	247	157	30	1	0	31
Experience in conducting end-of-year reviews	266	181	6	1	0	12
Adverse determinations may be overturned by State Office	18	58	188	115	28	59
Adverse determinations may be overturned by USDA's National Appeals Division	12	47	191	115	41	60
Political influence	2	2	155	98	132	77
Other factors	7	5	10	3	7	434

Question 5: When did you last receive the following types of training on payment limitation and eligibility determinations?

	Within the past year	Within the past 2 to 4 years	5 or more years ago	Never received this training	No answer/ Not checked
Formal, statewide training	79	208	126	41	12
On the job training (i.e., instruction from review team, District Director, or PT on end-of-year reviews)	189	149	62	45	21
Other training	39	22	7	25	373

Question 6: How useful was each type of training in preparing you to make payment limitation and eligibility determinations?

	Extremely useful	Very useful	Moderately useful	Somewhat useful	Of little or no use	Never received this training	No answer/ Not checked
Formal, statewide training	66	174	100	57	14	36	19
On the job training (i.e., instruction from review team, District Director, or PT on end-of-year reviews)	115	179	78	27	7	33	27
Other training	21	19	10	8	1	22	385

Question 7: In the space below, please list any additional resources that would help you in making payment limitation and eligibility determinations.

Provided comments = 200

Did not provide comments = 266

Question 8: When were the following types of payment limitation and eligibility determination training last available to your county committee?

	Within the past year	Within the past 2 to 4 years	5 or more years ago	Never available	Don't know/No answer/ Not checked
Formal, statewide training	19	67	130	136	114
On the job training (i.e., instruction from review team, District Director, or PT on end-of-year reviews)	118	91	63	93	101
Other training	29	9	2	30	396

Question 9: In your opinion, should commodity certificates be counted towards the $75,000 payment limitation that currently only applies to loan deficiency payments and marketing loan gains?

Definitely yes	Probably yes	Uncertain	Probably no	Definitely no	Don't know/ No answer/ Not checked
130	77	48	47	78	86

Question 10: Please explain why you believe commodity certificates should or should not be counted towards payment limitations.

Provided comments = 335

Did not provide comments = 131

Question 11: In your opinion, should nonrecourse marketing loan forfeitures be counted towards the $75,000 payment limitation that currently only applies to loan deficiency payments and marketing loan gains?

Definitely yes	Probably yes	Uncertain	Probably no	Definitely no	Don't know/ No answer/ Not checked
51	56	62	72	119	106

Question 12: Please explain why you believe nonrecourse marketing loan forfeitures should or should not be counted towards payment limitations.

Provided comments = 276

Did not provide comments = 190

Question 13: Please use the space below to provide suggestions or comments on improving the end-of-year review process.

Provided comments = 304

Did not provide comments = 162

Question 14: Please use the space below to provide suggestions or comments on improving payment limitations and eligibility requirements.

Provided comments = 293

Did not provide comments = 173

Question 15: Please use the space below to provide suggestions or comments on FSA's method of selecting farms for review.

Provided comments = 287

Did not provide comments = 179

Question 16: If you would like to provide any other comments on the issues covered in this questionnaire, please provide them in the space below.

Provided comments = 139

Did not provide comments = 327

Comments from the U.S. Department of Agriculture

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

United States Department of Agriculture

Office of the Secretary
Washington, D.C. 20250

TO: Lawrence J. Dyckman
Director
Natural Resources and Environment
General Accounting Office

APR 09 2004

FROM: J. B. Penn
Under Secretary
Farm and Foreign Agricultural Services

SUBJECT: Draft GAO Report: GAO-04-407 Job Code 360338, Farm Program Payments: USDA Needs to Strengthen Regulations and Oversight to Better Ensure Recipients Do Not Circumvent Payment Limitations

The following are general comments in response to the draft subject audit report.

We would note that the portions of the regulations that are the focus of this audit report are basically the same provisions that have been in effect since the implementation of the 1987 amendments to the Food Security Act of 1985 (the 1985 Act), and have not been changed by Congress. We, therefore, believe the current implementation of these provisions is consistent with the intent of Congress.

The 1987 amendments include certain payment eligibility requirements for the receipt of program benefits. Participants must provide significant contributions of inputs such as capital, land, equipment, active personal labor, and/or active personal management to the farming operation. The amendments also include various payment limitation amounts that are applicable to the programs that are subject to these rules now found at 7 CFR Part 1400. With the exception of revised payment limitation amounts, these rules have remained essentially unchanged since the initial implementation of the 1987 amendments to the 1985 Act. However, the programs subject to these rules, and the requirements of these programs, have changed dramatically.

Until the enactment of the Federal Agriculture Improvement and Reform Act of 1996 (the 1996 Act), participants generally had to plant certain crops to be eligible for farm program payments. The payments were linked directly to the actual crops and acreage planted for the program year. Under the 1996 Act and the Farm Security and Rural Investment Act of 2002 (the 2002 Act), the payments were *de-coupled*. Participants in the Direct and Counter-cyclical Program are not required to plant a crop to receive program payments; if a crop is planted, it does not have to be the same crop for which program benefits are received.

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See comment 1.

The result is the Farm Service Agency (FSA) is faced with something of a dilemma in the implementation of the 1987 amendments. One statute requires the participant to provide significant contributions and personal activities to the farming operation to meet payment eligibility requirements. The other statute does not require the participant to conduct any farming activities, i.e., plant a crop, to comply with program eligibility requirements.

The types of farming operations and who/what are conducting the farming operations now are significantly different than in 1987. Certain business organizations, such as limited liability companies, were just beginning to be recognized and utilized at the inception of the 1987 amendments. For a variety of reasons, including business, liability, tax, and economic reasons, the trend is away from farming operations conducted by individuals to larger, more diversified farming operations conducted by joint operations whose members are entities. The application of current rules becomes a challenge, particularly in the determination of who provides the required contributions of active personal management, which is one key area of the subject report.

See comment 2.

An additional requirement is set forth in section 1001D of the 1985 Act that precludes the making of certain payments if the person has a three-year average adjusted gross income in excess of $2.5 million. This rule is applied to the individual and entity, whereas the payment limitation is controlled by "person" as defined by statute and regulation, which in many cases is different than the individual or entity. This "means test" for program payment eligibility has required FSA to request and become familiar with financial information and business documentation not previously an issue for making the required payment eligibility determinations.

See comment 3.

See comment 4.

See comment 5.

While this report mentions some perceived weaknesses in FSA's implementation of the 1987 amendments, and some possible cases of rule violations by program participants, the report fails to mention that the vast majority of payment recipients are eligible under any current eligibility test or restriction imposed by Congress. The total payments received for a large number of farming operations do not approach the amount that one “person” may receive. The actual numbers illustrated in Appendix III of the report bear this out. Appendix III shows that the majority of general partnerships in 2001 that received payments were comprised of two members, and the partnerships of this nature received an average of $58,035 in program payments. By statute, the payment limitation for general partnerships is controlled at the member level. Therefore, with the total amount received divided by the two members, the result is approximately $29,000 each. This appendix does not mention that this $58,035 was the total of **all** production flexibility contract payments, market loss assistance payments, loan deficiency payments, and market loan gains. Pursuant to payment limitations, production flexibility contract payments by themselves could have totaled $40,000 per “person.” Market loss assistance payments could have totaled an additional $40,000 per “person.” Loan deficiency payments and market loan gains for 2001 could have totaled $150,000 per “person.” Therefore, in this illustration, the **total** that each of the members of the general partnership received was well under any of the respective payment limitations. The remainder of Appendix III reveals the same.

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This report examined the review process that the Agency currently utilizes for payment eligibility and payment limitation compliance purposes. As is noted in the report, there are procedures to waive an end-of-year review of a selected farming operation under specific circumstances. However, the report included an erroneous conclusion that if the farming operation is not reviewed, the operation does not have to provide supporting documentation. We would note that all participants of programs subject to the rule at 7 CFR Part 1400 must submit a farm operating plan and supporting documentation for payment eligibility and payment limitation purposes. Program payments and benefits cannot be issued until all required documentation is timely submitted and the appropriate and affirmative payment eligibility and payment determinations are made. A county FSA committee or other reviewing authority may request supporting documentation for a farming operation at any time the activities or representations of the operation are deemed questionable.

See comment 6.

The draft audit report mentioned and illustrated in detail the structure of a large farming operation that was perceived to be a scheme to circumvent the payment eligibility and payment limitation provisions. The report also mentioned that it was organized as a means for a non-farming entity to obtain benefits. The conclusion was made that FSA is reluctant to question these operations because it does not believe current regulations provide sufficient basis to take action. We do not agree with that characterization. The scheme or device provisions of the current regulation and the statute itself provide authority to take action. Determinations of scheme or device can be made, and have been made, under current regulations.

See comment 7.

The following are comments on the specific recommendations for executive actions.

(1) Develop and enforce measurable requirements defining a significant contribution of active personal management.

We appreciate the desirability of establishing measurable requirements for defining a significant contribution of active personal management. As is noted in the draft audit report, such a measurable requirement was proposed in 1988 when the original proposed rule implementing the 1987 amendments to the 1985 Act was published in the Federal Register. It was proposed that a significant contribution of either active personal management or active personal labor be determined as an amount which is the smaller of: (1) 1,000 hours per calendar year; or (2) 50 percent of the total hours which would be required to conduct a farming operation which is comparable in size to such individual's or entity's commensurate share in the farming operation. However, in response to comments received on the proposed rule, the use of time as the measure of significance for a contribution of active personal management was removed from the final rule. We agree that it would be beneficial if there was a standard that was easy to measure and could be applied to all farming operations when determining a significant contribution of active personal management. However, we continue to question whether the amount of time expended in the performance of active personal management is an appropriate measure of significance.

See comment 8.

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See comment 8.

If the length of time it takes to perform active personal management is not the appropriate measure of significance, the remaining alternative would seem to be the relative worth of the active personal management performed. The current regulation and procedure pertaining to active personal management provides that a significant contribution of active personal management is determined by considering whether the activities are critical to the profitability of the farming operation, taking into consideration the individual's or entity's commensurate share in the farming operation. These contributions of active personal management must also be at risk, the same as other contributions to the farming operation. The current procedure requires the reviewing authority to make a judgment as to whether the claimed contribution of active personal management is a significant contribution to the farming operation. Again, we recognize that it would be beneficial if a readily measurable standard, such as the amount of time expended, could be applied. We would again note that these provisions have remained essentially unchanged since the initial implementation of the 1987 amendments to the 1985 Act. Therefore, we believe the current regulations and procedure on this matter are consistent with the intent of Congress.

(2) Revise regulations to clarify whether schemes or devices require fraudulent intent and seek congressional authority if necessary.

See comment 9.

We believe the current regulations are sufficient to encompass the types of cases intended by the statute. The current regulatory definition of scheme or device refers to a scheme or device that "evades" payment limitation and payment eligibility provisions and provides examples of acts that are considered to be schemes or devices. There is a difference between "evasion" and "avoidance" in the realms of both payment limitation and taxes. The terms are not interchangeable. Congress has recognized that a significant number of farming operations are structured to maximize the amount of payments a "person" receives, both directly and indirectly. In fact, many people, including members of Congress, think of the payment limitation as being twice what it actually is; they assume individuals will receive payments in a farming operation that is structured to maximize the amount of payments an individual can receive under the "three entity rule."

(3) Issue more detailed guidance on the kinds of arrangements that may constitute a scheme or device under its regulations.

See comment 10.

As noted above, we believe the current regulations are sufficient to encompass the types of cases intended by the statute. However, we will review our procedures on scheme or device to determine if additional guidance can be provided. We would note that the nature of a scheme or device determination is such that the specifics of a particular case must be examined to determine whether a scheme or device determination is appropriate. Cases that may, on the surface, appear to be similar because of the way the operation is structured, or because of other factors, can currently result in different determinations as to whether a scheme or device has been adopted.

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(4) Improve the sampling methodology for selecting farming operations for review in order to have a greater assurance that only eligible recipients receive payments.

See comment 11.

Any farming operation subject to payment eligibility and payment limitation determinations must provide information on the structure and conduct of the farming operation by completing a farm operating plan for payment eligibility review. Depending on the nature of the farming operation, current procedure may require documentation to support the information on the farm operating plan before the reviewing authority makes payment eligibility and payment limitation determinations. For example, a copy of the trust agreement must be provided for any trust represented to be an irrevocable trust. Additionally, the reviewing authority may require whatever documentation necessary to make proper "actively engaged in farming" and "person" determinations. Therefore, payments are issued only to recipients determined by the reviewing authority to be eligible to receive the payments.

See comment 11.

The current process to select farming operations for "end-of-year" reviews was developed to select operations that are more likely to have an adverse payment limitation or payment eligibility determination. The previous selection process involved a sample drawn from each county. That selection process often resulted in the selection of producers that received minimal payments and/or owned all land in the farming operation. Review of these farming operations was not considered as being a productive use of resources unless there was a reason to question the determinations that had been made for a specific farming operation. The selection process was, therefore, changed to perform a judgmental selection on a nationwide basis and based on the Office of the Inspector General (OIG) methodology.

See comment 11.

The issue was raised in this report that the sampling is not valid or statistically sound. As indicated above, the current process is intended to be a judgmental selection and is not represented to be a statistical sample. The resultant sample is valid to the extent of the sampling requirements. However, we are currently in discussions with OIG to see what, if any, changes to the current selection process would be appropriate.

(5) Ensure that FSA field offices conduct compliance reviews in a timely manner.

We agree it is desirable to conduct reviews in a timely manner. However, an end-of-year compliance review of an operation completed in an acceptable manner requires extensive time and resources. OIG has expended extensive time and personnel resources to complete the review of operations. Although review teams are established to conduct end-of-year reviews, the same FSA field personnel and resources used to conduct the review activities are also expected and required to timely implement and administer all other Agency programs. While deadlines are established and noted for the completion of these reviews, other more pressing issues, such as implementation of the 2002 Act and issuance of program payments and benefits often have to take priority. Ultimately, however, if it is determined payment eligibility requirements were not met because a farming operation was not conducted as represented, adverse determinations are made, and demand letters for refunds issued. This is true even though the review may not have been completed within the period provided by procedure.

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(6) Develop management controls to ensure that FSA field staff make use of all available tools to assess payment recipient's compliance with the act.

See comment 12.

As noted above, conducting an end-of-year review can involve the expenditure of a significant amount of time. Current procedure only requires interviews if documentation does not adequately establish who is providing the claimed contributions. Although we agree that interviews can be beneficial in some cases, we do not believe that requiring interviews in every case would always yield additional meaningful information. However, we agree that "personal knowledge" is not appropriate documentation for an end-of-year review and we will clarify procedure accordingly.

(7) Establish and maintain a consistent methodology for collecting, analyzing, and summarizing data to identify patterns and trends in compliance overtime and across States.

Although current procedure requires reports from State and county offices on end-of-year reviews, we recognize that a consistent methodology is not currently in place to analyze and summarize data to identify patterns and trends. The practical value of such analyses and summaries is subject to question. However, we are currently building a database that will include end-of-year reviews.

(8) Provide training that emphasizes the financial and legal aspects of compliance reviews.

As farming operations become more complex, FSA personnel are required to review many business documents in addition to Agency documents to make the necessary payment eligibility and payment limitation determinations. Agency personnel who are called upon to conduct end-of-year reviews are not auditors. However, we agree that a certain degree of knowledge is required in order to know what certain business documents are, the information to be obtained from them, and how to appropriately review the documents. We are planning a training session for later this year and hope to be able to address the perceived shortcomings identified in the report.

The following are GAO's comments on the U.S. Department of Agriculture's letter dated April 9, 2004.

GAO's Comments

1. USDA stated that FSA is faced with something of a dilemma in the implementation of the Farm Program Payments Integrity Act of 1987 (1987 Act) in that the act requires participants to provide significant contributions to the farming operation in order to receive payments, but other, more recent statutes allow recipients to receive certain payments without growing crops. USDA does not suggest that these recent statutes have repealed the actively engaged in farming requirements. Our congressional requester asked us to address these currently existing statutory and regulatory requirements, which we have done.

2. Our report recognizes the new requirement precluding payments to persons with a 3-year average adjusted gross income in excess of $2.5 million in the background section of this report. This requirement was directed by the Farm Security and Rural Investment Act of 2002, which amended the Food Security Act of 1985.

3. We question FSA's assertion that the vast majority of payment recipients are eligible under any current eligibility test. As we note in this report, FSA has a number of weaknesses in its oversight of farm program payments and as a result does not know how many recipients meet the eligibility requirements of the 1987 Act. Our analysis shows that 90 percent of payment recipients receive about one-third of farm payments, indicating that the vast majority of recipients are not likely to reach the payment limits.

4. We agree that the average payment received by general partnerships composed of two members is less than the total of payment limits for the different types of farm program payments that one "person" may receive. (The average payment illustrated in app. III has been updated to $57,890 from $58,035, which was in the draft report reviewed by FSA.) However, the nature of averages is such that some partnerships received total payments less than the average, and others received total payments greater than the average. For example, our analysis of the payments received by 19,152 general partnerships composed of two members in 2001 showed that 1,118 partnerships exceeded the limit of $40,000 for production flexibility contract payments for one person,

and 2,223 partnerships exceeded the limit of $40,000 for market loss assistance payments for one person.

5. The tables in appendix III of this report and the draft report that USDA reviewed contain notes clearly indicating that the data presented in the tables included production flexibility contract payments, market loss assistance payments, loan deficiency payments, and marketing assistance loan gains, and the corresponding payment limit for each type of payment.

6. FSA misinterpreted our statement regarding supporting documents provided by farming operations when selected for compliance reviews. According to FSA's policy in *FSA Handbook Payment Limitations, 1-PL (Revision 1), Amendment 40*, and as noted in our draft report, before applying for farm program payments, farming operations file a farm operating plan with their local FSA field office. The plan documents the name of each recipient, the number of recipients that qualify for payments, and the recipients' share of profits and losses. FSA reviews the plan to determine the number of recipients that qualify for payments and whether the recipients, based on their statements, are actively engaged in farming. At the end of the year, FSA field offices review a sample of these plans to help monitor whether farming operations were conducted in accordance with these approved plans. For these end-of-year reviews, FSA requires substantially more documents than it requires at the beginning of the year. However, FSA participant files with the needed information for the end-of-year review—farm operation documents, including leases, contracts, partnership agreements, accounting records, bank statements, and tax statements—were readily available only for 523 of the 1,573 farming operations FSA field offices selected for review for 2001. Of the remaining farming operations, 966 had their compliance reviews waived by FSA and therefore were not reviewed. Since FSA did not conduct a review for about two-thirds of the farming operations, FSA field offices did not require these operations to submit additional documents at the end of the year to support the farm operating plan.

7. This statement contradicts what FSA officials told us during a conference in February 2004 to discuss the report's findings. At that time, headquarters officials said the types of operations we identify in the report are not specifically addressed in FSA's regulations and they were not sure if these cases would meet the criteria for a scheme or device. FSA officials also stated they have no data on how many of

these operations exist. The officials indicated that FSA field officials who make noncompliance decisions might be reluctant to question these operations because they do not believe current regulations provide a sufficient basis to take action. The headquarters officials noted it is difficult to prove fraudulent intent and requires significant resources to pursue such cases, and even if a recipient is found ineligible to receive payments this decision may be overturned on appeal. Although FSA noted in its written comments on the draft report that determinations of scheme or device can be made, and have been made, under current regulations, FSA was unable to provide data on the number of actions it has taken in recent years.

8. We continue to believe that FSA needs to better define what constitutes a significant contribution of active personal management. Without specifying measurable standards for what constitutes a significant contribution of active personal management, FSA allows individuals who may have had limited involvement in the farming operation to qualify for payments. Active personal management should be explicitly defined to make this criterion more objective and measurable. We note that the Commission on the Application of Payment Limitations for Agriculture concluded that a lack of clear criteria likely makes it easier for farming operations to add recipients in order to circumvent payment limitations. As we note in this report, the U.S. Internal Revenue Service uses 500 hours to determine material participation in a business enterprise. USDA believes that its implementation of the 1987 Act is consistent with the intent of the Congress. However, USDA agreed that it would be beneficial to have a measurable standard to help measure active personal management for those recipients required to be actively engaged in farming. It stated that a measure of time was proposed when initial rules were written to implement the 1987 Act. However, based on comments it received, USDA removed the time measure from the proposed regulations and adopted a standard based on the relative worth of the active personal management performed. We believe that by providing more specific requirements for what constitutes a significant contribution of active personal management, as it has for other eligibility requirements, FSA could help ensure that individuals receiving farm program payments are not simply getting paid for allowing their name to be used in a farming operation document.

9. Based on USDA's comments to our draft report, it is still not clear whether FSA's regulations, or the statute, require a demonstration of

fraudulent intent in order to find that someone has adopted a scheme or device. By focusing on the difference between avoidance and evasion, FSA seems to imply that it is necessary to demonstrate fraudulent intent. However, as we note in our report, FSA's regulations are unclear on the need to demonstrate fraudulent intent for a scheme or device.

10. We agree that the specifics of each particular case must be examined to determine whether a scheme or device has been adopted. However, we believe that guidance could be more helpful to officials making those determinations if it were to provide some examples of what might constitute a scheme or device.

11. Our recommendation to improve the sampling methodology is based on the concern that USDA's methodology selects many of the same farming operations year after year, and as a result, USDA annually waives compliance reviews for over one-half of its sample. If USDA intends to continue to use this methodology, then it should develop a means to track which farming operations are selected each year and remove these operations from the pool of eligible candidates for the 3 succeeding years. A reasonable probability sampling plan can be devised without having to randomly select farming operations in every county, as USDA's previous plan did. Drawing a few small farming operations in the sample is not a sound reason to avoid all probability-sampling methods. A probability sample is superior to a judgmental sample, which only allows USDA to measure compliance in the selected sample. A probability sample can be projected to the population of all farm payment program recipients, thereby allowing USDA to have greater assurance that only recipients complying with payment limitation requirements receive payments.

12. We agree that requiring FSA staff to conduct interviews for every end-of-year review would not always yield additional meaningful information, and we do not mean to imply the need for interviews in all cases.

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Acknowledgments

In addition to the individuals named above, Thomas Cook, Carol Herrnstadt Shulman, and Cleofas Zapata made key contributions to this report. Important contributions were also made by Jennifer Popovic, Rebecca Shea, and Amy Webbink.

Related GAO Products

Farm Programs: Changes to the Marketing Assistance Loan Program Have Had Little Impact on Payments. GAO-01-964. Washington, D.C.: September 28, 2001.

Farm Programs: Information on Recipients of Federal Payments. GAO-01-606. Washington, D.C.: June 15, 2001.

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