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STRENGTHENING REGULATIONS AND OVERSIGHT TO BETTER ENSURE AGRICULTURE FINANCING INTEGRITY

HEARING

BEFORE THE

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STRENGTHENING REGULATIONS AND OVERSIGHT TO BETTER ENSURE AGRICULTURE FINANCING INTEGRITY

WEDNESDAY, JUNE 16, 2004

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 11:18 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Charles E. Grassley (chairman of the committee) presiding.

Also present: Senators Baucus and Lincoln.

OPENING STATEMENT OF HON. CHARLES E. GRASSLEY, A U.S. SENATOR FROM IOWA, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. Thank you all very much for being patient. A lot of times we come to these hearings late and do not have an excuse. This time, there is a vote on on the floor of the Senate. I have not missed a vote in 11 years, and I am not intent upon missing this one.

So, I thank you all very much for being patient. For those of you who are in the audience, thank you for coming as well. Most importantly, thank you, folks who have prepared testimony, for the hard work that you have done.

This hearing is for the purpose of introducing and discussing a report by the General Accounting Office that evaluated qualifications and oversight associated with farm entity financing.

So, I want to thank Larry Dyckman, Director of Natural Resources and Environment at the General Accounting Office, who will testify, and then Ron Maxon, Tom Cook, Carol Herrnstadt Schulman, and Cleofas Zapata. These are all from the General Accounting Office and all of these people made significant contributions to the material that is being presented today.

As everyone here knows, I have long been an advocate for reasonable, legitimate farm program payment limits. In fact, as a family farmer, I enjoyed some income from at least the AMT this year, and a lot of years also from the loan deficiency payment, and sometimes if we get low prices, from the counter-cyclical payments. So, I am a person who has benefitted from this as well.

But I think, though, that it is legitimate to have good payment limits as well, so I have worked on that and have been successful in the Senate, but not successful in the House to this point, and I am not going to give up on that.

But the American people do, in fact, recognize the importance of the family farmer to our Nation and the need to provide an adequate safety net for family farms.

In recent years, however, assistance to farmers has come under increasing scrutiny. Critics of farm program payments have argued that the largest corporate farms reap most of the benefits of these payments, something like a statistic of 60 percent of the payments going to 10 percent of the Nation's farmers, and that obviously would be the largest farmers.

What is more, farm payments that were originally designed to benefit small- and medium-sized family farmers have contributed to their own demise. Unlimited farm payments have placed upward pressure on land prices and have contributed to over-production and lower commodity prices, driving many family farmers off the farm.

The Senate agreed, by an overwhelming bipartisan vote during the 2002 farm bill debate and two Senate Budget Committee markups that targeting Federal assistance to small- and medium-sized family farmers is the right thing to do.

It has been my hope since the farm bill conference committee dropped the payment limit amendment that Congress would establish legitimate, reasonably payments similar to S. 667, the payment limits bill that I introduced this session.

This hearing, though, is NOT about lowering payment limits to reasonable levels for the 1.3 million individuals and entities receiving farm program payments. Program payments are a necessary element in the "safety net" Congress established to assist family farmers. Some folks forget that I have defended farm payments throughout my career due to the inherent risk involved with agricultural production.

The ability of farm program payments to provide financing to small- and medium-sized producers in times of need has proven to be a crucial instrument for the survivability and sustainability of the agricultural community.

But if Congress is expected to continue to support farm programs, we have to prove to the taxpayers that the programs are tailored for their desired effect. Between 1999 and the year 2002, farmers received approximately $60 billion in Federal farm payments from USDA to support production of "program crops," which include, but are not limited to, corn, cotton, barley, rice, and wheat.

Congress enacted the Agricultural Reconciliation Act of 1987, commonly referred to as the Farm Program Payments Integrity Act, to establish eligibility conditions for recipients and to ensure that only entities "actively engaged in farming" received payments.

To be considered actively engaged in farming, the Farm Program Payments Integrity Act requires an individual or entity to provide a significant contribution of inputs, capital, land, and equipment, as well as a significant contribution of services of personal labor or active management to the family farming operation.

I wrote the General Accounting Office to request an analysis of the implementation and current application of the Farm Program Payments Integrity Act. The 1987 Act created the three entity rule and was intended to tighten rules requiring farm program recipients to be actively engaged in farming.

Congress intended to end abuses such as the widely publicized "Mississippi Christmas tree," where one farm was subdivided into many corporations, each receiving payments up to the established limit.

However, press accounts over the past 2 years have called into question how effective the 1987 Act is. For example, a story in the press described a family owned property which reportedly received $38 million between 1996 and 2001 on a 61,000 acre spread.

The farm was leased to a complex partnership involving 39 local investors, who in turn had 66 separate corporations, which were seemingly created to maximize government payments.

This arrangement, and others like it, raised questions about the interpretation and enforcement of the 1987 Act, and that part of the Act which required each partner to be actively engaged in farming.

Specifically, what standards are being applied to determine whether a significant contribution of active personal labor, active personal management, or a combination of the two is being provided by the payment recipient?

I also asked the General Accounting Office to determine if these standards reflect the intent of Congress in passing the 1987 Act, and if not, what reform is necessary?

The General Accounting Office conducted its review from May of 2003 through March of 2004. The information the General Accounting Office will reveal today shows that just about anybody can get a piece of the pie.

My constituents, who have dirt under their fingernails, have a hard time understanding this. They know that Congress never intended the guy who makes a couple of calls a year to act like he is in the farming process to get the biggest piece of the pie.

I think we can all learn something from this report. Hopefully, this information will help us to get past regional disparities and establishing a new consensus position for the good of the agricultural community.

Once again, I would like to thank the General Accounting Office for their hard work and look forward to hearing your testimony.

Would you like to go ahead, Mr. Dyckman? Oh. Did you want to be recognized?

Senator LINCOLN. I can wait if you want.

The CHAIRMAN. Well, do it right now.

OPENING STATEMENT OF HON. BLANCHE LINCOLN, A U.S. SENATOR FROM ARKANSAS

Senator LINCOLN. Thank you, Mr. Chairman. Thank you for holding this hearing today.

As one who represents a leading farm State in the U.S. Senate, I care very deeply about maintaining the integrity of U.S. farm policy, in part because my Arkansas farm families, as do the Chairman's, care deeply about many, many issues here.

While I have not seen the full report that GAO is presenting here today, I remain confident that 99.9 percent of all of our farm families are hardworking and honest people. That said, there may be a few bad actors that can unfortunately undermine the very important safety net that we have created in the farm bill.

My Arkansas farm families are hardworking people who do something pretty incredible every day, and I am enormously proud of it. They provide us with the safest, most abundant, and most affordable food supply and fiber supply in the world. I know the Chairman is equally as proud of those great farm families in his State.

In fact, they not only feed a hungry world, but with your strong leadership in this committee, Mr. Chairman, they are increasingly fueling a Nation with biodiesel and ethanol, which the Chairman and I both have worked diligently on.

Today, Americans pay less than 11 percent of their income for this bounty, and the farm policy that makes it all possible accounts for only about one-half of one percent of the entire Federal budget. In any other sector of government, this would be considered a huge success here in Washington.

President Kennedy once said that our farmers deserved praise, not condemnation, and their efficiencies should be cause for gratitude, not something for which they are penalized. Food for thought, I think, for the critics out there who we read about all the time in the big-city papers who fail to realize what hardworking farm families do each and every day.

Mr. Chairman, when I learned that we were going to be getting this report here in the Finance Committee, I started to think really about a lot of the parallels that we talk about in this committee and some of the issues that we traditionally work on here together in the Finance Committee.

As you know, we do use the Tax Code to provide incentives and to provide help to all kinds of activities. In fact, we have been working, I think, to repeal the entire extraterritorial income regime because it was struck down as a tax subsidy.

That is the context, I think, in which we must consider U.S. farm policy here in the Finance Committee today, and I hope that we will. It is no different, really, than the JOBS bill, which I strongly support, and which would not have been possible without the incredible leadership of the Chairman and the leadership of Senator Baucus.

The JOBS bill recognizes that the world marketplace is not free and fair, and so we have a responsibility to U.S. employers who provide millions of American jobs to help level that playing field. That bill is not about welfare. That bill is not about means testing. It is about protecting American jobs, American working families.

Well, the farm bill is really no different. It is not about welfare and should not be about eligibility testing. It is about an industry that, today, creates 25 million American jobs, produces $3.5 trillion in economic activity here at home, and accounts for 15 percent of our Nation's GDP, and 25 percent of my home State's economy.

The farm bill helps support all of this in a very distorted world marketplace, just like the JOBS bill does. So from my perspective, I do not believe that further payment limitations are appropriate, in the first place, any more than they would be appropriate in the JOBS bill that we have just recently taken up here in the Senate and hope to conclude in the conference in the Congress.

Now, I do think that we ought to enforce the law strictly and vigorously, absolutely, I do. I appreciate the Chairman's effort in this regard. He is a strong supporter and a friend of American agriculture, and I know that he wants to do the right thing for American agriculture and for the American taxpayer.

I have worked closely with him and feel confident in that regard. We are very fortunate to have a friend of farmers, and a farmer himself, as a Chairman of this committee in the U.S. Senate.

But we also have oversight and enforcement problems in other agencies other than the Farm Service Administration. We also know that we have a massive gap between the amount of taxes owed and paid in this country, and I believe we are going to be having a hearing on that in the committee as well in the coming months, we hope.

I have here, I think, a document put together by the Budget Committee which lists the so-called tax expenditures that we have in the Code. According to the document, tax expenditures are defined as "revenue losses resulting from Federal tax provisions that grant special tax relief designed to encourage certain kinds of behavior by taxpayers, or to aid taxpayers in special circumstances."

So, as you can see by definition, these tax expenditure provisions are somewhat similar to the assistance that we make to agricultural producers. They are just passed through in tax cut form.

So, in fact, the document goes to say, these provisions may, in effect, be viewed as spending programs channeled through the tax system. They are, in fact, "classified in the same functional category as in the U.S. budget."

So I would like to encourage the Chairman and others on the committee to work with me in commissioning GAO to study some of the same issues that we will bring up here today, or that will be brought up here today.

I would like to know if there are abuses involved with the 128 Federal spending programs, if they need to be limited to firms, or businesses, or taxpayers of certain sizes or incomes, and if they are currently limited in such a way, and if they need to be further restricted.

So as we look at the points that will be brought out in this GAO study and we hear from this panel that will discuss that, my hope is that we will also look at, under this committee's jurisdiction, the others that we can bring up and also take a look at.

Mr. Chairman, I would hope that we will have the support of the committee in requesting that GAO study on those 128 Federal spending programs.

We have, as I said, before us a report concerning farm payment programs that, by law and under our international trade commitments, cannot spend out more than $19.1 billion in payments each year.

And while they could add up to almost $100 billion over the next 5 years, I believe that we should expand the GAO study to include the $4.4 trillion in tax subsidies that will be passed out over the same time, and certainly look forward to working with the Chairman and others on the committee interested in hopes of expediting this request to GAO.

So, Mr. Chairman, I am hoping that you will join us, and will be helpful as we submit a request to GAO for that further information, and we can expedite that request.

The CHAIRMAN. The only thing I would ask you to consider, would be two. Number one, maybe wait until after we have our hearing that you have already referred to. Senator Baucus and I nailed down a series of hearings we are going to have between now and the end of the session, and one of the hearings touches on what you said.

The other one would be, and I should be able to answer this question for myself but I cannot, to the extent to which some of the work that you might want to ask the General Accounting Office to do, that maybe the Joint Committee on Taxation would be the more appropriate one to do that. That would not be exclusively one or the other, but that there might be some division of labor there that would be more appropriate.

Senator LINCOLN. Well, we will be more than happy to look at where the appropriate place is. But I just found that today, as we are going to GAO for a study on this subsidy, that perhaps GAO would be the appropriate place to go for the other 128 subsidies that we see within the Tax Code.

The CHAIRMAN. Yes. And also I think I should give you an explanation of the fact that originally we were working with the Committee on Governmental Affairs.

In fact, the Committee on Governmental Affairs originally asked if they could hold a hearing on this General Accounting Office report, and I very much agreed to that. In fact, I wanted them to hold it. We even did a lot of planning on the committee.

Then later in the process, the Governmental Affairs Committee realized that it had a logistical problem scheduling a hearing on the issue in a timely fashion, and proposed a potential date in August in conjunction with a hearing that they were holding on crop insurance.

I had already then asked the General Accounting Office to hold distribution of the report for 30 days, and at that point did not feel that I could wait until August. So, I decided to invite the General Accounting Office before this committee, and that is why we are here today.

Would you proceed, Mr. Dyckman?

STATEMENT OF LAWRENCE J. DYCKMAN, DIRECTOR, NATURAL RESOURCES AND ENVIRONMENT, GENERAL ACCOUNTING OFFICE, WASHINGTON, DC; ACCOMPANIED BY THOMAS COOK, SENIOR AGRICULTURE ANALYST, NATURAL RESOURCES AND ENVIRONMENT, GENERAL ACCOUNTING OFFICE, WASHINGTON, DC

Mr. DYCKMAN. Thank you, Mr. Chairman and Senator Lincoln. I do want to introduce Tom Cook, sitting to my right, who is the lead analyst on this assignment. I also want to mention, Amy Webbink from our General Counsel's Office is with us today, too.

I am pleased to be here today to discuss the results of our review of USDA's implementation of the Farm Program Payments Integrity Act of 1987, which we conducted at your request. The report was released this morning.

As you mentioned, farmers received a significant share of the Federal budget in absolute terms. Between 1999 and 2002, USDA paid farmers an average of $15 billion annually to help support major commodities. As you indicated, these payments went to 1.3 million farmers. These are individuals, as well as entities such as corporations or partnerships.

The Act, in part, is a response to concerns that farm payments were going to individuals not involved in farming. Therefore, it sought to ensure that these payments went only to farmers who are "actively engaged in farming." The Act also established, as you indicated, payment limits for these recipients.

Now, my testimony today focuses on two primary issues, and they are discussed in our blue book report. First, how well has USDA's regulations for active engagement in farming helped limit farm program payments? And I do not mean limit in terms of legitimate payments, but limit those that should not be eligible. And, second, how effectively has USDA overseen that payments only go to farmers who meet the Act's requirements?

Now, in summary, Mr. Chairman, I have got to tell you that individuals may circumvent the farm payment limits because of what we see as weaknesses in USDA's regulations.

Specifically, I refer to the regulation's definition of "active engagement in farming" and the way the regulations deal with schemes and devices. We also found that USDA can more effectively oversee farm payment limit requirements.

Now, let me turn to the first weakness that I referred to. Under the Act, to be actively engaged in farming an individual recipient must significantly contribute to, among other things, personal labor or active personal management.

However, the regulations do not provide a measurable standard for what constitutes a "significant contribution of active personal management." This allows individuals, we believe, who may have limited involvement with the farming operation to qualify for payments.

Now, we do not know how large this problem is, and, quite frankly, USDA does not either. But we do know that a survey that we did of USDA field offices showed that about 99 percent of recipients, practically everyone, asserted that they were eligible for payments completely or in part because of their active personal management.

The department broadly defines "active personal management" specifically as activities that are critical to the profitability of the farming operation, taking into consideration the individuals or entities' commensurate share in the farming operation.

In contrast, for example, USDA provides quantitative standards for what constitutes a significant contribution of active personal labor, 1,000 hours of work annually, for example. But, again, most farmers do not use this requirement.

Several farming operations we examined illustrate this problem. For example, one 12,000 acre operation was managed by a general partnership of 11 partners. The partners asserted that they qualified for about $1 million in payments in 2001 because they contributed capital and active personal management.

There were five management meetings in 2001. Three were not in the same State as the farm. Only 7 of the 11 partners participated in all meetings, and none of the partners lived in the State where the farm was located.

But, finally, based on our review of the minutes documenting these meetings, it is unclear whether some of the partners contributed significant active personal management.

Now, we also did a survey of 535 USDA field offices, and it showed that USDA's employees agree that the department can, and should, strengthen the management contribution standard.

Also, as you probably know, in 2003 the USDA Commission on Farm Payment Limits concluded that the lack of clear criteria on what constitutes a significant contribution of active personal management likely makes it easier for farming operations to add recipients to avoid payment limits.

I would like, now, to turn to the second weakness in the USDA regulations. That is, the regulations are unclear about whether certain transactions and farming operation structures could be considered schemes or devices to evade payment limits.

Under the Act, such schemes or devices disqualify a person from payments for 2 years. According to USDA regulations, a scheme or device can include, among other things, creating fictitious entities for the purpose of concealing a person's interest in a farming operation.

We found several large farming operations that were structured as one or more partnerships, each consisting of multiple corporations that increased farm payments in a questionable manner.

Depending on how USDA interprets its regulations, these operations might be considered to evade, or have the effect of evading, payment limits, and, hence, constitute a scheme or device.

For example, one family had two general partnerships encompassing multiple entities with family and non-family members. The family-owned affiliated non-farming entities that conducted businesses with the farming entities.

Now, our testimony board to our left and to your right illustrates the legal structure of this farming operation and the flow of payments to the non-farming entities. It is also on page 8 of my full statement.

I might add that this was actually a simpler organizational chart. We had more complex ones, but we could not fit them on the chart.

In 2001, the two partnerships collected more than $800,000 in farm payments on 6,000 acres. However, both farming partnerships incurred a small net loss. The loss was incurred, in part, because we believe the farming operation first paid above-market prices for goods and services, and, second, received a net return from the sale of the crop to the non-farming entities that appeared to be lower than market prices because of the apparent excessive charges related to purchasing and processing the crop; basically, not arm's length transactions.

Now, with these types of transactions, the farm payments were channeled to the family-held non-farming entities. However, when we spoke to USDA officials about this, they agreed in principle with us, but they said that they are reluctant to question these types of operations because they do not believe USDA's regulations provide a sufficient basis for action. We have referred the two examples in our report to the Inspector General's office, at USDA.

Now, let me turn to USDA's oversight. We found that USDA is not effectively overseeing farmers' eligibility for farm program payments, for several reasons.

First, 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.

Second, USDA does not complete its compliance reviews in a timely fashion. Third, for about half of the 2,000 farming operations we reviewed, USDA officials did not use available tools to verify that persons were actively engaged in farming. By "available tools," I am talking about direct interviews or examining key financial information at the farm.

In conclusion, Mr. Chairman and Senator Lincoln, we believe that USDA could better ensure that recipients of farm program payments do not circumvent the payment limitations.

We are not talking about lowering the limits or raising the limits. We are just simply talking about compliance with the regulations that are on the books, compliance with the law, or better defining the regulations and making them more clear so they can be enforced.

To this end, we made eight recommendations to USDA to address the weaknesses we identified in the regulations and in their oversight.

That concludes my short statement. I would be happy to answer any questions.

[The prepared statement of Mr. Dyckman appears in the appendix.]

The CHAIRMAN. Senator Baucus, would you like to make a comment?

Senator BAUCUS. Briefly, Mr. Chairman. Thank you very, very much.

The CHAIRMAN. Then I will ask questions.

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA

Senator BAUCUS. Thank you for the opportunity to offer my thoughts on this.

You might say that during consideration of the 2002 farm bill, I and many other Senators, especially those on the Agriculture Committee, worked very hard with my colleagues, including my very good friend, Chairman Grassley, to craft a sound, effective farm policy.

The foundation of the farm bill, as everyone will recall, is built on two principles. First, we wanted a strong safety net that would cushion producers in hard times. Second, we wanted to make the United States' agriculture sector more competitive, especially in this era when global markets exert such incredible influence on domestic markets.

Today's GAO report appears to raise questions about the integrity of one element of the United States' farm policy. The report does not offer an opinion on the level of payment limitations, but instead suggests that USDA could do a better job of enforcing rules regarding who is eligible to receive a payment.

No one supports circumvention of the law. If our system is to be effective, we must ensure its integrity. Nevertheless, I suspect that the report's findings also probably reveal, though perhaps not intentionally, a more fundamental structural problem in our farm policy.

Payment limitations disproportionately affect certain commodities in certain regions of the country. In this sense, they can be unfair. This weakness ought to be a concern for anyone who cares about the future of the United States farm policy.

Worse, in my opinion, payment limits actually inhibit competitiveness with the United States' farm economy. A competitive industry requires efficiency, and efficiency is often best achieved through economies of scale.

In capital intensive crops such as wheat or rice, payment limitations inhibit a farmer's ability to achieve economies of scale that he or she needs to maximize efficiencies. In a time when our farmers face an increasingly global market, efficiency is more than a luxury, it is an imperative.

This is an important debate and one that we should have. The current farm bill expires at the end of the 2007 crop. Until then, we should rigorously examine all aspects of farm policy, especially those that concern the integrity of the system with an eye towards crafting an even better farm bill.

The GAO report requested by Chairman Grassley offers us a look at a very important part of this system, and for that I thank him. I look forward to working with him and others on this committee as we undertake that effort.

The CHAIRMAN. We will have 10-minute rounds of questions.

Mr. Dyckman, could you please expand on the nature and significance of the problem associated with individuals claiming a significant contribution of active personal management to qualify for farm program payments?

Mr. DYCKMAN. Well, as I indicated, Mr. Chairman, in my statement, the key problem is that there is no measurable standard. I think it is a basic rule of management that if you cannot measure it, you cannot manage it.

If you cannot measure a compliance requirement, it is very difficult for those that are charged with responsibility for making sure that there is compliance, basically the USDA, to determine whether there is compliance. The standard is very vague. It is not clear.

As I indicated, the vast majority, almost 99 percent of farmers or recipients of farm payments do claim personal management as opposed to labor. Therefore, it is quite important from our perspective, from the Congress' perspective, and from the taxpayers' perspective, to, we think, have a clear, measurable standard so you can make a determination, so there is no vagueness around it.

I might add that we did query FSA county directors and asked their opinion of the standard. The majority of them told us that it would be very helpful to clarify the definition of what constitutes active personal management, and 50 percent supported a quantifiable criteria.

Senator LINCOLN. What was that number?

Mr. DYCKMAN. Fifty percent of those we queried would support a quantifiable criteria.

Senator LINCOLN. Were these farmers?

Mr. DYCKMAN. No, these were FSA officials.

The CHAIRMAN. Based on your audit work, could you comment on the prevalence and financial impact to the government of these types of cases?

In your opinion, what percentage of joint operations, general partnerships, and joint ventures that received payments in 2001 included members claiming active personal management but were not really actively engaged in farming?

Mr. DYCKMAN. Well, because of our sampling approach and because of USDA's sampling approach, we were not able to do a complete projectable sample. But of the 86 completed compliance reviews that we looked at that USDA had completed, in 30 percent of those 86 cases, or 26 cases, it appeared to us that some recipients had little involvement in the farming operation.

I think what we are talking about is potentially millions of dollars of payments being made to people of questionable eligibility. But we do not know the magnitude of the problem and, unfortunately, USDA does not. Its data systems do not allow it to understand the problem much better than we do from our review, and I think that is part of the problem.

The CHAIRMAN. Skipping on, the report alluded to the proposed regulations of the 1987 defining a significant contribution of active personal management with a quantitative figure. That idea was scrapped by the U.S. Department of Agriculture before the final regulation was published.

After reviewing the end result, do you believe the IRS standard for material participation in a business or enterprise, which would be $500, would provide the necessary quantitative measure to limit the problems that you found?

Mr. DYCKMAN. Well, that is an interesting question, Mr. Chairman. I am not a tax expert, but we did speak with a former IRS attorney to get a better understanding of that requirement of the IRS Code. I believe it is 469 of the IRS Code.

As I understand the rationale behind that, it was introduced as part of the 1986 Tax Reform Act, and I think the regulation might have gone into effect about 1988, so it was really almost the same time frame as the farm requirements for eligibility that we are talking about today.

The problem that the Congress saw when it imposed that requirement, is that there were tax shelters that attorneys, doctors, and professionals were buying into to offset and to take passive losses and offset them against active income. The IRS need some quantifiable standard to determine whether or not an individual was actively engaged in a business or it was purely a tax scheme that was bought into.

So, one of the tests to determine that was the 500 hours a year. According to this official, it has worked exceedingly well. It has basically shut down many of these tax shelters because doctors and lawyers would quickly see that there is no way that they could devote 500 hours to this endeavor as an investment tool.

Now, will it work in farming? That is something I think has to be looked at in a regulatory process in terms of USDA again proposing possibly regulations to get input from the farming community, and others. Obviously, it is a much more quantifiable standard and one that can be measured much more easily than the existing standard.

So, in theory, I do support that. But, of course, you have to proceed slowly. You have to make sure that it is something that the farmers could actually work with, but I think it is a reasonable approach, something that we could build on. They originally had 1,000 hours, as you indicated, and maybe that was excessive. But surely we can come up with some quantifiable measure.

The CHAIRMAN. Yes.

In Appendix 4 of our report, I note in the responses to your survey of FSA county directors that a majority thought commodity certificate gains should be counted towards the $75,000 payment limitation that currently only applies to loan deficiency payments and marketing loan gains. Could you comment on their responses?

Mr. DYCKMAN. Yes. I will have Mr. Cook respond.

The CHAIRMAN. All right. Mr. Cook?

Mr. COOK. Yes. In that appendix, we found that, based on our survey of county FSA officials, that 54 percent of county FSA officials believed that commodity certificate gains should be counted against the $75,000 payment limitation. Thirty-three percent thought that they should not be counted towards the payment limitation.

I might add that most of these county officials that we surveyed were located in areas of the country that currently receive commodity certificate gains, cotton and rice growing areas of the country. So, the majority of county FSA officials did believe that they should be counted against the payment limit of $75,000.

The CHAIRMAN. All right.

How do the General Accounting Office's findings compare to some of the findings of the Payment Limitation Commission?

Mr. DYCKMAN. Well, the Payment Limitation Commission, obviously, was a fairly thick report and addressed a lot of different issues pertaining to payment limitations. But on the key issue in our report, or one of two key issues in terms of the need for a quantifiable standard, I think we are in unison.

I think we are singing off the same song sheet. They indicate it is a problem. They indicate there is a need to do a look-see and to come up with a more quantifiable standard. They do not offer a specific solution, which is fine, because I think it is up to USDA to map out the specific solution to the issue.

But they do see that as a problem, and they pointed out that many farms organize just to get additional direct payments. Surely that is not the intent of the farm bill.

On the issue of schemes and devices, they did not, apparently, look into that issue because it is not covered in their report.

The CHAIRMAN. I have got some time left on my 10 minutes. Let me go back to a point I skipped that I would like to bring up again. That would be, beyond what you have identified in the report, do you have other examples of individuals receiving payments that have not demonstrated a significant contribution of active personal management?

Mr. DYCKMAN. Yes, we do. As I indicated, we looked at 86 compliance reviews that were completed by FSA, and about 30 percent, or in 26 cases, some of the recipients, appeared questionable to us as to whether or not there was active personal management.

So, while our report only talks about two cases, there are other cases. As I indicated, we do not know the full extent of the problem, but unfortunately neither does USDA.

The CHAIRMAN. All right.

Another question. This will probably have to be my last one. Could you expand on the problem and significance of your finding that some farming operations may be engaging in schemes or devices to increase their farm program payments? Do you have any idea how many other farming operations may be organized in that manner, and then what would be the overall potential financial impact?

Mr. DYCKMAN. Well, again, the essence of the problem that we found was that you have these organizations created that are farming entities and non-farming entities which may be legally created, but the problem is, there are not arm's length transactions between the two.

You can qualify for direct payments and potentially other payments with each of the partnerships created. However, if the farming operations have a net loss, the way the farming payments actually get channeled down to, I will use the term "kingpin," is by having these seemingly non-arm's length transactions where you are selling things to the farmers at excessive costs and you are buying their goods at below the fair market price. So, that is the essence of the problem.

We did see additional cases of these. We know that others exist, but we do not know the magnitude of the problem. We think this is also a multi-million dollar problem and something that USDA should look into.

Now, it is very labor intensive, I have to concede, to try to trace these types of organizational structures and to prove that there are not arm's length transactions. I might add that there might be Internal Revenue Code issues involved with these as well.

As I indicated, the two cases in our report, we did turn over to the Inspector General's office, and we trust that they will look into them.

The CHAIRMAN. Thank you.

Now it is time for you, Senator Lincoln.

Senator LINCOLN. Thank you, Mr. Chairman.

I did not get to finish m y statement, so I would like to ask unanimous consent to include my entire statement into the record.

The CHAIRMAN. I hope I did not cut you off.

Senator LINCOLN. You did not. You are fine. No, sir. I would just make sure it is all in there, and it will save us time for questions.

The CHAIRMAN. Yes, I will be glad to. Without objection, it will be included.

Senator LINCOLN. Great.

[The prepared statement of Senator Lincoln appears in the appendix.]

Senator LINCOLN. I would also like to have any of my questions I cannot get included in the record to be answered by GAO. I apologize, I am not as prepared, and I have not read the whole study.

The CHAIRMAN. Is your request that you would have questions to submit in writing beyond the ones you are going to ask orally?

Senator LINCOLN. Yes, sir.

The CHAIRMAN. Oh, yes. And you may get questions, too, from other members. You are familiar with that.

Mr. DYCKMAN. Yes, that is fine.

Senator LINCOLN. I do not know. I know that the press and some others on the committee got their report last night, but I did not get mine until this morning, and I know that was an oversight, Mr. Chairman. So, I may have additional questions that I would like to have answered as I get through the entire report.

Gentlemen, you all make some good points. I think that the Chairman and I agree that the bad actors are something that we do want to eliminate in any system, whether it is the Tax Code, doctors and lawyers, passive and active questions, whether it is agriculture, or what have you.

But making sure that the farm policy that we have in this country actually is geared to make sure that all farmers from across this country can have access not only to a program and a safety net that will provide them the ability to provide for their families, but also to be able to be able to be competitive in the global marketplace.

A couple of questions that I have for you all. You talk about USDA's standard of personal management decisions that are critical to the profitability of the farming operation are not measurable. You are talking about measuring who and what participates in this operation.

It seems to me that whether you are the one that makes the decision to take out a loan to buy crop insurance, to plant one crop instead of another, when to market your crop or how much of it to market, whether to buy equipment, whether to lease land, for example, all of these are very critical decisions that may not take a lot of time, but can make or break the operation.

There is no doubt, these are critical decisions. If there is one thing that the Chairman and I know as farmers, it is that there are many things that happen to a farmer that are way beyond their control.

Making those decisions whether to spend a lot of money and resources on fuel, labor, seed, fertilizer and what have you in February when it is a beautiful day and you are anxious to get your crop started, is a critical decision.

It may not be a lot of one, but if the monsoons come in March, you have got a problem. So in terms of measuring the critical nature of the decision making in this farming operation, I think, it is not as easy as it may seem.

You have indicated some of that, and I appreciate that. But I just hope that we will take a greater look at that in terms of furthering production agriculture in the United States.

What he or she plows, plants, or harvests, and the like, I mean, we have a hard time quantifying that and I think it is important for us to take note that it is not an easy question to answer.

So if that is an issue for you all, I hope in terms of what you are suggesting we use to quantify that, you might be a little bit more explicit on.

But when you talk about, the two-thirds of payments go to the top 10 percent of farmers, is it not correct that your definition would lump any farmer who really receives $12,000 or more in direct payments into that 10 percent?

And I really hope that farm families across the country are listening to that figure, because $12,000 in direct payments makes you a big farmer when you use your GAO statistics, or USDA's statistics in terms of the bigger ones.

But is there not a better model that we could use that would reflect only those who are actually making all, or nearly all, of their income off of the farm? That is what these programs are geared towards, right? They are geared to help.

Mr. DYCKMAN. Right. But many, as you know probably better than I, most farmers earn income off the farm, outside of the farm.

Senator LINCOLN. Some of them have to in order to stay afloat.

Mr. DYCKMAN. Right. Some of them have to, and some of these farms are investments. So, I am not sure of the question.

Senator LINCOLN. I mean, I think what you are trying to say is that 10 percent of the farmers are producing 90 percent of the food and fiber.

Mr. DYCKMAN. Those are USDA statistics as well. Right. So I do not believe we are disagreeing.

Senator LINCOLN. But you are saying, of those, that they are getting the majority of their income off the farm if they are producing that much of the food and fiber?

Mr. DYCKMAN. No, that is not our intent.

Mr. COOK. No. Our calculation in our report where we provide the information that 10 percent of the recipients receive about two-thirds of payments, that includes more than direct payments. That includes all. That includes the production flexibility contract payments, loan deficiency payments.

Senator LINCOLN. All the programs.

Mr. COOK. Yes. All of them. Correct. So it is not limited to direct payments.

Senator LINCOLN. But you are still saying that in that category, that those people are getting a sizeable amount of their income off the farm?

Mr. COOK. No. No, we are not saying that.

Mr. DYCKMAN. That was not the intent of our implication.

Senator LINCOLN. I would disagree with that, I think, just in looking at the farms that we have.

The CHAIRMAN. I am not saying this to be argumentative, but your report really does not deal with the issue of payment limitations. It deals with what the definition is of "actively involved in farming," right?

Mr. COOK. That is correct. And it does not get involved in the issue of the other incomes that these persons are earning.

The CHAIRMAN. I will not take time away from you. You will have your full time. But I think in my opening statement, maybe I would have misled you, Senator Lincoln, because I made this point about 10 percent getting 60 percent of the benefit.

But I was explaining, that was in regard to attempts that I had made in the past about payment limitations, which is still an issue I am working on. But that is not the issue here. The issue here is, the enforcement of the words in the 1987 Act "actively engaged in farming," or whatever the exact words are.

Mr. COOK. Program Payment Integrity Act.

The CHAIRMAN. Yes. In the 1987 Act.

So, you proceed.

Senator LINCOLN. All right. Thank you, Mr. Chairman.

Some of what you mentioned, you reflect on the personnel at USDA through the FSA and whether they are adequately supported or prepared to kind of do the work that they need to do in those FSA offices. Well, I can quantitatively say to you they are not. They are continually being asked to use part-time, temporary employees.

We have been begging up here for more resources through FSA to be able to provide these offices the ability to work more hands-on with their agricultural producers to be able to look more closely at the programs that they are there to implement, but they clearly do not have the time or the personnel to implement the programs that exist.

So, your point there is well taken. I do not think you are going to get any argument from me that they do not have the ability, the time, or the resources, or any of that. I think that is a key point of what we could do to make sure that things were being done properly.

Mr. DYCKMAN. Let me just add, though, of course I agree with you fully on that, and we indicate that training is a problem also. But I think that if the regulations were clearer, it would be easier for FSA to "enforce" the Act.

That is our point. Every agency has limited responsibilities, and the Farm Act proposed a large amount of responsibilities on FSA, and they have carried it out fairly well. Farmers are receiving their payments on time, basically.

Senator LINCOLN. Have you visited those FSA offices?

Mr. DYCKMAN. We have visited FSA offices.

Senator LINCOLN. And have they been in certain regions of the country?

Mr. COOK. Yes.

Senator LINCOLN. Where?

Mr. COOK. As our report indicates, we visited field offices in California, Arkansas, Louisiana, Mississippi, Nebraska, and Texas.

Senator LINCOLN. I would say that, of all those States you have mentioned, those are obviously the ones you are going to find where people are going to hit their limits because they are farming capital-intensive crops, unlike the other offices where you would go where they are farming crops that are not going to hit their limits.

Mr. COOK. Right. As we mentioned in the report, we drew our sample from the FSA sample, which targets larger payments. So, just by the nature of doing compliance reviews of large farming operations, it automatically takes you to those areas of the country.

Senator LINCOLN. Sure. Well, I would just point to the comment that Senator Baucus made, which is the economy of scale. If you are paying $400,000 to $800,000 for a piece of equipment and you are going to hit your limit on farming 200 acres of rice, or you are going to hit your limit at cotton at a higher number, but certainly lower than what you can provide a return on, you have got to look at the possibility of how you can partner yourself in order to make sure that you can, in an economy of scale, provided the marketplace that we have in the global economy, an ability to keep yourself afloat.

I guess you indicate that 45.2 percent of payments to entities go to general partnerships. Now, I do not know if that is supposed to send a shiver up my spine as being intrinsically evil or something.

What percentage of these general partnerships are made up of dads and moms on a farm with their three sons? Maybe there are two brothers. Maybe there is an uncle and a nephew. Maybe there is a group of four cousins trying to keep a farm together. I do not know what that point is. If it is that big business is taking over agriculture, I just do not see that. I have got to say, I come from a part of the country where meeting that economy of scale is virtually impossible unless you do partner with family members in order to make sure that you can farm in that economy of scale that is going to allow you to get not only the kind of equipment you need, but to deal with the kind of resources and capital investments you have to make, whether it is paying an electric bill to pump water on rice, whether it is the pesticide and insecticide chemical application that is required, and the amount of acreage and the value of that land, and the kind of compromising situation that puts you in, to have to have that much land to farm whether you own it or rent it. I think, in fact, USDA studies have shown us that number of corporate-owned farms are down.

After holding, I guess, somewhat steady for years, they are in the low single digits as a percentage of overall farms in terms of corporate headings. But, again, this general partnership issue of bringing people together to make sure that you can be competitive in a global marketplace, I do not know. I mean, if that is your intent, is to——

Mr. DYCKMAN. Our intent was simply to provide the information that we were requested. One of the pieces of information was to show the breakdown of the types of entities that are receiving farm payments.

This is not to suggest that there is anything wrong with that, but as the report indicates, where we did find problems for those farms that apparently are not either complying with the regulations, or it is questionable whether they are.

Senator LINCOLN. Well, again, through the work of the FSA offices—and I visit them regularly. Some of them are working overtime. Many of those employees are part-time employees. They get no benefit from working overtime. They get no health benefits from the kind of diligent workers they are, and putting 2, 3, and 4 years into a job where they know they have no security.

I mean, there is an inherent problem there, too, if you are going to administer something. I understand your proposal, which is that it should be better defined.

But are we going to just always have to go to a better definition because all we are going to use is part-time employees, not people who can really represent the intent of the law that Congress is passing because we want full-time professional Federal employees that can administer the programs and the intent of the law that we passed?

Just in closing, Mr. Chairman, I did not have the opportunity to review the report, but I also was curious if you gentlemen, in preparing the report, had the opportunity to explore the global competitiveness implications of really messing around with further changes in payment limitations.

We have lost about 3 million jobs. That is what the JOBS bill has been all about and what we have looked at, stemming the tide, helping to stop offshoring. The farm bill that we produced is agriculture's global competitive legislation.

If we tell farmers that they should not enter into general partnerships, they should not get bigger than what Washington tells them to, and so on, and so forth in terms of defining how they are going to be, are we not really putting our farming families in a straightjacket in terms of their competitive nature in the global marketplace?

I feel like we, as government, should be creating an environment where our farmers are able to make the business decisions that they need within the law that allows them to compete in the world, notwithstanding there are bad actors. We know that they exist.

But making sure that there is a law created in order that farm families all across this country are able to be a part of that competitive nature of the global marketplace. And again, in the part of the country I come from, it is very different.

Being able to make that capital investment and be able to get the return that you need is a critical part, and what you have looked at are really those offices where we are going to hit those limits very quickly because of that.

Mr. DYCKMAN. Well, we did not look into the global issues. We simply looked, as I indicated, as to whether or not, for those farmers that are applying and that are receiving payments, what controls are there? What are the internal controls to determine that they are receiving payments that the Congress has decided they should be eligible for?

Senator LINCOLN. So there is no competitive comparison.

Mr. DYCKMAN. No. And as I indicated earlier, we have nothing against corporations, partnerships, and joint ventures. Obviously farmers have to structure for a variety of reasons in certain ways, and the larger farms may have to structure differently. But our concern is protecting the taxpayers' investments and making sure that the law is being complied with. That is your concern, too, I know.

Senator LINCOLN. That is, absolutely. That is why I am hoping and encouraging that the Chairman will allow us to send you another request to look at the other possibilities of the 128 subsidies that come through this committee.

Thank you, Mr. Chairman.

The CHAIRMAN. Yes. Thank you very much.

In closing, I think I would emphasize where the Senator from Arkansas left off, that what I asked in the report was the General Accounting Office to study only the enforcement of the regulations of "actively engaged in farming." We did not ask you to look into anything about payment limitations. We did not ask you to look into anything about structure.

Just look at individuals that received payments, and did anybody receive payments who was not meeting the definition of "actively engaged in farming," and what was the reason if it was not being enforced, being followed, and what might have been the result of that, like money going to people that should not be getting it, all because Congress was concerned about people maybe not being in farming should not be getting any farm program payments. That is all we asked you to do, and you have done it well and I want to thank you. I have thanked you, now, twice.

But in the process of thanking you, I think I need to extend to all of the General Accounting Office, I am probably one of the major requesters of studies by the General Accounting Office, but very little in agriculture, more on health issues and more on Defense Department issues.

But I think you do a very great service, and I hope you will extend my thanks to other people who work down there, beyond just the work that you have done for this committee.

Thank you very much. The hearing is adjourned.

[Whereupon, at 12:17 p.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

United States General Accounting Office

GAO

Testimony
Before the Committee on Finance, U.S. Senate

For Release on Delivery
Expected at 11:00 a.m. EDT
Wednesday, June 16, 2004

FARM PROGRAM PAYMENTS

USDA Should Correct Weaknesses in Regulations and Oversight to Better Ensure Recipients Do Not Circumvent Payment Limitations

Statement of Lawrence J. Dyckman, Director
Natural Resources and Environment

G A O
Accountability * Integrity * Reliability

GAO-04-861T

Mr. Chairman and Members of the Committee:

I am pleased to be here today to discuss the Committee's interest in the U.S. Department of Agriculture's (USDA) implementation of the Farm Program Payments Integrity Act of 1987 (1987 Act). My testimony today is based on our recent report on this subject, which was requested by the Chairman of the Senate Committee on Finance and which is being publicly released today.[1]

Between 1999 and 2002, USDA paid farmers an average of $15 billion annually 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. Annually, almost two-thirds of these payments go to about 10 percent of the producers.

After hearing several concerns about farm payments going to individuals not involved in farming, the Congress enacted the 1987 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. 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 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. 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.

My testimony today focuses on two primary issues discussed in the report: (1) how well USDA's regulations for active engagement in farming help limit farm program payments and (2) the effectiveness of USDA's oversight of farm program payments' requirements for active engagement in farming.

[1]U.S. General Accounting Office, *Farm Program Payments: USDA Needs to Strengthen Regulations and Oversight to Better Ensure Recipients Do Not Circumvent Payment Limitations*, GAO-04-407, (Washington, D.C.: April 30, 2004).

In summary, we found the following:

- Individuals may circumvent the farm payment limitations because of weaknesses in USDA's regulations. These regulations are designed to ensure recipients are actively engaged in farming. However, they do not provide 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 our survey of USDA's field offices, in the compliance reviews they conducted, about 99 percent of payment recipients asserted they met eligibility requirements through active personal management. Moreover, USDA's regulations lack clarity as to whether certain transactions and farming operation structures that we found could be considered schemes or devices to evade, or that have the purpose 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 two years.
- According to our 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. Also, USDA's compliance reviews are often completed late. As a result, USDA may be missing opportunities to recoup ineligible payments. Further, for about one-half of the farming operations we reviewed for 2001, field offices did not use available tools to determine whether persons were actively engaged in farming.

In our report to you, we made eight recommendations to the Secretary of Agriculture to strengthen FSA's oversight of farmers' compliance with the 1987 Act. In commenting on the report, USDA agreed to act on most of the recommendations. However, USDA stated that its current regulations are sufficient for determining active engagement in farming and for 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.

Background

The 1987 Act requires 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 capital, land, or equipment, as well as a significant contribution of personal labor or active personal management to the farming operation. Hired labor or hired management may not be used to meet the latter 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. Recipients must also 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. 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.[2]

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 must 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.

Within USDA, the Farm Service Agency (FSA) is responsible for enforcing the actively engaged in farming and payment limitation rules. 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

[2]Under the Farm Security and Rural Investment Act of 2002, each of the income support programs has a separate payment limit. For example, 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. Benefits received through commodity certificate gains and marketing loan forfeitures do not count against the payment limitations. Farm Security and Rural Investment Act of 2002, Pub. L. No. 107-171, 116 Stat. 134, 213.

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. These criteria have principally resulted in sampling farming operations in areas that produce cotton and rice—Arkansas, California, Louisiana, Mississippi, and Texas.

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

Many recipients meet one of the farm program payments' eligibility requirements by asserting that they have made a significant contribution of active personal management. Because FSA regulations do not provide a measurable, quantifiable standard for what constitutes a significant management contribution, people who appear to have little involvement are receiving farm program payments, according to our survey of FSA field offices and our review of 86 case files. 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 that 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 53 percent (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.

Some recipients appeared to have little involvement with the farming operation 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. For example, in 2001, 11 partners in a general partnership operated a farm of 11,900 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. However, 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 determined was ineligible. 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.

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 actual contributions, and requiring management to be on-site.[3] More than

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

60 percent of those surveyed, for example, indicated that clarifying the standard would be an improvement. In addition, 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 recipients in order to avoid payment limitations.[4]

We also 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.[5] According to FSA's regulations, this statutory provision includes (1) persons who adopt or participate in adopting a scheme or device and (2) 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.[6]

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 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 that a family had set up the legal structures for its farming operation and also owned the affiliated nonfarming entities. This operation included two farming partnerships comprising eight limited liability companies. The two partnerships operated about 6,000 acres and collected more than $800,000

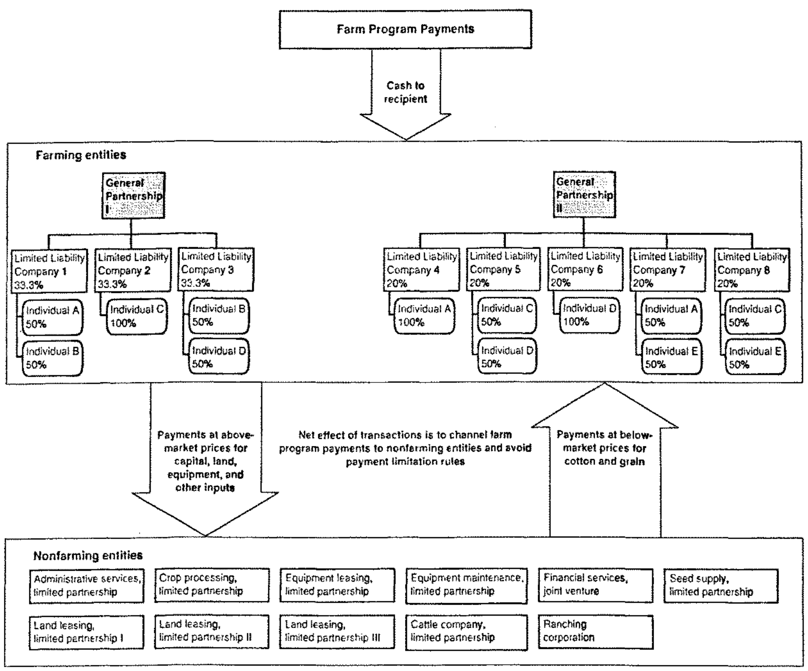
[4]See U.S. Department of Agriculture, Office of the Chief Economist, Commission on the Application of Payment Limitations for Agriculture, *Report of the Commission on the Application of Payment Limitations for Agriculture* (Washington, D.C.: August 2003).

[5]7 U.S.C. § 1308-2.

[6]7 C.F.R. § 1400.5.

in farm program payments in 2001. The limited liability companies included family and non-family 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 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 1 shows the organizational structure of this operation and the typical flow of transactions between farming and nonfarming entities.

Figure 1: Large Operation Containing Farming and Nonfarming Entities



Source: GAO analysis of FSA compliance files and statements.

Note: Percentages shown are share of ownership.

Similarly, we found another general partnership that farmed more than 50,000 acres in 2001 and that 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.[7] The shareholders who contributed the active personal management for these corporations were officers of the corporations. Each officer provided the active personal management for three 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 as well as 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.[8]

As in the first example, 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 price. For example, in one transaction the gross receipt was about $1 million but after the grain elevators deducted fees for the quality of the grain and such actions as drying and storing the grain, 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 legal structure for the farming entities but had no direct ownership interest in the farming entities.

It is unclear whether either of these operations falls within the statutory definition of a scheme or device or whether either otherwise circumvents

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

[8]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.

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. 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 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."[9] In our discussions with FSA headquarters officials in February 2004 on the issue of farming operations that circumvent the payment limitation rules, they noted that while an operation may be legally organized, it 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.

Other FSA 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 FSA finds a recipient ineligible to receive payments, its decision might be overturned on appeal within USDA. The FSA officials noted that when FSA loses these types of cases, the loss 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,"

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

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 provision as appearing to require intentionally fraudulent or deceitful conduct. On the other hand, FSA regulations only provide this as one example of what FSA considers to be a scheme or device. The regulations 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. Finally, guidance contained in *FSA Handbook Payment Limitations, 1-PL (Revision 1), Amendment 40,* does not clarify the matter because 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.

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

In addition to the weaknesses described 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 recipients to be reasonably assured of compliance with the payment limitations. 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. Field staff responsible for these reviews 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. 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. In 2001, the latest year for which data are available, only 523 of 1,573 sampled entities were to be reviewed.[10] Field offices sought and received waivers for 966 entities primarily because the entities were previously reviewed or the farming operation involved only a husband and wife.[11] According to FSA headquarters officials, the sampling process was developed in the mid-1990s and it can be improved and better targeted.

Second, 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.[12] 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. 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.

Third, FSA staff do not use all available tools to assess compliance. For one-half of the case files we reviewed for 2001, field offices did not use all available tools to determine whether persons are actively engaged in farming. FSA compliance review policy requires field staff to interview persons asserting that they are actively engaged in farming before making a final eligibility decision, unless the reason for not interviewing the

[10]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.

[11]State offices may waive selected compliance reviews for farming operations that were previously reviewed and 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.

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

person is obvious and adequately justified in writing.[13] Indeed, 83 percent of the 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 these persons and did not adequately document why they had not done so. 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 indicated 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.[14] 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.

Fourth, 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 must 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.

Finally, these problems are exacerbated by a lack of periodic training for FSA staff on the payment limitations and eligibility rules. Training has generally not been available since the mid-1990s.

In conclusion, 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

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

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

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. Moreover, FSA is not providing adequate oversight of farm program payments under its current regulations and policies.

In our report to you, we made eight recommendations to the Secretary of Agriculture for improving FSA's oversight of compliance with the 1987 Act, including: developing measurable requirements defining a significant contribution of active personal management; clarifying regulations and guidance as to what constitutes a scheme or device; improving its sampling method for selecting farming operations for review; and developing controls to ensure all available tools are used to assess compliance with the act. 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.

Mr. Chairman, this concludes my prepared statement. We would be happy to respond to any questions that you or other Members of the Committee may have.

For further information about this testimony, please contact Lawrence J. Dyckman, Director, Natural Resources and Environment, (202) 512-3841, or by email at dyckmanl@gao.gov. Ron Maxon, Thomas Cook, Cleofas Zapata, Carol Herrnstadt Shulman, and Amy Webbink made key contributions to this statement.

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Questions for the Record from Senator Grassley for Mr. Lawrence J. Dyckman, June 16, 2004

Question

Currently, prices for most major crops are above the loan rate and therefore ineligible for marketing loan benefits. How does this affect the conclusions in your report?

GAO's Response

Although marketing loan benefits are currently not available for most crops, producers continue to receive "direct payments" which are not tied to crop prices. In fact, we found that most of the very large recipients organize their farming operation in a way (that is, add persons) to maximize their direct payments. For most large recipients, the key factor driving the structure of the farming operation appears to be the direct payments.

Question

Can you explain the relationship between commodity certificate gains and (1) payment limitations and (2) the actively engaged in farming requirements?

GAO's Response

The marketing assistance loan program offers producers four possible types of benefits: loan deficiency payments, marketing loan gains, loan forfeiture gains, and certificate exchange gains. Loan forfeiture gains and certificate exchange gains are not subject to payment limits. However, producers who receive loan forfeiture gains or certificate exchange gains must meet the actively engaged in farming requirements. Of the approximately $50 million in loan forfeiture gains paid in 2001, cotton and rice accounted for 94 percent of the total forfeiture gains for all crops. Similarly, of the $2 billion in certificate exchange gains paid in 2001, cotton and rice accounted for 99 percent of the total certificate gains for all crops. Most of certificate exchange gains are provided to producers through cooperative marketing associations. According to the *Report of the Commission on the Application of Payment Limitations for Agriculture*, if loan forfeiture gains and loan certificate gains were subject to the $75,000 payment limitation that currently applies to loan deficiency payments and marketing loan gains, USDA would save $400-500 million annually assuming 1999 to 2001 crop prices.

Question

In your report, you cited a number of weaknesses in USDA's oversight procedures and practices in terms of sampling methodology, timely review and staff training. USDA has said its field offices were busy with many other responsibilities including implementing the 2002 farm bill and didn't have resources to timely complete its required reviews of actively engaged provisions. In your view what does USDA need to do to remedy this problem?

GAO's Response

As with most federal agencies, USDA must maximize the use of its resources. It has important responsibilities to ensure that American farmers are informed and supported as the Congress intended. However, the Department also has a responsibility to ensure that farmers comply with the program provisions and that taxpayers' interests are protected. Often times, USDA tends to deemphasize this important, latter set of responsibilities. We believe the recommendations in our report will help USDA to better ensure that recipients of farm program payments do not circumvent payment limitations.

Questions for the Record from Senator Conrad for
Mr. Lawrence J. Dyckman, June 16, 2004

Question

Has the GAO estimated the amount of resources—both staff and funding—that USDA devotes to ensuring compliance with current farm program payment limits?

GAO's Response

We did not estimate the amount of resources USDA devotes to ensuring compliance with farm program payment limitation and eligibility rules. However, the *Report of the Commission on the Application of Payment Limitations for Agriculture* noted that the government's costs of implementing and enforcing payment limitations are about $16 million per year. According to the report, these costs include: employee and other expenses to oversee that forms related to the administration of payment limitations are filled out and filed properly; costs to load information electronically and to develop, maintain, and refine software used to track payments; and costs to investigate, gather evidence, and prosecute instances in which producers have either violated or appear to have violated regulations on payment limits. USDA's Farm Service Agency (FSA) county offices, which interact with producers and process forms used for payment eligibility and payment limitation determinations, incur the bulk of the government cost.

Question

Is there any evidence that USDA attempts to publicize its efforts to ensure program compliance, much like the IRS tends to highlight its enforcement efforts as April 15 approaches?

GAO's Response

FSA Handbook: Payment Limitations, 1-PL (Revision 1), Amendment 40 requires FSA county offices to annually advise all producers of the payment limitation and eligibility requirements through a newsletter or other practical means available. Information provided to producers includes farm programs subject to the provisions and payment limitation amounts. During the course of our review we noted some evidence that this information was being provided to producers.

Question

Do existing USDA enforcement efforts, such as they are, tend to be rather uniform across the country, or is there some regional variability in the intensity of enforcement efforts?

GAO's Response

As we note in our report, 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. Additionally, 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. 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. Likewise, because of these limitations we were unable to determine the extent of regional variability in enforcement efforts.

Question

To the extent that USDA has uncovered cases of fraud and abuse, does the GAO believe that USDA has taken appropriate action against those found to have violated program regulations?

GAO's Response

As we note in our report, FSA finds few producers in violation of program regulations. Of the 347 farming operations that FSA reviewed for 2001, it found 18 operations with members that were not in compliance with the actively engaged in farming requirements. Final results for these 18 operations are unknown because noncompliance decisions are subject to appeal. Additionally, USDA was unable to provide information on the number and results of fraud cases it investigated.

Question

What role, if any, does USDA's Inspector General play in all this, including in helping FSA to develop measurable standards for determining what constitutes a significant contribution of active personal management?

GAO's Response

USDA's Inspector General conducts audits and evaluations, as well as investigations and law enforcement efforts relating to USDA's programs. In addition, investigators concentrate on preventing and detecting crimes, and assisting with, and preparing for, the prosecution of criminal and civil cases. Assisting FSA in developing measurable standards for determining what constitutes a significant contribution of active personal management is a policymaking action that the Inspector General is reluctant to get involved in because it would raise questions of independence when the Inspector General later audits the program.

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

GAO

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Highlights

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

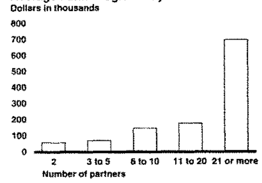
What GAO Found

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
Dollars in thousands



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:	Significant contribution to the farming operation of one or a combination of the following:
• capital • land, or • equipment	• 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.

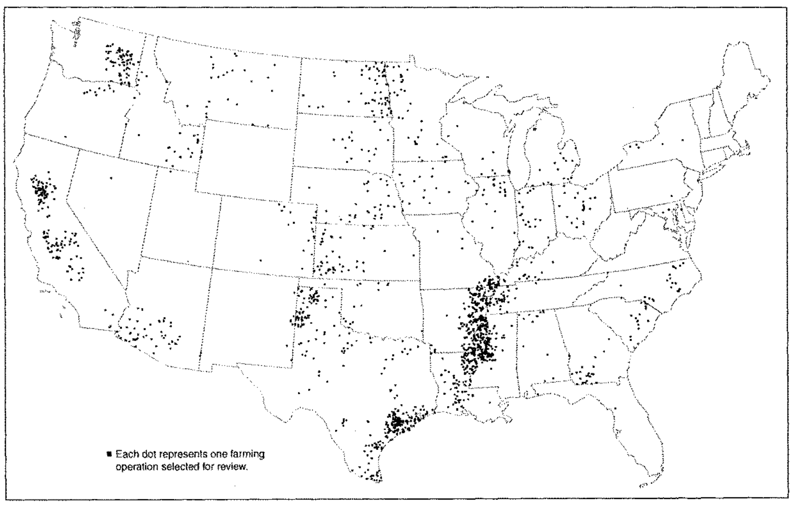
Some farming operations may reorganize to overcome payment limits to maximize their farm program benefits. Larger farming operations and farming operations producing crops with high payment rates such as rice and cotton may establish several related entities that are eligible to receive payments. However, 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.

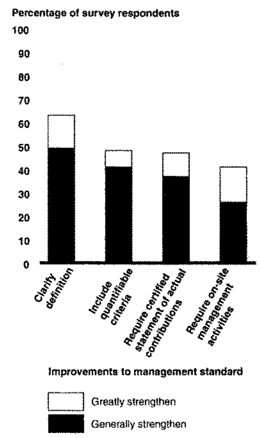
In another example, in 2001, six partners in a general partnership operated a farm of about 6,400 cropland acres. All six partners asserted they met the actively engaged in farming requirement by making a significant contribution of equipment and providing active personal management. FSA's compliance 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).

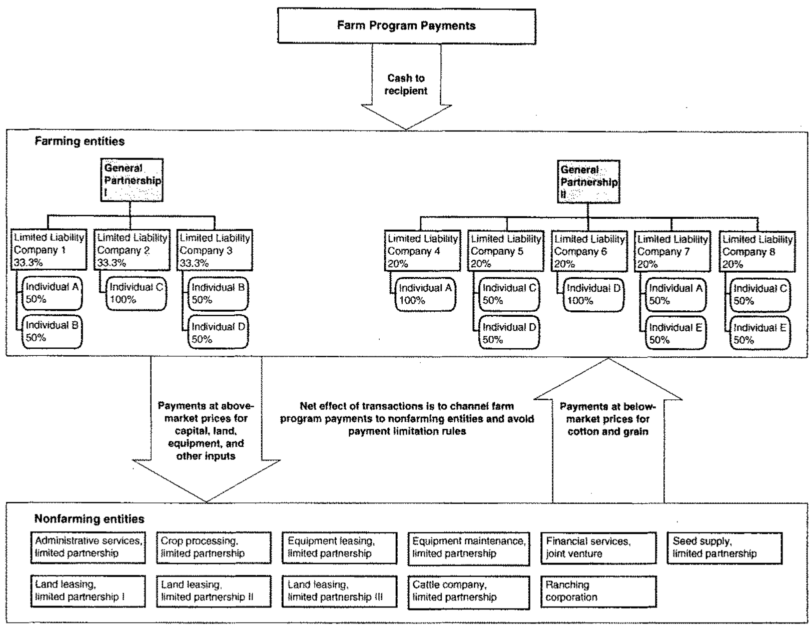
or have close ties to the farming operation's partners who were instrumental in setting up the legal structure for the farming operation. These transactions include activities such as purchasing the farming operation's goods and services—including land, equipment, and capital—and also selling the farming 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

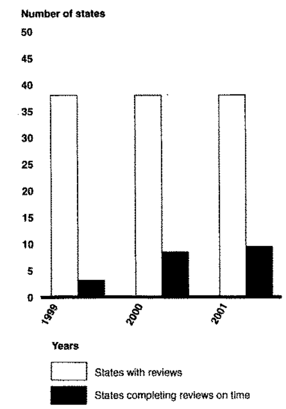
Only 9 of 38 FSA state offices responsible for conducting compliance reviews for 2001 completed the reviews and reported the results to FSA headquarters within 12 months, as FSA policy requires.[34] FSA headquarters selected the 2001 sample on March 27, 2002, and forwarded the selections to its state 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

		Entities		Payments		
Type	Partners/members	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

Appendix I

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.

Appendix II

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.

Appendix IV

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.

USDA

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 0 9 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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See comment 6.

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 7.

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.

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.

See comment 8.

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.

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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.

See comment 12.

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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.

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.

Appendix VI

GAO Contacts and Staff Acknowledgments

GAO Contacts

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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.

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PREPARED STATEMENT OF HON. BLANCHE L. LINCOLN

Mr. Chairman, thank you for holding this hearing. As one who represents a leading farm state in the U.S. Senate, I care deeply about maintaining the integrity of U.S. farm policy in part because my Arkansas farm families care deeply about this issue. While 99.9 percent of all our farm families are hard working and honest people, one bad actor can undermine this very important safety net.

My Arkansas farm families are hard working people who do something pretty incredible every day: they provide us with the safest, most abundant, most affordable food and fiber supply in the world. In fact, they not only feed a hungry world but, with your strong leadership on this committee Mr. Chairman, they are increasingly fueling a nation with biodiesel and ethanol.

Today, Americans pay less than 11% of their income for this bounty and the farm policy that makes it all possible accounts for only about one-half of one percent of the entire federal budget. In any other sector of government, this would be considered a great success. You know, President Kennedy once said, "Our farmers deserve praise, not condemnation; and their efficiency should be cause for gratitude, not something for which they are penalized." Food for thought for the critics out there who we read about all the time in the big city papers.

Now, I know that everyone is entitled to their own facts, but I would be remiss if I did not remind those critics of the 2002 Farm Bill of what they predicted when this bill passed and what actually happened. First, they said that it would bust the budget, never mind that it was fully contemplated within the budget. But, in fact, from FY 03 to FY 05, the Farm Bill has come in $17.3 billion cheaper—about 33 percent less—than originally expected. They said that it would lead to overproduction but according to USDA, production remains steady. They said it would lead to depressed farm prices but today the "across commodity index" for crop prices is at a record high. They said it would interfere with trade but today our exports are at an all time record high. And, they said it would lead to fewer and larger farms but USDA's statistics do not bear this out at all. Both are steady. Maybe this is why the 2002 Farm Bill enjoys broad support in farm country from folks across the political spectrum.

The critics also said that agriculture no longer matters to the American economy. Well, take a look at a Wall Street Journal article from December 17 of last year which, in fact, proclaims the exact opposite. Let me quote a little from that article. "The present boom is proving that agriculture still matters in the U.S. Rising farm incomes are helping ease the blow of the loss of manufacturing jobs in Midwest states." And the Wells Fargo Chief Economist was quoted in the story as saying, "The farm sector is a significant source of strength in the U.S. economy."

So, the critics were wrong about U.S. farm policy. And, Mr. Chairman, clearly, as important as they are to me and my state, a lot more is riding on U.S. farm policy than just our farm families. Mainstreet USA and even our largest cities have a stake in this important legislation. To doubters, I'd point to the 1980's farm financial crisis when we saw stores boarded up throughout rural America and when even cities like Chicago suffered, as noted in an Economist magazine article. One has to wonder what would have happened in farm country, to Mainstreet, and even our larger U.S. cities had we not responded with ad hoc assistance from 1998 to 2002 when prices reached record lows and we had the lowest real net cash income on the farm since the Great Depression. The 1980's for those who remember probably give us a glimpse.

In any case, the Chairman knows very well as do my other colleagues the challenges America's farm families face in a world market place that is not free or fair. When U.S. farmers survey the world, they see an average bound tariff of 62% against their products. Now, compare this to the 12 percent that our foreign competition sees when they want to send something here. And when U.S. farmers look at the world, they see subsidies in Europe for example sitting at around $400 per acre while our help to our own farmers is around $40. I know the Chairman is working very hard to lead us to better days in this regard—but today that is the reality. America has said to the world, "we are ready to level the playing field for everyone" but the response we've gotten back from many quarters is, "you bring down your help to U.S. farmers and we'll hang onto ours, thank you very much." Hope springs eternal and I have great hope that we can make progress in the Doha Round but we are not there yet.

Mr. Chairman, when I learned we were going to be getting this report here in the Finance Committee I started to think about the parallels to some of the issues that we traditionally work on together here. As you know, we use the tax code to provide incentives and help to all kinds of activities. In fact we have been working to repeal the entire Extraterritorial Income Regime because it was struck down as a tax subsidy.

That is the context in which we must consider U.S. farm policy here in the Finance Committee. It's no different than the JOBS bill which I strongly support and which would not have been possible without your leadership Mr. Chairman and the leadership of Senator Baucus. The JOBS bill recognizes that the world market place is not free and fair and so we have a responsibility to U.S. employers who provide millions of American jobs to help level the playing field. That bill is not about welfare. That bill is not about means testing. It is about protecting American jobs.

Well, the Farm Bill is no different. It is not about welfare. It should not be about means testing. It is about an industry that today creates 25 million American jobs, produces $3.5 trillion in economic activity here at home, and accounts for 15 percent of our nation's GDP and 25% of my state's economy. The Farm Bill helps support all this in a distorted world market place just like the JOBS bill does. So from this Senator's perspective, I don't believe that further payment limitations are appropriate in the first place anymore than they would be appropriate in the JOBS bill.

Now, do I think that we ought to enforce the law strictly and vigorously? Absolutely I do and I appreciate the Chairman's efforts in this regard. He is a strong supporter and friend of American agriculture and I know that he wants to do the right thing for American agriculture and the American taxpayer. We are very fortunate to have a friend of the farmer, a farmer himself, as Chairman of the Finance Committee of the United States Senate.

But we also have oversight and enforcement problems in other agencies other than the Farm Services Administration. We also know that we have a massive gap between the amount of taxes owed and paid in this country and I believe we are going to be having a hearing on that in this Committee as well.

I have here the Document put together by the Budget Committee which lists the so called "tax expenditures" that we have in the code. According to the document, "Tax Expenditures" are defined as "revenue losses resulting from Federal tax provisions that grant special tax relief designed to encourage certain kinds of behavior by taxpayers or to aid taxpayers in special circumstances." So as you can see by definition these tax expenditure provisions are somewhat similar to the assistance that we make to agricultural producers, they are just passed through in tax cut form. In fact, the document goes on to say, "These provisions may, in effect, be viewed as spending programs channeled through the tax system. They are, in fact, classified in the same functional categories as in the U.S. Budget."

I intend to commission a GAO study with some of our colleagues, Mr. Chairman, studying the same issues you have brought up today. I would like to know if there are abuses involved with these 128 Federal spending programs, if they need to limited to firms, businesses or taxpayers of certain sizes or incomes, and if they are currently limited in such a way, if they need to be further restricted.

We have here before us a report concerning a farm program payments that by law and in our international trade commitments cannot send out more than $19.1 billion in payments each year. And while that could add up to almost $100 billion over the next five years, I believe we should expand the GAOs study to include the $4.4 trillion in tax subsidies that will be passed out over the same time and I look forward to working with the Chairman and others interested in the hopes of expediting this request. Would the Chairman be willing to work with me to submit and expedite this request?

Finally, before closing Mr. Chairman, let me just comment a little on the tone and tenor the critics of farm policy have taken in regard to the whole Farm Bill but payment limitations in particular. I have been very disappointed on a number of levels by what I see as a divide and conquer strategy being pursued by those who really oppose U.S. farm policy altogether but who have failed to kill it using their real objections. I'm also very disappointed by the personal attacks against anyone who does not share their view, including Members of Congress, and frankly the misrepresentation of facts.

First, this business that farm policy is geared to big agribusiness. Supreme Court Potter Stuart once said about a particular topic that he "could not define it, but he knows it when he sees it" and that is true about people helped under this legislation. They are real farm families. The statistics that critics use are couched in USDA's definition of a farmer which is anyone who produces $1,000 of product or more on the farm in a given year—the equivalent of a 4-acre corn farm. With this very broad definition in mind, it is important to note that while 38 percent of farm families receive 87 percent of the benefits, these farm families also produce 92 percent of America's food and fiber, make most if not all of their living off the land, and operate the equivalent of a 372 acre corn farm or larger. You know, I always read about the Riceland Foods, Incorporated example where my Arkansas co-op is supposedly getting hundreds of millions of dollars as if that's old man Riceland ripping off Uncle Sam. But, as some know, Riceland is a co-op of about 9,000 farm families who share these benefits. And, if split evenly among them all, payments are about $14,000 per farmer. That's just a little taste of the misrepresentation going on out there.

The bottom line is that payment limitations have the real potential to put Arkansas farm families in a terrible spot. At once the federal government says, "go out and do what you need to do to be competitive in the world" and then at the same time, we say, "but, hey, don't get bigger than the romanticized size we visualize here in Washington or we'll punish you." But, the fact is we have payment limitations in farm policy and I accept them as part of the compromise we struck in the 2002 Farm Bill. The 2002 Farm Bill was debated for over 2 years and a contract was made with America's farm families, a contract that my Arkansas farmers, their lenders, and others they do business with all the way up and down Mainstreet are relying on and have made business decisions on. That was the main point of the bipartisan Commission on Payment Limitations made up of Senate, House, and Executive appointees for and against pay limits, Democrat and Republican: Don't change the rules midstream. I think we should take their report to heart.

With that, I thank the Chairman again for his strong leadership on behalf of America's farm families and for holding this hearing.