
Chapter 2

Administering Payment Eligibility and Limit Rules

This chapter presents some of the key payment eligibility and payment limit rules pertaining to the three programs considered by the Commission. The administration of farm program payment limits requires first determining which farmers and farm businesses are eligible for payments and then determining how much they may receive. The cornerstone of current payment limitation and payment eligibility law is the Farm Program Payment Integrity Act of 1987, enacted as part of the Omnibus Budget Reconciliation Act of 1987. Its provisions became effective with the 1989 crop year. As indicated in the preceding chapter, the 2002 Act established the current payment limits under the three programs considered by the Commission.

The payment limitation and payment eligibility regulations are found at 7 C.F.R. Part 1400. These regulations are administered by USDA's Farm Service Agency (FSA). Most payment limitation and payment eligibility determinations are made initially by a county or area FSA committee. The FSA developed a payment limit handbook, 1-PL, to instruct field staff on how to implement the payment limitation and payment eligibility regulations. Interested readers may request copies from the FSA.

Payment limits for the three farm programs considered by the Commission apply to "persons," which includes entities. Each person has a separate payment limit. The definition of person, as used in the administration of payment limits, encompasses both individuals and the various types of entities that farmers set up to organize their business. All individual farmers and farm business entities must be "actively engaged in farming" to be considered as persons eligible for payments. That means they must contribute significant amounts of inputs to the farming operation. A discussion of the different types of farm business entities and how they are treated as persons in the administration of payment limitations follows. More detail is then provided on what it means to be actively engaged in farming.

Farm Business Organization and "Person" Determination

This section presents some of the most common ways farmers organize their business and how these business organizations are treated as persons under current payment limitation rules.

Sole Proprietorship

Around 90 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, for instance, that only the owner, not the business, can be sued. Owners of sole proprietorships are personally liable for all their farm's debts. An individual running a sole proprietorship is considered to be one person under current payment limitation rules.

Joint Operations

Joint operations, defined by the FSA as two or more individuals who pool resources and share profits or losses, make up about 5 percent of farm businesses. As with sole proprietorships, joint operations have no legal existence independent of their owners. Participants in a joint operation have unlimited personal liability for the farm's debts. Each participant in a joint operation is considered to be one person under current payment limitation rules and adding additional individuals to the joint operation could qualify the joint operation for additional payments.

Under current payment limitation rules, spouses jointly operating a farm may be treated as two separate "persons" if neither spouse owns a substantial share of another entity that receives farm program payments as a separate person. Spouses can also be treated as two separate persons 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.

General partnerships are the simplest form of partnership and most States permit their formation with just an oral agreement. The FSA makes payments under the three programs considered by the Commission directly to the partnership rather than to the individual partners. Each partner is considered to be one person under current payment limitation rules, which means that the general partnership could qualify for additional payments by adding more individuals or entities to the partnership.

Entities that Reduce Financial Risk

Farmers structure 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 are considered to be one person under current payment limitation rules limit regardless of how many members, partners, or shareholders they have.

About 4 percent of farming operations are organized as corporations, most of which are owned by members of a single family. 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 farmers may choose the corporate form of farm business organization to protect their personal assets in case of farm financial difficulties.

Limited liability companies are the newest way farmers can organize their businesses. 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, 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 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 benefits.

Other Entities

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.

Ownership Shares and Person Determination

If an individual or entity has more than a 50-percent ownership interest in a corporation, limited liability company, limited liability partnership, limited partnership, or similar entity, the interest holder and the entity are treated as one person under current payment limitation rules. Any portion of an entity owned by the interest holder's spouse, minor children, or trust for the benefit of those children counts towards the interest holder's share. For example, if a farmer runs a sole proprietorship and in addition owns 75 percent of a farming corporation that operates another farm, the individual and the corporation would be treated as one person.

In the event two or more individuals or entities together own more than 50 percent of two or more farming entities, all of the entities are considered to be one person. For example, suppose two farming corporations each have four shareholders as shown in the following table.

Corporation A		Corporation B	
Shareholder	Percent of shares owned	Shareholder	Percent of shares owned
A	30	A	20
B	30	B	20
C	30	C	20
D	10	E	40

Individuals A, B, and C together own 90 percent of corporation A and 60 percent of corporation B. Since A, B, and C own more than 50 percent of corporations A and B, the two corporations would be counted as one person under current payment limitation rules.

Three-Entity Rule

Prior to the 1989 crop year, the payment limitation rules did not limit the number of entities (corporations, limited liability companies, limited partnerships, or similar entities) through which an individual could receive farm program payments. Beginning with the 1989 crop year, the three-entity rule has limited the number of entities through which an individual can receive program payments. Under the three-entity rule, an individual who receives payments as an individual cannot receive payments from more than two entities. An individual who does not receive payments as an individual may receive payments from up to three entities. Individuals who could potentially receive payments from more than the allowed number of entities must designate from which entities they will receive payments. The other entities not designated have to forego that individual's share of payments. The three-entity rule enables an individual to receive total payments up to twice as large as the limit for one person—the individual's limit and up to half of the limit from two other entities.

Example: Applying the three-entity rule

A farmer operates a sole proprietorship that collects \$40,000 in direct payments (remember the per-person direct payment limit is \$40,000). In addition, the farmer is a 50-percent shareholder in three farming corporations that collect direct payments:

Corporation 1 collects \$40,000

Corporation 2 collects \$40,000

Corporation 3 collects \$20,000

The three-entity rule dictates that the farmer can receive payments from just two of the corporations. Logically, the farmer would select corporations 1 and 2 in order to maximize total direct payments received. Direct payments stemming from the individual's own farm and participation in farming corporations would total \$80,000 (\$40,000 from the sole proprietorship plus \$20,000 from corporation 1 plus \$20,000 from corporation 2). Corporation 3 would have to forego the farmer's \$10,000 share of direct payments.

As discussed above, if the individual owns more than one-half of another entity, the individual and the entity would be combined into one person.

The three-entity rule does not apply to individuals, general partnerships, and joint operations. For example, take a farmer who operates two farms. On the first farm, the farmer is sole operator and the farmer is the member of a two-person general partnership that operates the second farm. In this example, the three-entity rule does not apply and the farmer would be treated as a single person eligible for \$40,000 in direct payments.

Actively Engaged in Farming

A person must meet the requirement of being actively engaged in farming to be eligible for farm program payments. To be considered actively engaged in farming, the person must make significant contributions to the farming operation in two areas:

- (1) operating funds, equipment, land, or a combination thereof; and
- (2) active personal labor, active personal management, or a combination thereof.

In addition, the above contributions, together with other qualifying contributions, must be commensurate with the individual's claimed share of the profits and losses of the farming operation, and the contributions must be at risk.

Operating Funds, Equipment, Land, or a Combination Thereof

A person must contribute a significant amount of operating funds, equipment, or land or a significant amount of a combination of two of the three or all three of the items.

For a single item, a significant contribution is a share of the item's total value that equals at least one-half of the person's ownership share (share of the business profits or losses). Total value for operating funds is the amount needed to run the operation for a year; total value for land and equipment is what it would cost to rent those items for a year.

Example: Determining significant contribution of resources

A general partnership farms on land that would rent for \$200,000 a year. One partner with a 25-percent ownership share (receives 25 percent of partnership profits or losses) provides land that would rent for \$50,000. That contribution alone, 25 percent of the total rental value of partnership land (\$50,000 contribution divided by \$200,000 total rental value equals 25 percent), qualifies the partner as making a significant contribution from the operating funds, equipment, and land group.

The partner could have contributed land worth \$25,000 and still qualify, since that contribution would be 12.5 percent of the operation total (\$25,000 contribution divided by \$200,000 equals 12.5 percent), which equals one-half of the partner's ownership share (one-half of 25 percent ownership share equals 12.5 percent).

A person might contribute a portion of two of the items or a portion of all three, but not a significant amount of any single item. In that case, the overall contribution is judged significant if it represents a share of total farm operating expenses that equals at least 30 percent of the person's ownership share. Total farm operating expense includes the cost of any inputs such as seed and fertilizer, along with the rental value of equipment and land.

Active Personal Labor, Active Personal Management, or a Combination Thereof

In addition to making a significant contribution from the previous group of inputs, a person must make a significant contribution of at least one of the items in this group or a significant contribution of a combination of the two items.

A significant contribution of active personal labor is at least the smaller of:

- 1,000 hours in a year, or
- one-half of the hours needed to operate a farm comparable in size to the person's share of the operation.

Example: Determining significant contribution of labor or management

A general partnership operates a farm requiring 1,000 hours of labor each year. One partner, who has a 50-percent ownership share, contributes 300 hours. It would take 500 hours of labor to operate a farm of the size corresponding to that partner's ownership share (1,000 hours total labor needed times 50 percent equals 500 hours). The partner's labor contribution is significant since it is more than one-half of 500 hours (300 hours divided by 500 hours equals 60 percent).

Since management is not easily measured, no attempt is made to determine what portion of total active personal management any person contributes. A management contribution is judged significant if it is critical to farm profitability, keeping in mind the person's ownership share. That is, the management contribution of a person with an 80-percent ownership share would need to impact farm profitability relatively more than the contribution of a person claiming a 20-percent share.

When a person contributes a combination of labor and management, but neither contribution meets significance requirements, the collective contribution is considered significant if it enhances farm profitability as much as a significant contribution of either of the two individual items would have. A person's overall contribution from the two groups must be at least commensurate with (meaning proportional to) the person's ownership share. Additionally, the contribution must be at risk, meaning the person must share in any loss the farming operation incurs.

Example: Determining contribution commensurate with ownership share

A two-person general partnership uses land that would cost \$100,000 to rent along with seed, fertilizer, and other inputs that cost \$50,000. The partners claim equal ownership shares. Partner one provides land that would cost \$25,000 to rent along with enough operating funds to purchase all the other inputs. Partner two provides the remainder of the land. The partners share equally in labor and management. Both partners' contributions are commensurate with their 50-percent ownership shares. (\$25,000 in land plus \$50,000 operating funds equals 50 percent of \$150,000 total operating cost; \$75,000 in land equals 50 percent of \$150,000 total operating cost; labor and management contributions are equal).

Treatment of Family Members, Landowners, and Tenants

The “actively engaged in farming” requirements are relaxed for family members, share rent landowners, and crop share renters. In farming operations in which a majority of the individuals are family members, adult family members are considered to be actively engaged in farming if they make a significant contribution of active personal labor or active personal management, or a combination thereof to the farming operation, the family member’s share of the profits or losses from the farming operation is commensurate with the family member’s contribution to the operation, and the family member’s contributions are at risk.

A landowner is considered to be actively engaged in farming if the landowner receives rent or income for the use of the land based on the land’s production or the operation’s operating results, the landowner’s share of the profits or losses from the farming operation is commensurate with the landowner’s contribution to the operation, and the landowner’s contributions are at risk. This type of business arrangement is typically referred to as a crop share lease. For instance, a landowner and tenant might agree that the landowner will receive one-third of the harvested crop from the land rented to the tenant. Sometimes share rent landowners also pay a share of the production expenses. Under a crop share lease, the landowner and tenant share the risk, since the returns to each vary depending on the volume of the crop produced on the rented land.

A crop share renter is considered to be actively engaged in farming if the renter makes a significant contribution of active personal labor to the farming operation, the renter’s share of the profits and losses from the farming operation is commensurate with the contribution to the operation, and the renter’s contributions are at risk.

Review of Payment Limit Determinations

Decisions about who is actively engaged in farming and how many persons an operation may claim are made using information farmers provide on a form called the “CCC-502” or “Farm Operating Plan.” Usually committees composed of local farmers, in conjunction with FSA county office staffs, evaluate those forms. FSA State offices review farm operations containing six or more persons. Farmers are only required to update the CCC-502 when they make a change in the organization of the farming operation.

Each year the FSA national office uses computer programs to select a sample of farming operations to review their adherence to payment eligibility and payment limit rules. In essence, that means seeing if the farming operation is run as it was portrayed on the CCC-502 form. Among criteria leading to an operation’s selection are adding or deleting a member of a joint operation or receipt of a large amount of program benefits. Farmers selected for this review must provide documentation on their operations, which could include loan documentation, canceled checks, lease agreements, and partnership agreements, along with a variety of other documentation. In addition, the USDA Office of Inspector General occasionally

initiates audits of farming operations for compliance with payment eligibility and limit rules or conducts audits at the request of the FSA. A person who is found to adopt or participates in schemes or devices with the purpose of evading the payment limitation rules is ineligible for payments in that year and the following year.

Conclusions

- Current payment limit administration has two major aspects: payment eligibility criteria (for example, payment recipients must be “actively engaged in farming”) and payment limit implementation (for example, payment recipients can receive payments from no more than three entities).
- “Persons” are the unit to which payment limits currently apply. Persons may be human beings or forms of business organizations.
- The type of farm business organization influences how many persons can be attached to a farming operation. Types of business organizations that reduce farmers’ risk (such as corporations, limited liability companies or limited partnerships) generally count as a single payment limit person. Types of organizations where producers pool resources but are individually liable for claims against the farm (for instance general partnerships) can potentially have as many payment limit persons as there are members of the partnership.
- Being able to associate more persons with the operations and thereby obtain more payment limits per operation may cause some producers to select a form of business organization that is not in the best interest of business management. For example, a farm may organize as a general partnership rather than as a corporation, when a corporate organization may be preferable for protection from liability or other reasons.
- An individual who receives payments as an individual by operating a farm as the sole operator, as a member of a joint operation, or as a partner in a general partnership can receive payments from two other entities (the three-entity rule), effectively doubling the payment limitation. The two additional entities must be corporations, limited liability companies, limited partnerships, or similar “entities” or some combination thereof. The three-entity rule likely creates additional incentives for farmers to organize their farming operation in ways that would not otherwise occur in the absence of payment limits. The three-entity rule does not apply to spouses jointly operating a farm.
- If the individual owns more than 50 percent of an entity (for example, a farming corporation), the individual and the entity would not have separate payment limits; that is, the individual and the entity’s payment limit would be combined into one single payment limit person.

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- To be eligible for payments, individuals and entities (“persons”) must be “actively engaged in farming.” Generally, persons must contribute time (labor or management) and capital (land or equipment or operating expenses) to the farming operation to be considered actively engaged in farming. This actively engaged concept is an effort to define who is truly a farmer.
 - The actively engaged concept is intended to ensure that individuals or entities that do not share the risks of the operation and do not provide capital and legitimate labor or management to the operation do not qualify for payments. The current rules address this principle; however, who provides active management in a complex operation and how much they provide are difficult to measure.
 - The FSA and the Inspector General have ongoing programs to review enforcement of payment limits. These programs audit samples of farm operations to ensure compliance with payment limitation rules. A person in violation of payment limitation rules may become ineligible for farm program payments in that year and the following year.