An Agricultural Law Research Article

Introduction to Federal Farm Program Payment Limitation and Payment Eligibility Law

by

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This article provides an overview of the federal farm program payment limitation and payment eligibility rules. These rules are a cornerstone of the federal domestic commodity programs for they apply to most programs, including the most economically significant programs. In conjunction with the eligibility requirements specific to each program, these rules define who is eligible for program payments and set the payment limits.

The rules discussed in this article are those in effect as of June 15, 2002. Included are the statutory changes made by the 2002 Farm Bill, the Farm Security and Rural Development Act of 2002. The regulations implementing the changes made by the 2002 Farm Bill, however, are not included because they had not been promulgated as of the date of this article.

1. What Is "Payment Limitation and Payment Eligibility Law"?

"[A]ny program that transfers income to farmers presents three fundamental questions: why should income be transferred to farmers; who should receive the income; and how much should an individual be permitted to receive."¹ The rules that are collectively known as the payment limitation and payment eligibility rules provide most of the answers to the last two of these questions. In addition to limiting the amount of program payments a "person" may receive, these rules generally provide that only "persons" who are "actively engaged in farming" are eligible for program payments.² The rules therefore play a central role in federal domestic farm policy.

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¹ Christopher R. Kelley, Rethinking the Equities of Federal Farm Programs, 14 N. ILL. U. L. REV. 659, 669 (1994).

² The phrase “payment limitation and payment eligibility law” should not be understood to imply that all of the eligibility requirements for the various programs are found in this body of law. Each of the programs has eligibility requirements specific to that program. Virtually all of these requirements, however, incorporate by reference some or all of the payment limitation and payment eligibility rules or are otherwise made subject to some or all of these rules. For a detailed discussion of payment limitation and payment eligibility law, see Christopher R. Kelley & Alan R. Malasky, Federal Farm Program Payment-Limitations Law: A Lawyer's Guide, 17 WM. MITCHELL L. REV. 199 (1991). See also J.W. Looney & Lonnie R. Beard, Farm Business Planning: Coordinating Farm Program Payment Rules with Tax Law, 57 UMKC L. REV. 157 (1989).
A. The Statutes.

The payment limitation and eligibility statutes are codified at 7 U.S.C. §§ 1308 - 1308-5. Some program payment limits, however, are contained in separate statutes. For example, the $50,000 limit for Conservation Reserve Program (CRP) payments is found at 16 U.S.C. § 3834(f)(1).

B. The Regulations.

The payment limitation and payment eligibility regulations are found at 7 C.F.R. Part 1400. Most of these regulations have been in effect since the 1989 crop year. Until 1996, however, the regulations were codified at 7 C.F.R. Part 1497.

The regulations are divided into six subparts. Subpart A contains general provisions, including definitions of important terms and phrases. Some important rules, such as the so-called “financing rules,” are found in these definitions.

Subpart B contains the rules used in making “person” determinations, including the so-called “combination rules.” The so-called “substantive and bona fide change rule” is also found in Subpart B.

Subpart C contains the rules used in making “actively engaged in farming” determinations. Although most programs condition payment eligibility on the participant being a “person” who is “actively engaged in farming,” eligibility for some programs is not conditioned on the participant being “actively engaged in farming.” With respect to these programs the rules contained in Subpart C will not apply.


4. Prior to the 1989 crop year the regulations were found at 7 C.F.R. Part 795. These rules were significantly different from the current rules.

5. Subpart A consists of sections 1400.1 through 1400.10.

6. The financing rules are found in the definitions of “capital,” “equipment,” and “land.” See 7 C.F.R. § 1400.3 (defining “Capital,” “Equipment,” and “Land”).

7. Subpart B consists of sections 1400.100 through 1400.109. With the exception of 7 C.F.R. §§ 1400.100 and 1400.109, all of the regulations in Subpart B contain one or more “combination rules.”


9. Subpart C consists of sections 1400.201 through 1400.212.
Subpart D contains the rules for designating “permitted entities” in connection with the so-called “three-entity rule.” 10 The three-entity rule permits the doubling of the payment limit.

Subpart E contains rules that apply when the program participant is a cash-rent tenant. These rules often apply because many program participants farm land that is rented for cash or a guaranteed amount of the crop. 11

Finally, Subpart F sets forth the eligibility requirements for foreign persons. In addition, this subpart contains notification requirements that apply to both foreign and domestic entities. 12

C. The FSA Handbook.

The payment limitation and eligibility rules are administered by the USDA Farm Service Agency (FSA), the successor agency to the USDA Agricultural Conservation and Stabilization Service (ASCS). Most payment limitation and eligibility determinations are made initially by a county or area FSA committee. Determinations involving farming operations conducted by general partnerships or joint ventures having more than five members, however, are made by the state FSA committee. 13

The county, area, and state FSA committees have been instructed to follow the directives contained in the FSA Handbook, the agency's internal procedures manual. The Handbook volume containing the payment limitation and payment eligibility directives is known by its "short-reference," "1-PL (Rev. 1)." This revision of 1-PL has been amended numerous times.

Because the county, area, and state FSA committees and their staff use 1-PL (Rev. 1) in making their determinations, 1-PL (Rev. 1) is an important reference. Most FSA offices will permit program participants or their representatives to review their copy. A copy can also be obtained without cost from the FSA's Information Office in Washington. Since 1-PL (Rev. 1) is amended frequently, maintaining a current copy requires periodic requests for the most recent amendments. Recent notices relating to 1-PL (Rev. 1), which often are incorporated into amendments, can be found on the FSA site on the USDA's web page, http://www.usda.gov.

The federal courts have consistently ruled that the Handbook's directives do not have the force and effect of law because they are not promulgated as legislative rules under the Administrative Procedure Act (APA). 14 Nonetheless, the FSA and its predecessor, the ASCS, historically have

10. Section 1400.301 is the only regulation appearing in Subpart D.

11. Subpart E. Section 1400.401 is the only regulation appearing in


13. See 7 C.F.R. § 1400.2(f).

14. See generally Christopher R. Kelley, Recent Developments in Federal Farm Program Litigation, 25 U. MEMPHIS L. REV. 1107, 1109-18 (1995). Subject to limited exceptions, the APA’s rulemaking procedures require that notice of proposed rulemaking be published in the Federal Register, followed by an opportunity for public comment and the publication of the final rules in the Federal Register. See 5 U.S.C. § 553. The contents of the FSA Handbook, as such, are not published in the Federal
treated the *Handbook’s* directives as if they were legally binding rules. This does not present serious problems when the particular directive being treated as a legally binding rule is consistent with the payment limitation and payment eligibility statutes and regulations. Not all of the directives are consistent with the statutes or regulations, however.

In the case of *Jones v. Espy*15 a federal district court ruled that a *Handbook* directive that was not authorized by a statute or a published regulation could not be used to deny farmers their program payments. In response to the *Jones* decision, the ASCS formed an ad hoc group of national and field office ASCS employees known as the Policy and Regulatory Review Taskforce. The Taskforce published an initial report on August 25, 1993. Among other conclusions, the *Report of Policy and Regulatory Review Taskforce—Phase I* reported as follows:

The payment limitation operational procedures contain the following provisions not authorized by the regulations:

- Equipment contributions must be paid for in order for the contribution to be counted as a significant contribution of equipment.
- Land that is covered by a contract for deed or deed of trust cannot be used as a contribution of land.
- Embedded entity rules.
- Definition of a ”farming operation.”
- Definition of an ”interest in a farming operation.”
- The ”substantive change rules.”
- The ”paper change rules.”
- Sharecropper rules.

To date, the FSA has not conformed all of these operational procedures to the payment limitation and payment eligibility statutes and regulations. To the extent that these procedures are inconsistent with these statutes and regulations, a court is not likely to enforce them. To the extent that these provisions can be fairly deemed to interpret ambiguous or incomplete provisions in the statutes and regulations, however, there is the possibility that a court may defer to them under one or the other of the deference doctrines announced in *Christensen v. Harris County*16 and *Bowles v. Seminole Rock & Sand Co.*17


16. 529 U.S. 576, 586-88 (2000) (ruling that unpublished agency interpretations of an ambiguous federal statute were only entitled to deference commensurate with their “power to persuade,” a standard articulated in *Skidmore v. Swift & Co.*, 323 U.S. 134 (1944)). See also *United States v. Mead Corp.*, 533 U.S. 218, 227-39 (2001) (discussing *Christensen* and ruling that *Skidmore* deference applied to a United States Custom Service tariff classification ruling).

17. 325 U.S. 410 (1945) (ruling that an agency’s interpretation of its own legislative regulations should be given judicial deference unless the interpretation is inconsistent with the legislative rule, violates the Constitution or a federal statute, or is plainly erroneous).
FSA payment limitation and eligibility determinations are administratively appealable to the USDA National Appeals Division (NAD). The role that Handbook directives should play in NAD determinations is debatable. The USDA NAD statute provides that NAD determinations are to be based on the “laws applicable to the matter at issue, and applicable regulations published in the Federal Register. . . .” The NAD regulations, however, expand on this standard by permitting NAD determinations also to be based on the “generally applicable interpretations of such laws and regulations.” The debatable question, therefore, is whether the NAD regulations properly permit NAD determinations to be based on Handbook directives by implicitly deeming these directives to be “generally applicable interpretations of such laws and regulations.”

Irrespective of whether a court or the USDA NAD will give weight to the Handbook’s directives, the FSA offices will treat the directives in 1-PL (Rev. 1) as the “law.” Accordingly, the directives must be considered on any payment limitation and payment eligibility issue.

2. What Does Payment Limitation and Payment Eligibility Law Do?

Current payment limitation and payment eligibility law serves three basic functions. First, it limits the dollar amount of certain farm program payments a “person” can receive in a crop or fiscal year. Second, it limits the number of “entities” through which an individual may receive payments. Third, it generally limits payment eligibility to “persons” who are “actively engaged in farming.”

A. Payment limitations law limits the dollar amount of certain farm program payments a “person” can receive in a crop year or fiscal year.

Payment limitation and eligibility law imposes per-“person” dollar limits on certain program payments. The limits are program-specific. There is no “overall” limit that caps the total payments that a person can receive from his, her, or its participation in multiple programs.

The following table sets forth the limits for the most economically significant programs under the 1996 Farm Bill, the Federal Agricultural Improvement and Reform Act of 1996, and subsequent legislation, excluding the 2002 Farm Bill:


19. 7 U.S.C. § 6998(c).

20. 7 C.F.R. § 11.10(b).
In fiscal years 1988, 1999, 2000, and 2001, Congress supplemented production flexibility contract payments with market loss assistance payments (MLA). These payments were not limited, but they were paid in proportion to a participant’s production flexibility contract payments. In 1998, these supplemental payment were one-half of the production flexibility contract payments. Thus, in 1998, a participant who received $40,000 in production flexibility contract payments also received $20,000 in MLA payments. In 1999 and 2000, MLA payments equaled the production flexibility contract payments. Thus, in 1999 and 2000, if a participant received $40,000 in production flexibility contract payments, he or she would receive another $40,000 in MLA payments. In 2001, the sum appropriated for MLA payments to parties to production flexibility contract payments exceeded by about $5 million the sum appropriated for production flexibility contract payments.23

<table>
<thead>
<tr>
<th>Program Payments Subject To The General Payment Limitation and Eligibility Statute</th>
<th>Limit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Production flexibility contract payments</td>
<td>$40,00021</td>
</tr>
<tr>
<td>Marketing assistance loan gains and loan deficiency payments</td>
<td>$75,00022</td>
</tr>
<tr>
<td>Selected Other Program Payments Separately Limited</td>
<td>Limit</td>
</tr>
<tr>
<td>1998 &amp; Multi-Year Crop Loss Assistance Program</td>
<td>$80,000</td>
</tr>
<tr>
<td>1999 and 2000 Crop Loss Assistance Programs</td>
<td>$80,000</td>
</tr>
<tr>
<td>Non-Insured Crop Disaster Assistance Program (NAP)</td>
<td>$100,000</td>
</tr>
<tr>
<td>Conservation Reserve Program (CRP)</td>
<td>$50,000</td>
</tr>
</tbody>
</table>

21. The funding for the production flexibility contract program includes sums from the refund of unearned deficiency payments from previous years and forfeited production contract payments. 7 U.S.C. § 7213(c)(1), (2). Production flexibility contract payments made from these funds are subject to a $50,000 limit extending for the seven-year term of the production flexibility contracts. 7 U.S.C. § 7213(e).


Beginning with the 2000 crop year and at the participant’s option, marketing assistance loan gains can be realized without limitation through the use of commodity certificates.\textsuperscript{24} Under this peculiar procedure, no certificate is actually issued, but one is “deemed” to have been issued. The certificate is then purchased by the program participant at the posted county price (wheat, feed grains, and oilseeds) or the adjusted world price (rice and upland cotton) for the commodity under loan and then immediately exchanged for the commodity. The payment pays off the loan at a rate lower than its original repayment rate as would be the case if no certificate had been exchanged. The gain realized from this exchange, which will be the same as it would have been without the participant’s purchase of the certificate, is not subject to a limit. Although the purchase and exchange of the certificate has no economic substance, it is deemed to alter the character of the transaction enough to strip the payment limit. Congress apparently authorized this procedure to avoid the public scrutiny that might have resulted if it had simply provided that marketing assistance loan gains would not be limited. Although Congress authorized use of the same procedure for loan deficiency payments, the Secretary has not elected to implement it.

The 2002 Farm Bill establishes two new payment mechanisms, direct payments and counter-cyclical payments.\textsuperscript{25} It retains marketing assistance loans and loan deficiency payments, and commodity certificates continue to be available as a means for removing the payment limit on marketing assistance loan gains for certain commodities. Under the 2002 Farm Bill, the limits are as follows.\textsuperscript{26}

\begin{itemize}
  \item \textsuperscript{25} Direct payments under the 2002 Farm Bill are similar to production flexibility contract payments under the 1996 Farm Bill in that they are paid irrespective of crop prices and are based on historical production of the covered commodities, not current production. See Farm Security and Rural Investment Act of 2002, Pub. L. No. 107-171, tit. I, § 1103, 116 Stat. 134, 149 (to be codified at 7 U.S.C. § 7913) (direct payments for wheat, corn, grain sorghum, barley, oats, upland cotton, rice, soybeans, and other oilseeds); id. § 1303, 116 Stat. 134, 170 (to be codified at 7 U.S.C. § 7953) (direct payments for peanuts). Counter-cyclical payments are also de-coupled from current production, but they are paid only whenever the “effective price” for the commodity is below the commodity’s “target price.” See id. § 1104, 116 Stat. 134, 150 (to be codified at 7 U.S.C. § 7914) (counter-cyclical payments for wheat, corn, grain sorghum, barley, oats, upland cotton, rice, soybeans, and other oilseeds); id. § 1304, 116 Stat. 134, 171 (to be codified at 7 U.S.C. § 7954) (counter-cyclical payments for peanuts).
  \item \textsuperscript{26} Id. § 1603(a), 116 Stat. 134, 213 (to be codified at 7 U.S.C. § 1308). The limits on direct payments and counter-cyclical payments for peanuts are separate from the limits for same payments for the other eligible commodities. With respect to marketing assistance loan gains and loan deficiency payments, the limit for peanuts, wool, mohair, and honey are separate from the limits for the same payments for the other eligible commodities. See id.
\end{itemize}
<table>
<thead>
<tr>
<th>Program Payment</th>
<th>Limit</th>
</tr>
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<tbody>
<tr>
<td>Direct Payments</td>
<td>$40,000</td>
</tr>
<tr>
<td>Counter-cyclical payments</td>
<td>$65,000</td>
</tr>
<tr>
<td>Marketing loan gains and loan deficiency payments</td>
<td>$75,000</td>
</tr>
</tbody>
</table>

B. Payment limitation law limits the number of "entities" through which an individual may receive payments.

Payment limitation and eligibility law restricts the number of "entities," such as corporations and limited liability companies, through which an individual may receive program payments. As discussed below, the rule imposing this limit is commonly called the "three-entity rule." This rule is controversial because it permits the doubling of the payment limits.

C. Payment limitation law limits program eligibility to "person" who are "actively engaged in farming."

Payment limitation and payment eligibility law also defines who may receive certain program payments by imposing eligibility requirements in addition to the program-specific eligibility requirements. The general purpose of these requirements, particularly the rules limiting eligibility to individuals and entities who are "actively engaged in farming," is to prevent "passive" investors from receiving program payments. The "person" and "actively engaged in farming" rules are a central, but complex, feature of payment limitation law. These rules are discussed below.

3. Why Limit Farm Program Payments?

A. The dollar limits historically have been intended to reduce program costs and to address distributional inequities.

The dollar limits on program payments are intended to reduce program expenditures and to address perceived inequities in the payments' distribution. Under the now-defunct acreage reduction programs, annual program expenditures were largely determined by commodity prices. Low commodity prices meant high program expenditures. The limits served to "cap" the expenditures for these and other commodity price-dependent programs. It also prevented producers with large farming operations from receiving more than was deemed to be acceptable. Whether the limits were successful in either respect is debatable. The United States General Accounting Office has concluded that the limits did not reduce payments as much as expected.\(^{27}\)

Small farm advocates who disapproved of the acreage reduction programs' production-based bias in favor of larger producers have criticized the limits as meaningless.\(^{28}\) Partially in response to


such criticisms, other commentators called for "hard and fast" per-farm limits without offering any specific suggestions on how this might be accomplished.29

Resolving whatever shortcomings may exist in the current payment limitation rules presents political and practical problems. The dollar limits’ impact on individual producers varies from insignificant to very significant. Only producers who farm land with relatively large crop acreage bases were directly affected by the $40,000 limit on production flexibility contract payments. Similarly, except when crop prices are very low, only producers who currently raise relatively large volumes of the crops eligible for marketing assistance loan gains and loan deficiency payments are directly affected by the $75,000 combined limit for these gains and payments.30 Moreover, with respect to production-based programs, such as marketing assistance loan program and the loan deficiency payment program, producers of crops whose prices are low in a particular year are more directly affected than producers of crops whose prices are high in that year. Therefore, larger farming operations whose production tends to be in oversupply usually have a greater stake in maintaining high limit amounts than do smaller farming operations.

On the other hand, all producers are indirectly affected by the limits to the extent that relative wealth among producers matters. In other words, to the extent that generous limits favor larger farming operations, smaller farming operations are disadvantaged in land rental markets and other venues. In addition to favoring some individual producers over others, higher limits also favor certain geographical regions, such as the South and West, where the incidence of large farming operations tends to be greater than in other regions, such as the Upper Midwest or the Northeast. Finally, federal farm program payments arguably favor inefficient producers over efficient producers. If this is true, higher limits serve to subsidize inefficiency to a greater extent than lower limits.

When the acreage reduction programs were in effect, the payment limits needed to be set high enough to encourage large farming operations to enroll in them. Since these programs were designed to raise farm income directly through cash payments and indirectly through supply management, they needed the participation of large farming operations to effectively manage supply.

The $50,000 limit on the deficiency payments made through the acreage reduction programs that were abolished by the 1996 Farm Bill was not crop-specific. It was the same for all acreage reduction program crops—wheat, feedgrains, rice, and upland cotton. It was often reached on a relatively small acreage for crops such as rice and cotton. Therefore, instead of using higher crop-specific limits for these crops, the "three-entity rule" was adopted to permit producers of these crops, most of whom farmed in the South, Southwest, and California, to effectively double their payments.

High payment limits and the “three-entity rule” no longer serve the purpose of attracting farmers to participate in a supply management program. With the possible exception of the Conservation Reserve Program, none of the current programs is a supply management program. Moreover, participation in the production flexibility contract program is nearly universal among eligible farms. In recent years the same has been true of the loan deficiency payment program. Recently farmers have favored certain crops, especially soybeans, partially because of their relatively high loan deficiency


30. The availability of commodity certificates has effectively nullified the limit on marketing assistance loan gains for certain commodities. See supra note 24 and the accompanying text.
payments and lower costs of production. In 1999, instead of using the $75,000 to limit loan deficiency payment program expenditures, Congress raised the limit to $150,000 for that year. The increased limit helped to boost net cash farm income in 1999 to the second-highest level on record.31 The limit was again raised for the 2000 and 2001 crop years.

Producer behavior with respect to the payment limits is predictable. Farming operations having sufficient crop acreage base to “bump” the $40,000 production flexibility contract payment limit and/or the current production to “bump” the combined $75,000 limit for marketing assistance loan gains and loan deficiency payments often sought to add “persons” to increase the total number of limits available to the farming operation. This was especially true when commodity prices are depressed and, consequently, program payments constitute a substantial percentage of farm income. The same behavior can be expected with respect to payments authorized by the 2002 Farm Bill.

Irrespective of their other effects, the limits and their attendant “person” and “actively engaged in farming” rules impose administrative costs. Although the dollar limits are easy to understand and to apply, the “person” and "actively engaged in farming” rules are not so easily understood or applied. In one study, ASCS employees described the predecessors to the current rules as "too complicated to fully understand."32 The current rules are even more complicated. Accordingly, the FSA must continuously devote time and funds to training and other activities associated with administering the rules.

There is a cost to program participants as well. "A hidden cost in the [rules] is the emotional toll it takes on farmers” who try to stay within the rules while not fully understanding them.33 Because the payment limitation rules impose administrative and other “transaction costs,” their elimination has been advocated as a cost-savings measure.34

B. The "person" and "actively engaged in farming" rules are intended to define who may receive payments.

Unlike the dollar limits, the "person" and "actively engaged in farming" rules are principally concerned with program eligibility. While these rules ostensibly define who is eligible for payments as opposed to how much can be received, defining who may be a "person" separately eligible for a limit also has an impact on program expenditures and payment distribution. In other words, the limits on who (i.e., which "persons") can receive payments matter just as much as, if not more than, how much can be received by each eligible "person."


34. Carole Frank Nuckton, Farm Program Conflicts: The $50,000 Case, CHOICES, Fourth Quarter 1989, at 34, 35.
Current payment limitation and eligibility law generally defines who may receive payments as "persons" who are "actively engaged in farming." There are exceptions, however. The following table indicates which programs are subject to the “person” and “actively engaged in farming” rules:

<table>
<thead>
<tr>
<th>Program</th>
<th>Applicable Rules</th>
</tr>
</thead>
<tbody>
<tr>
<td>Production flexibility contracts (1996-2002); direct payments and counter-cyclical payments (2002-2007)</td>
<td>“Person” and “actively engaged in farming”</td>
</tr>
<tr>
<td>Marketing assistance loans (no gain)</td>
<td>Not applicable</td>
</tr>
<tr>
<td>Marketing assistance loan gains</td>
<td>“Person” and “actively engaged in farming”</td>
</tr>
<tr>
<td>Loan deficiency payments</td>
<td>“Person” and “actively engaged in farming”</td>
</tr>
<tr>
<td>1988, 1999, and 2000 crop loss assistance</td>
<td>“Person” only</td>
</tr>
<tr>
<td>Non-Insured Crop Loss Assistance</td>
<td>“Person” only</td>
</tr>
<tr>
<td>Conservation Reserve Program</td>
<td>“Person” and “actively engaged in farming”</td>
</tr>
</tbody>
</table>

The “person” and "actively engaged in farming" rules do not directly limit the number of "persons" who can qualify for payments from a single farming operation. To the contrary, they encourage farming by multiple-member general partnerships. Farming through a general partnership is the most effective way for multiple “persons” to receive payments from a single farming operation. In addition, the rules permit an individual to receive payments from up to three “entities.” Thus, as have the dollar limits, the “person” and “actively engaged in farming” rules have been criticized for promoting the aggregation of land into large farming operations and permitting some individuals to receive more payments than they "deserve."

For these reasons, some believe that the current rules should be replaced by more restrictive rules, including abolition of the three-entity rule. Attempts to abolish the three-entity rule and to lower the payment limit amount drew considerable attention during the debate over the 2000 Farm Bill.35

Another option for limiting who may receive payments, one which has been implemented on a limited basis before the enactment of the 2002 Farm Bill, is to deny payments to persons whose net income, gross revenue, or some other measurement of wealth exceeds a certain sum. This option contemplates "means testing" program eligibility. As mentioned below, some programs have used a "means test," but “means testing” was not a function of payment limitation and payment eligibility law until the enactment of the 2002 Farm Bill.

C. With the enactment of the 2002 Farm Bill, payment limitation law now imposes a "means test" for program eligibility.

Before the enactment of the 2002 Farm Bill, payment limitation and eligibility law did not disqualify otherwise eligible farmers based on their income. Although not a part of payment limitation

35. See, e.g., Sally Schuff, Senate To Dissect Farm Bill at Length, Feedstuffs, May 6, 2002, at 1.
and payment eligibility law, “means testing” was established in 1988 for disaster assistance.\textsuperscript{36} “Means testing” was continued for other ad hoc disaster assistance programs, including the 1998, 1999, and 2000 crop loss assistance programs.\textsuperscript{37} It is currently in effect for the Non-Insured Crop Disaster Assistance Program (NAP).\textsuperscript{38}

Under the 2002 Farm Bill and beginning with the 2003 crop year, eligibility for all programs subject to the payment limitation and payment eligibility rules will be subject to a “means test” expressed as an “adjusted gross income limitation.” In general terms, this limitation denies program payments to individuals or entities whose averaged adjusted gross income for the three preceding tax years exceeds $2.5 million, unless at least seventy-five percent of this income was derived from farming, ranching, or forestry operations.\textsuperscript{39}

4. What Is the "Three-entity Rule"?

A. The “three-entity rule” limits the number of entities through which an individual may receive program payments.

Under the payment limitation and eligibility rules, a corporation, limited liability company, limited partnership or similar “entity” may receive farm program payments. In turn, the entity can, and usually will, distribute these payments to its shareholders or members. Prior to the 1989 crop year, the payment limitation rules did not limit the number of entities through which an individual could receive program payments. Since the 1989 crop year, however, the “three-entity rule” has limited the number of entities through which an individual can receive program payments. Under this rule, an individual who receives payments as an individual cannot receive program payments from more than two entities. An individual who does not receive payments as an individual may receive program payments from up to three entities, hence the name "three-entity rule.”

B. The “three-entity rule” allows the limits to be doubled.

The three-entity rule allows the payment limits to be doubled. For example, assume that Farmer A farms as an individual. In addition, he holds a 50 percent interest in two limited liability

\textsuperscript{36} Persons whose “qualifying gross revenues” exceed $2 million were ineligible for disaster assistance under the first “means-tested” disaster assistance programs. 7 U.S.C. § 1421 note § 231; Federal Crop Insurance Reform and Department of Agriculture Reorganization Act of 1994, Pub. L. No. 103-354, § 112, 108 Stat. 3178, 3202-03. The pros and cons of “means testing” and “targeting” program payments are discussed in Daniel A. Sumner, Targeting and the Distribution of Program Benefits in Agricultural Policies in a New Decade 125 (Kristen Allen, ed. 1990).

\textsuperscript{37} See 7 C.F.R. §§ 1477.106(f) (1998 crop loss assistance) (using a qualifying gross revenues in excess of $2.5 million standard); 1478.6(e)(f) (1999 crop loss assistance) (same); 1480.6(f) (2000 crop loss assistance) (same).

\textsuperscript{38} See 7 U.S.C. § 7333(i)(4); 7 C.F.R. § 1437.13(a)(2) (using a qualifying gross revenues in excess of $2 million standard).

Each of these LLCs has a farming operation that is separate from the other LLC’s farming operation and from Farmer A’s farming operation.

Also assume that in his individual capacity Farmer A will receive the full limit of $40,000 in direct payments, the full limit of $65,000 in counter-cyclical payments, and the full combined limit of $75,000 in marketing assistance loan gains and loan deficiency payments for a total of $180,000. Assume further that each of the LLCs also will receive these amounts through their respective separate farming operations.

Under these assumptions, because Farmer A’s distributive share is 50 percent of each LLC’s payments, he will receive $90,000 ($20,000 + $32,500 + $37,500) from each LLC. As a result, the $180,000 he receives directly as an individual will be doubled by the amount he receives indirectly as a member of the two LLCs. The result would be the same for Farmer A if, instead of farming separately, Farmer A, AB LLC, and AC LLC farmed as a general partnership.

The three-entity is not always used to double an individual’s effective limit. To the contrary, it is commonly used to capture a payment amount somewhere between the single limit amount and the doubled limit amount. For example, in a farming general partnership consisting of A, an individual, and AB LLC, a limited liability company equally owned by individuals A and B, A would be relying on the three-entity rule to be eligible for payments up to 150 percent of a single limit. Likewise, if the general partnership consisted of individual A, individual B, and AB LLC, both A and B would be using the three-entity rule to receive payments directly as individual partners and indirectly though AB LLC.

C. The “three-entity rule” does not limit the number of “persons” in a farming operation.

The three-entity rule does not limit the number of “persons” in a farming operation who are eligible to receive payments. In theory, a hundred-member general partnership could conduct a farming operation in which all of its members were “persons” who were “actively engaged in farming.” The number of “persons” in a farming operation, therefore, is primarily constrained by the practical difficulties associated with operating a farm with multiple “persons.” These difficulties include coordinating farm program planning with tax, estate, and general business planning. As to the latter, the joint and several liability of the individual partners for the debts of the partnership is a consideration.

40. Farmer A cannot have more than a 50 percent interest in either LLC. If he does, the LLC(s) in which he has more than a 50 percent interest will be “combined” into him. See 7 C.F.R. § 1400.101(a).

41. Individual B in this example could completely “passive” with respect to the farming operation if the “significant contribution” of capital, equipment, or land was made by the partnership and individual A made a “significant contribution” of “active personal labor” or “active personal management” as an individual and as a 50 percent member of the LLC. See 7 C.F.R. §§ 1400.203(b), 1400.204(b). In other words, assuming the land and production of the farming operation will generate the payments, individual A can receive up to 150 percent of a single limit simply by finding another person to participate as an equal member in the LLC.
weighing against farming as a partnership. Other difficulties include the problems that can arise from apportioning control of the farming operation among multiple partners.\footnote{But see supra note 41 (providing an example in which an individual essentially has complete operational control over a farming operation in which another individual receives payments indirectly as a member of an LLC).}

5. **Who May Be a "Person" for Payment Limitation Purposes?**

For payment limitation and eligibility purposes, a "person" is \textit{separately} entitled to receive payments up to the applicable limit. The terms "person" and "separate person" thus are sometimes used interchangeably. In the payment limitation and eligibility regulations, the term "person" is usually synonymous with "separate person."

\begin{itemize}
  \item A. "\textit{Persons} may be individuals, corporations, limited liability companies, and certain other business organizations, but general partnerships, joint ventures, and similar "joint operations" may not be "persons.""
\end{itemize}

Individuals and certain common forms of business organization such as a corporations, limited liability companies, limited partnerships, and trusts may be "persons." General partnerships, joint ventures, and cooperative marketing associations, however, are not eligible for "person" status. In addition, trusts, estates, charitable organizations, and states and their agencies may be "persons."\footnote{See 7 C.F.R. § 1400.3 (defining "Person").}

General partnerships and joint ventures are called “joint operations” in the payment limitation and payment eligibility regulations. Joint operations may not be "persons." Their individual members, however, may be "persons."

As a general rule, general partnerships and joint ventures are more advantageous for payment limitation and eligibility purposes than corporations, limited liability companies, and limited partnerships. While a corporation, limited liability company, or limited partnership will be only one "person" irrespective of the number of its shareholders or members, each of the partnership's or joint venture's members may be a separate "person" unless there is a “combination” of “persons” under one of the so-called “combination rules.” Therefore, more "persons" are potentially available to a farming operation conducted by a general partnership than to a farming operation conducted by a corporation, limited liability company, or limited partnership.\footnote{Corporations, limited liability companies, and limited partnerships have the advantage over general partnerships of being able to compensate their shareholders or members for their "significant contribution" of “active personal labor” or “active personal management.” See id. § 1400.204(b). Members of general partnerships cannot receive a salary or other guaranteed payment for these services to the farming operation. They can only be entitled to receive their respective distributive share of the partnership’s net earnings.}

A trade-off for this gain, however, is that the members of a general partnership who conduct a farming operation will be jointly and severally liable for the partnership’s liabilities under state law. This
disadvantage can be mitigated to some degree by forming a partnership of single-member limited liability companies in lieu of individuals if state law permits single-member limited liability companies.

B. Separate "persons" must have a "separate and distinct" economic investment in the farming operation.

A separate "person" must satisfy the so-called "separate and distinct" requirements. These requirements are satisfied when a "person"

1. has a separate and distinct interest in the land or the crop involved;
2. exercises separate responsibility for such interest; and
3. maintains funds or accounts separate from that of any other individual or entity for such interest.45

These "separate and distinct" requirements are intended to ensure that program participants have an independent economic investment in the farming operation. General partnerships and joint ventures may satisfy these requirements on behalf of their members. Although these requirements are tersely worded, they are very important for their violation leads to the affected person's ineligibility for separate "person" status. If, for example, the personal funds of a general partner are commingled with the funds of the farming general partnership or vice versa, the partner will be denied "person" status.46

Another arrangement having the potential to run afoul of these "separate and distinct" requirements is one in which a family or other group that otherwise farms separately jointly purchases inputs or exchanges equipment or services. Under the payment limitation and payment eligibility rules, there is nothing wrong with joint purchasing arrangements or the exchange of equipment or services as such. Such arrangements, however, should be conducted so that the separate farming operations remain separate and distinct from each other. Thus, the prudent course of conduct in such situations is to conduct all transactions between or among farming operations on an "arm's-length" basis and to create and maintain the appropriate documentation demonstrating that each farming operation satisfied the "separate and distinct" requirements. With respect to joint purchases, each farming operation should promptly pay for its share of each joint purchase so that it cannot be argued that one operation is funding or otherwise blending its finances with another. With respect to equipment or services exchanges, there should be a demonstrably equivalent exchange to avoid the reality or appearance that one operation is assuming the responsibilities of another.

The third "separate and distinct" requirement requires "persons" to "[m]aintain funds or accounts separate from that of any other individual or entity for such interest [in the land or crop involved]."47 This requirement is a prohibition against commingling. It is not a "financing" prohibition. The only financing restrictions contained in the payment limitation and payment eligibility rules are found in the definitions of "capital," "equipment," and "land."48 These restrictions apply to "actively engaged in farming" determinations, not "person" determinations, as is discussed later in this article.

45. See id. § 1400.3 (defining “Person”).
46. In this instance, the FSA probably would combine all of the partners into one “person.”
47. 7 C.F.R. § 1400.3 (defining “Person”).
48. See id. § 1400.3 (defining “Capital,” “Equipment,” and “Land”).

16
All that the third “separate and distinct” requirement requires is the separate maintenance of funds and accounts.

C. **Certain “persons” may be “combined” with other “persons.”**

Under a collection of payment limitation rules known as the "combination rules," some individuals are deemed to be too economically interdependent with other individuals or entities to be separate "persons." These combination rules deny separate "person" status to "persons" who would otherwise be eligible for a separate limit.

For example, a corporation and its shareholders are generally considered to be separate "persons." Thus, as was noted in the discussion of the "three-entity rule" above, a corporation may receive program payments based on its fulfillment of the "person" and "actively engaged in farming" requirements. Its individual shareholders may receive program payments from separate operations in which they are "persons" who are "actively engaged in farming." So long as none of the shareholders holds more than a 50 percent interest in the corporation, the corporation's and each shareholder's payments will be separately limited.

If, however, one of the corporation's shareholders holds more than a 50 percent interest in the corporation, one of the "combination" rules will "combine" the corporation with the majority shareholder. When this combination occurs, the corporation is subject to the same limit as the majority shareholder. If the majority shareholder has already reached his or her payment limit, the corporation will not be eligible to receive payments.

This combination rule, sometimes called the “more than 50 percent interest combination rule,” applies to corporations, limited liability companies, and similar entities. It counts the "interest owned by the individual’s spouse, minor children, and trusts for the benefit of such minor children." Thus, if the voting membership interests in a corporation or an LLC are owned 40 percent by the husband (H), 15 percent by H's wife, and 45 percent by H's brother, the LLC will be combined into H.

A second combination rule also applies to corporations, limited liability companies, and similar entities. This combination rule, sometimes called the "two or more/two or more combination rule,” applies if “the same two or more individuals or entities own more than 50 percent of the interest in each of two or more limited partnerships, corporations, or other similar entities engaged in farming. . .” The following is an example of an arrangement that will lead to a combination under this rule, assuming that both corporations are participating in a federal farm program that is subject to the payment limitation and eligibility rules:

<table>
<thead>
<tr>
<th>Corp. 1</th>
<th>Corp. 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>A, 30%</td>
<td>A, 10%</td>
</tr>
<tr>
<td>B, 20%</td>
<td>B, 20%</td>
</tr>
<tr>
<td>C, 15%</td>
<td>C, 25%</td>
</tr>
<tr>
<td>D, 35%</td>
<td>E, 45%</td>
</tr>
</tbody>
</table>

49. *See id. § 1400.101(a).*

50. *Id. § 1400.101(a).*

51. *Id. § 1400.101(b).*
To determine if the “two or more/two or more combination rule” applies, the first step is to identify who has an interest in more than one farming corporation. In the example above, A, B, and C each have an interest in the two corporations. Thus, there are two or more individuals (the rule also applies to entities) who each have an interest in two or more entities.

The next step is to add up the ownership interests of those with the interests in more than one farming corporation. If the total exceeds 50 percent, the two entities are combined. In this example, because the total exceeds 50 percent, the two corporations will be combined into one “person” for payment limitation purposes.

One or more combination rules apply to corporations and similar limited liability entities, trusts, estates, spouses, minor children, governmental bodies, and charitable organizations. These rules must be carefully considered in farm program planning. On occasion, a farming operation will be structured in a manner that will result in one or more combinations because the loss of payments resulting from the combination(s) will be offset by other, non-farm program related gains or advantages.

(i) The combination of husbands and wives.

Of all the combination rules, the general rule combining spouses has produced the most controversy, including litigation in which the general rule of combining spouses was upheld. The general rule is that spouses are one “person.” There are two exceptions. The first and more longstanding exception applies to spouses who farmed separately before their marriage and who

52. Corporations and similar limited liability entities are subject to two combination rules. See id. § 1400.101(a), (b).

53. See id. § 1400.103. The payment limitation and eligibility rules specifically define an “irrevocable trust.” Id. § 1400.3 (defining “Irrevocable trust”). Not every trust that is an “irrevocable trust” under state law will satisfy this definition.

54. See id. § 1400.104.

55. See id. § 1400.105.

56. See id. § 1400.106.

57. See id. § 1400.107.

58. See id. § 1400.108.

59. Women Involved in Farm Economics v. United States Dep’t of Agric., 876 F.2d 994 (D.C. Cir. 1989), cert. denied, 493 U.S. 1019 (1990). This case is sometimes referred to as the "WIFE case," a reference to the plaintiff's acronym.

60. 7 C.F.R. § 1400.105(a).
continue to farm separately after their marriage. Very few spouses can satisfy the requirements of this exception.

The second exception was authorized by the 1990 Farm Bill, and it took effect in the 1991 crop year. Under this exception, a husband and wife may each be deemed to be separate “persons” if

(a) neither spouse has a "substantial beneficial interest" (usually, but not necessarily, 10 percent or more) in another entity receiving farm program payments, and

(b) each spouse is a "person" who is "actively engaged in farming."

This second exception limits the spouses to one payment limit each, and it precludes either of them from using the three-entity rule when each of them are seeking to qualify for the direct receipt of payments. Thus, if spouses farm separately or as partners and want to avoid being combined, neither can have a “substantial” interest in a farming entity that participates in a farm program through which he or she receives payments indirectly.

Spouses who seek separate "person" status typically farm in a general partnership or a joint venture either as co-partners or in partnership with others. Depending on how they conduct their operation, they may be able to claim equal shares in the partnership or joint venture. An explanation of the advantage of structuring the farming operation so that the spouses are entitled to equal shares is offered in the hypothetical example following question 6 below.

(ii) The use of the “person” combination rules elsewhere.

Whenever Congress or the FSA specifies that the payment limitation and payment eligibility “person” definition applies, the "combination" rules usually apply. For example, under the "qualifying gross revenues" eligibility test for the 1999 and 2000 crop loss assistance programs, the gross revenues of a corporation, including a non-farming corporation, may be included in the gross revenues of its majority shareholder. Thus, under this program and certain other programs, an individual producer could have been "means tested" by the gross revenues of a non-farm corporation in which the producer was a majority shareholder.

61. Id. § 1400.105(a)(1).
62. See id. § 1400.3 (defining “Substantial beneficial interest”).
63. See id. § 1400.105(a)(2).
64. When a spouse owns a majority interest in the farming entity through which he or she receives program payments, the entity will be combined with the spouse under 7 C.F.R. § 1400.101(a), thus rendering the entity and the spouse one “person.” In this circumstance, the interest of the spouse in the entity is disregarded for purposes of the second exception to the husband and wife rule.
65. See id. §§ 1478.3 (defining “Person”) (1999 crop loss assistance); 1480.3 (same) (2000 crop loss assistance).
6. What Is Required to Be "Actively Engaged in Farming"?

Generally, only "persons" who are "actively engaged in farming" are eligible for program payments. The "actively engaged in farming" requirement is intended to distinguish "active" participants in a farming operation from those who are merely "passive" investors. Prior to the 1989 crop year, individuals could receive program payments merely by contributing capital to the farming operation. Sometimes this capital was borrowed using the anticipated farm program payments as collateral. Thus, an individual living on Fifth Avenue in New York City could receive farm program payments without doing anything more than contributing borrowed funds to the farming operation. Today, an individual living on Fifth Avenue can still receive program payments and can be "actively engaged in farming," but that individual cannot do so merely by contributing capital to the farming operation.

The "actively engaged in farming" requirement is grounded on the notion that "real farmers" contribute land, capital, or equipment and their own labor or management to their farming operation. It also incorporates the notion that a "real farmer" will make contributions to the farming operation in proportion to his or her share of the operation's profits and losses and that these contributions will be subject to farming's economic risks. Accordingly, the generally applicable "actively engaged in farming" requirement has three constituent elements:

To be "actively engaged in farming," a "person" must directly make to the particular farming operation
1. a "significant contribution" of
   (a) land, capital, equipment, or a combination thereof, and
   (b) "active personal labor," "active personal management," or a combination thereof; and
2. the "significant 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
3. the contributions must be "at risk."[68]

It can be helpful to think of these requirements as calling for (a) significant contributions, (b) commensurate contributions, and (c) at risk contributions. Thus, the "actively engaged in farming" requirement can be said to encompass the following constituent requirements:

<table>
<thead>
<tr>
<th>A “Significant Contribution” Requirement</th>
</tr>
</thead>
<tbody>
<tr>
<td>A “Commensurate Contribution” or “Commensurateness” Requirement</td>
</tr>
<tr>
<td>An “At Risk” Requirement</td>
</tr>
</tbody>
</table>

As to the “significant” contribution requirement, two elements must be satisfied in most circumstances: (1) the contribution of the inputs of capital, equipment, land, or a combination thereof;

66. See id. § 1400.201.

67. See id. § 795.7.

68. See id. § 1400.201(b) - (d).
and (2) the contribution of the services of “active personal labor,” “active personal management,” or a combination thereof. These two elements are sometimes called the “left-hand side” (inputs) and the “right-hand side” (services), respectively, of the significant contribution requirement. Thus, the “significant contribution” requirement can be depicted as follows:

<table>
<thead>
<tr>
<th>Inputs: “Left-hand side”</th>
<th>Services: “Right-hand side”</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital, equipment, land, or a combination thereof</td>
<td>“Active personal labor,” “active personal management,” or a combination thereof</td>
</tr>
</tbody>
</table>

An individual who farms as a sole proprietor usually has to satisfy all three of the contribution requirements. That is, an individual must make a “significant” contribution of one or more of the requisite inputs and services; his or her contributions must be commensurate with his or her share of the proceeds of the farming operation; and his or her contributions must be at risk. If, however, the individual owns all of the land he or she farms, the landowner exception will apply. Under this exception, the “significant contribution” requirement is satisfied by the individual’s contribution of his or her land to his or her farming operation. This leaves only the “commensurateness” and “at risk” contribution requirements left to be satisfied.

Members of a general partnership or joint venture do not have to make individual “significant contributions” of land, capital, equipment, or a combination thereof. Instead, the general partnership or joint venture may make the contribution for each of them. This is advantageous for the partnership’s or joint venture’s members for input contributions made at the partnership or joint venture level—in other words, by the partnership or joint venture—are attributed to each partner or member in proportion to their respective shares for “commensurate contribution” purposes. Otherwise, any member seeking to be deemed “actively engaged in farming” must contribute the requisite quantity of the qualifying input(s) to the partnership’s or joint venture’s farming operation.

Members of a general partnership or joint venture who seek to be deemed “actively engaged in farming” must make a “significant contribution” of “active personal labor,” “active personal management,” or a combination thereof. They must also satisfy the “commensurateness” and “at risk” requirements.

With respect to corporations, limited liability companies, and other limited liability entities, the entity must make the “significant contribution” or one or more of the qualifying inputs. The same is


70. See id. § 1400.207.

71. See id. § 1400.203(b).

72. See id. § 1400.203(a).

73. See id. § 1400.201(d).

74. See id. § 1400.204(a).
true for trusts and estates. Thus, with respect to these entities, the “left-hand” side of the “significant contribution” requirement must be satisfied by the entity.

“Entities,” of course, are themselves incapable of contributing personal services. Therefore, corporations, limited liability companies, and limited partnerships seeking to be deemed to be “actively engaged in farming” must have one or more of their shareholders or members having a single or combined interest of at least 50 percent make the requisite quantity of the qualifying services. A similar rule applies for trusts with respect to the income beneficiaries. With respect to estates, either the personal representative or the heirs must collectively “activate” the estate by contributing the requisite labor or management or both. As with all “persons” seeking to be “actively engaged in farming,” the “commensurate” and “at risk” contribution requirements also must be satisfied.

“Active personal labor” and "active personal management" are defined to exclude hired services. Shareholders in a corporation or members of a limited liability company or limited partnership, however, may be paid for their labor and management without disqualifying their services from being considered as a "significant contribution" of "active personal labor" or "active personal management." Partners, on the other hand, cannot receive a guaranteed wage or salary by the partnership for their labor or management. If they are paid, none of their labor or management will qualify as a "significant contribution" of "active personal labor" or "active personal management." Partners must be compensated only through their partnership "draws" or distributive shares.

"Active personal management" need not be performed on the farm. Thus, a person can contribute "active personal management" while residing on New York City's Fifth Avenue.

In general, a "significant contribution" of land, capital, or equipment is a contribution equal in rental value (land and equipment) or cash value (capital) to 50 percent of the contributor’s commensurate share of the total value of those respective inputs necessary to conduct the farming

75. See id. §§ 1400.205(a) (Trusts), 1400.206(a) (Estates).
76. See id. § 1400.204(b).
77. See id. § 1400.205(b).
78. See id. § 1400.206(a).
79. See id. § 1400.201(d).
80. See id. § 1400.3 (defining “Active personal labor” and “Active personal management”).
81. See id. § 1400.204(b).
82. See id. § 1400.3 (defining “Active personal management”).
83. Also, under the “landowner rule,” a "person" can be deemed to be "actively engaged in farming" merely by contributing land to the farming operation. See id. § 1400.207. Thus, a New York City resident who owns a farm in Alabama and share-leases the farm can be “actively engaged in farming.”
A "significant contribution" of "active personal labor" is 1,000 hours (one-half of a year's worth of 40-hour workweeks) or at least 50 percent of the hours necessary to conduct a farm comparable in size to the individual's share of the farming operation. A "significant contribution" of "active personal management" is a contribution that is "critical to the profitability of the farming operation, taking into account the individual's or entity's commensurate share in the farming operation." A somewhat similar standard applies when labor and management are contributed in combination.

"Significant contributions" of land and equipment can include owned or leased land or equipment, and owned or borrowed capital. If, however, the land, equipment, or capital was acquired through a loan made, guaranteed, or secured by an individual or entity with an "interest in the farming operation" its contribution cannot qualify as a "significant contribution." Nonetheless, such contributions may be included in the "commensurate" contribution calculation if certain requirements are met.

The so-called "financing rules" prohibit contributions of capital, equipment, or land from being deemed "significant contributions" if they were acquired through a loan made, guaranteed, or secured by someone with an "interest in the farming operation." These rules are found in the definitions of "capital," "equipment," and "land." They apply only when an input of capital, equipment, or land has been acquired (1) through a financing arrangement (2) involving someone with an "interest in the farming operation" of the contributor.

The regulations deem that person has an "interest in a farming operation" of the contributor of an input when that person

(1) owns or rents the land;
(2) has an interest in the agricultural commodities produced; or

84. See id. § 1400.3 (defining “Significant contribution”).
85. Id.
86. See id. § 1400.3 (defining “Active personal management”).
87. See id. § 1400.3 (defining “Capital,” “Equipment,” and “Land”).
88. See id. § 1400.3 (defining “Interest in a farming operation”).
89. See id. § 1400.3 (defining “Capital,” “Equipment,” and “Land”).
90. See id.
91. See id.
(3) is a member of a joint operation (e.g., general partnership or joint venture) that either owns or rents the land or has an interest in the agricultural commodities produced.\textsuperscript{92}

A contribution that violates a financing rule sometimes is referred to as a “tainted” contribution. Although a “tainted” contribution cannot be used to satisfy the “significant contribution” requirement, it can be used to satisfy the “commensurate contribution” and “at risk” requirements if certain conditions are met. These conditions are set forth in the definitions of “capital,” “equipment,” and “land.” In general, a “tainted” contribution can be counted toward the “commensurate contribution” and “at risk” requirements if the loan by which the input was acquired bears the prevailing interest rate.\textsuperscript{93}

The following “decision tables” offer guidance on applying the financing rules:

<table>
<thead>
<tr>
<th>Question</th>
<th>If . . .</th>
<th>Then . . .</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Was the capital acquired as the result of a loan?</td>
<td>Yes</td>
<td>Go to question 2.</td>
</tr>
<tr>
<td></td>
<td>No</td>
<td>This capital may be used as a significant contribution or to acquire a significant contribution of land or equipment.</td>
</tr>
<tr>
<td>2. Was the loan made by, guaranteed by, or otherwise secured by someone with an interest in the farming operation?</td>
<td>Yes</td>
<td>This capital may not be used as a significant contribution or to acquire a significant contribution of land or equipment. Go to question 3.</td>
</tr>
<tr>
<td></td>
<td>No</td>
<td>This capital may be used as a significant contribution or to acquire a significant contribution of land or equipment.</td>
</tr>
<tr>
<td>3. Does this loan bear the prevailing interest rate?</td>
<td>Yes</td>
<td>This capital may be used as a commensurate contribution or to acquire a commensurate contribution of land or equipment.</td>
</tr>
<tr>
<td></td>
<td>No</td>
<td>This capital may not be used as a contribution (significant or commensurate) or to acquire a contribution (significant or commensurate) of land or equipment.</td>
</tr>
</tbody>
</table>

The definitions of “equipment” and “land” permit contributions of leased equipment and land to count as “significant contributions.” If the equipment or land is leased from an individual or entity with an interest in the farming operation, it must be leased at its fair market value.\textsuperscript{94} In effect, leasing at less

\textsuperscript{92}. See id. § 1400.3 (defining “Interest in a Farming Operation”). An expanded and somewhat different definition is found in the FSA Handbook, 1-PL (Rev. 1) at ¶ 91. Among other variations on the regulatory definition, ¶ 91 of 1-PL (Rev. 1) excludes shareholders of a corporation when the corporation is the producer from those persons having an interest in the farming operation.

\textsuperscript{93}. See 7 C.F.R. § 1400.3 (defining “Capital,” “Equipment,” and “Land”).

\textsuperscript{94}. See id. § 1400.3 (defining “Equipment” and “Land”).
than fair market value amounts to “financing.” Thus, consider the following decision table for leased equipment (a decision table for land would be similar):

<table>
<thead>
<tr>
<th>Question</th>
<th>If...</th>
<th>Then...</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Is leased equipment used in the farming operation?</td>
<td>Yes</td>
<td>Go to question 2.</td>
</tr>
<tr>
<td></td>
<td>No</td>
<td>There is no need to use this decision table.</td>
</tr>
<tr>
<td>2. Is the equipment leased from an individual or entity with an interest in the farming operation?</td>
<td>Yes</td>
<td>The equipment must be leased at fair market value.</td>
</tr>
<tr>
<td></td>
<td>No</td>
<td>The equipment does not have to be leased at fair market value. Go to question 3.</td>
</tr>
<tr>
<td>3. Is any “tainted” capital used in this farming operation?</td>
<td>Yes</td>
<td>Go to question 4.</td>
</tr>
<tr>
<td></td>
<td>No</td>
<td>The leased equipment may be used as a significant and commensurate contribution.</td>
</tr>
<tr>
<td>4. Is sufficient “untainted” capital available in the operation to pay the lease?</td>
<td>Yes</td>
<td>The leased equipment may be used as a significant and commensurate contribution.</td>
</tr>
<tr>
<td></td>
<td>No</td>
<td>The leased equipment may not be used as a significant contribution, but it may be used as a commensurate contribution.</td>
</tr>
</tbody>
</table>

To illustrate how the financing rules might apply, assume individuals A and B farm as a general partnership. Under the definition of “interest in a farming operation,” they each have an interest in the partnership’s farming operation. Also assume that the partnership will borrow, in its name, all of the capital needed to fund its farming operation, including the funds required to lease the necessary equipment and land. If either A or B guarantee the loan to the partnership or secure it with their personal assets, the partnership’s contributions of capital, equipment, and land would not qualify as “significant contributions.”

Although the so-called “financing rules” often present difficulties, there are various ways to work through these difficulties. The best approach is to avoid a problem with a financing rule altogether by making sure that no one with an “interest in [the] farming operation” is involved in the financing leading to the acquisition of the input(s) needed to satisfy the “significant contribution” requirement.

95. See id. § 1400.3 (defining “Interest in a farming operation”). FSA Handbook 1-PL (Rev. 1) has a more complete definition of “interest in a farming operation.” For example, unlike the regulation, 1-PL (Rev. 1) provides that shareholders in a corporation do not have an interest in the farming operation of the corporation. 1-PL (Rev. 1) ¶ 91(B).

96. The FSA Handbook permits all of the members of a joint operation to guarantee a loan to the joint operation without violating a “financing rule” if none have an interest in another farming operation. See, e.g., 1-PL (Rev. 1), ¶ 296(C). Since this is not permitted by the regulations, reliance on the Handbook directive potentially is perilous.
If financing by someone with an interest in the farming operation cannot be avoided altogether, one alternative is to satisfy the “significant contribution” of capital, equipment, or land with the contribution of an input whose acquisition is not “tainted” by a financing rule violation. For example, if a lender insists on personal guarantees by the members of a general partnership for a loan to the partnership, the partnership’s contribution of this capital will not qualify as a “significant contribution.”

The partnership, however, may still be able to make the requisite “significant contribution” of an input or a combination of inputs by contributing equipment or land or a combination of both whose acquisition was not funded by the “tainted” capital borrowed from the lender. Alternatively, the lender could be persuaded to make two loans to the farming operation, one of which was not guaranteed by the partnership’s individual members. So long as the loan that was not guaranteed results in a contribution of at least 50 percent of the capital needed by the partnership for the year’s farming operation, this contribution of capital would qualify as a “significant contribution” of capital.

Illustration:

To illustrate how the "actively engaged in farming" requirements apply in an artificially simple hypothetical, consider the case of a husband and wife who farm as a general partnership. They began farming together after their marriage, and they participate in the direct and counter-cyclical payment programs. Neither spouse has an interest in any other farming operation that receives farm program payments. Neither spouse has an interest in any other farming operation that receives farm program payments. As discussed above, a general partnership cannot be a "person." Thus, here only the spouses can be "persons," and they can avoid being combined by availing themselves of the second exception to the "combination" rule for husbands and wives.

All of the land farmed by the partnership is owned by the partnership. The same is true for the needed equipment, and all of the necessary capital is borrowed by the partnership. As discussed above, only a "significant" amount of one of these inputs or a "significant" combination of two or more of them is required for "significant contribution" purposes; a “significant contribution” of all three inputs is not required.

The husband contributes 100 percent of the labor and 50 percent of the management. The wife contributes 50 percent of the management. Labor and management do not have to be contributed in combination; a "significant contribution" of one or the other will suffice. Finally, for purposes of this example, assume that all of the respective contributions of land, equipment, capital, labor, and management have an equal per-unit rental or other value, as applicable to the input or service (Husband: Land 1; Capital 1; Equipment 1; Labor 2; Management 1 = 6 or 60%; Wife: Land 1; Capital 1; Equipment 1; Land 0; Management 1 = 4 or 40%).

In this example, both spouses have satisfied both "sides" of the "significant contribution" requirement. The partnership satisfied the "left-hand side" for each of them, and they individually satisfied the "right-hand side."

97. This is an entirely unrealistic assumption because the dollar values of the land, equipment, and capital will almost always significantly exceed the monetary value of the contributed labor and management. Nonetheless, for simplicity in illustrating the importance of the "commensurateness" requirement, the assumption must be made. Otherwise, the required mathematics might devour the points this example illustrates.
Can the husband and wife claim equal shares in the farming operation? No. Their respective commensurate shares of the contributed land, capital, and equipment are equal because these inputs were contributed at the partnership level and thus are deemed to have been made equally between them. Their respective contributions of labor and management, however, are not equal. If the wife claims more than 40 percent of the farming operation's profits and losses, her contributions will not be "commensurate" with her claimed share of the profits of the partnership because she has only contributed 40 percent of the total contributions to the farming operation. Consequently, she will be denied all farm program payments, and her husband will not be entitled to receive what would have been her share.

Assuming that their respective contributions are "at risk," both the husband and wife will be "actively engaged in farming" if he claims a 60 percent interest in the partnership, and she claims a 40 percent interest. As a result, assuming that their farm will produce exactly $210,000 in direct and counter-cyclical payments, they will be leaving $21,000 "on the table." The husband's partnership distributive share right to $126,000 ($210,000 x .60) of those payments will be capped at $105,000 by the direct payment limit ($40,000) and the counter-cyclical payment limit ($65,000). As a couple, they will receive $189,000; she will receive $84,000 ($210,000 x .40), and he will receive $105,000.

This result is still a gain of $84,000 over what their farming operation would have received if they had been "combined" under the general combination rule for husbands and wives. If, however, their interests in the partnership had been equal and each of them had been “actively engaged in farming” with equal interests, they each would have received $105,000 for a total of $210,000.

Among other things, this example illustrates that each partner's "actively engaged in farming" status is separately determined. The problem this couple encountered with the "commensurate" contribution requirement would have been compounded if only one spouse, instead of the couple's partnership, owned or leased the land or equipment. In that case, the other spouse would have to acquire and contribute an equal amount of land or equipment if they wanted to have 75 percent/25 percent shares based on the contributions of labor and management assumed in this example. As discussed above, when the farming operation is conducted by a partnership, the partnership's members can make the "left-hand side" contributions individually or have the partnership make those contributions for them.

7. **Do All "Persons" Have to Satisfy All of the General "Actively Engaged in Farming" Requirements?**

The "actively engaged in farming" requirements are relaxed for landowners, family members, and sharecroppers. Of these "special classes," "family members" and landowners are the most common.

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98. In the "real world," depending on the relative value of the contributions, the spouses might be able to qualify for equal shares.

99. See 7 C.F.R. § 1400.207.

100. See id. § 1400.208.

101. See id. § 1400.209.
The "actively engaged in farming" rules are relaxed for farming operations in which a majority of the "persons" are individuals who are family members. A "family member" is defined to include lineal ancestors and descendants and siblings. It also includes spouses of those individuals who do not make a "significant contribution" to the farming operation.\textsuperscript{102} In such an operation, adult family members are excused from making "left-hand side" contributions. In other words, they will be deemed to be "actively engaged in farming" by making a "significant contribution" of "active personal labor," "active personal management," or a combination thereof.\textsuperscript{103}

Under the "landowner rule," a person who owns an interest in land and who receives rent or income for the use of that land based on the land's production or the farming operation's operating results is automatically deemed to be "actively engaged in farming."\textsuperscript{104} Such an arrangement is usually called a crop share lease.\textsuperscript{105} The use of custom farming services may also qualify a person as a "landowner."

"Landlords," on the other hand, may never be deemed to be "actively engaged in farming."\textsuperscript{106} A "landlord" is a person who receives a guaranteed return on the land's use, whether payable in cash or in a fixed quantity of the crops. Such an arrangement is usually called a cash lease.\textsuperscript{107}

8. What Other Rules Are Imposed by the Payment Limitation Statutes and Regulations?

Among the other commonly encountered payment limitation and eligibility rules are the "cash rent tenant rules" and the "substantive change rule."

A. The cash rent tenant rules.

Cash rent tenants are persons who rent land for cash or for a crop share guaranteed in amount.\textsuperscript{108} To be "actively engaged in farming," a cash rent tenant must make a "significant contribution" of

1. land, capital, or equipment and active personal labor; or

\textsuperscript{102} See id. § 1400.3 (defining “Family member”).

\textsuperscript{103} See id. § 1400.208. The “family member rule” probably contemplates that at least one adult family member will make a “significant contribution” of the qualifying input(s), but neither the regulations nor 1-PL (Rev. 1) are clear in this respect.

\textsuperscript{104} See id. § 1400.207.

\textsuperscript{105} See, e.g., id. § 1412.303(a)(3).

\textsuperscript{106} See id. § 1400.211.

\textsuperscript{107} See, e.g., id. § 1412.303(a)(2).

\textsuperscript{108} See id. § 1400.401(a). Under the cash-rent tenant rule, a person who rents land for free is also a cash-rent tenant.
2. equipment and active personal management.

If the cash rent tenant seeks to qualify under option 2 above and the equipment is leased from the landlord, the lease must reflect payment of the equipment's fair market value. If the equipment is leased from the person who is providing labor to the farming operation, the equipment lease and the labor fees must be based on fair market values, and the cash rent tenant must exercise complete control over a significant amount of the equipment during the crop year.\(^{109}\) Program participants seeking to qualify under option 2 above and who lease equipment from the same individual who provides hired labor must not give the equipment owner the right to use the equipment on demand.

Cash leasing farmland is very common, particularly by larger farming operations. Many, if not most, larger farming operations are conducted as general partnerships so as to “maximize” farm program payments. As to the cash rented land, each member of the partnership must satisfy the cash rent tenant rule.

Since large farming operations usually rely on hired labor for most of their labor needs, none of the individual partners ordinarily makes a “significant contribution” of “active personal labor.” Thus, for each of the members to satisfy the cash rent tenant rule with respect to the cash rented land, either each member must make a “significant contribution” of equipment or, preferably for ease in satisfying the “commensurate contribution” requirement, the partnership must make a “significant contribution” of equipment on behalf of its members. The partners must each make a “significant contribution” of “active personal management.” Because only equipment will satisfy the “left-hand side” of the “significant contribution” equation, its acquisition must not violate the so-called “financing rules.”

B. The "substantive change rule."

The "substantive change rule" applies when the number of "persons" in a farming operation increases from the preceding crop year. The increase will be recognized only if there was a "bona fide and substantive" change in the farming operation. For example, if bona fide, a 20 percent increase in total cropland is deemed to be such a substantive change. The regulations list other changes that can qualify.\(^{110}\) The change must take place by April 1 of the applicable program or fiscal year.\(^{111}\) If no bona fide and substantive change is made, the increase in “persons” is not recognized until the subsequent year.

The bulk of the substantive change rules are found in 1-PL (Rev. 1).\(^{112}\) These rules are among the most imprecisely drafted directives in 1-PL (Rev. 1), but they must be consulted given the brevity of the regulation in comparison to the lengthy directives found in 1-PL (Rev. 1).

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109. See id. § 1400.401(a).

110. See id. § 1400.109.

111. See id. § 1400.100(b).

112. See 1-PL (Rev. 1) ¶¶ 93-97.
9. What Paperwork Do Farmers Have to Complete Regarding Payment Limitation Compliance?

A. "Permitted Entities" Notification and the CCC Form 502 ("Farm Operating Plan").

The only payment limitation paperwork requirement expressly imposed by Congress is a notification requirement related to the "three-entity rule." Under this requirement, an individual who has an interest in more than the number of "permitted" entities must provide notification of the entities through which the individual will receive payments. The FSA, however, imposes a significant paperwork requirement by conditioning the receipt of payments on the voluntary submission of various forms and supporting documentation.

The basic payment limitation form is known as the "CCC Form 502." This form is called a "Farm Operating Plan," and it must be completed before payments can be received. The form asks for information regarding the producer's contributions to the farming operation that generally correlates to the "actively engaged in farming" requirements. If the operation has not changed from the preceding year, producers may so certify on an abbreviated form.

The CCC Form 502 is submitted in the name of the farming operation, and the Form varies depending on whether an individual, general partnership, entity, trust, or estate is conducting the operation. For example, farming operations conducted by an individual complete a 502A while general partnerships complete a 502B.

The farming operation must be in existence as of the "status date" for each program year, which is either April 1 of the crop year or the fiscal year, depending on the program. The number of "persons" on a farming operation may not be increased after the status date. The number of "persons" may be decreased, however, based on the farming operation's "status" on or before the date of the last program crop harvested.

B. "End-of-year reviews"

The FSA conducts "end-of-year reviews" of selected producers to determine whether they followed their respective farm operating plans. These reviews usually require those producers to provide nearly all of their operation's records for that crop year. On occasion, the USDA Office of Inspector General (OIG or IG) conducts audits of farming operations either on its own initiative or at the request of the FSA.


114. See 7 C.F.R. § 1400.100(a).

115. See id. § 1400.100(b).
10. **What about "Schemes and Devices" to Evade the Payment Limitation Rules?**

The payment limitation and payment eligibility statute prohibits "schemes or devices" having the "purpose" of evading the payment limitation rules. The regulations significantly expand this prohibition by prohibiting such actions that have the "effect" of evading the rules. A person who adopts or participates in a prohibited "scheme or device" is ineligible for payments in that year and the following year. 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.

False statements made in seeking farm program benefits can also lead to civil or criminal liability under the False Claims Act and criminal prosecution for mail fraud and other offenses.

*This article was prepared in June 2002.*

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117. *See* 7 C.F.R. § 1400.5(a).

118. *See id.* § 1400.5(b).

119. The regulation provides that examples of a scheme or device include "[c]oncealing information . . ., [s]ubmitting false or erroneous information, or [c]reating fictitious entities for the purpose of concealing the interest of a person in a farming operation." *Id.* § 1400.5(a).
