

Federal Farm Programs: Organizational Structure Matters – Part Two

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Overview

In Part One of this series earlier this week, I provided background on the basics of federal farm programs and how those benefits can be obtained. The structure question bears on the amount of payments that can be obtained. In today's Part Two I dive into the monetary limits and the adjusted gross income limitation that applies. That involves a discussion of the attribution rule, the definition of a person and the "separate and distinct" requirement.

Part Two of a Three part series on federal farm programs and the structure of the farm business – today's post continues the discussion.

Monetary Limit

As previously noted, the Farm Bill established a payment limit of \$125,000 per person or legal entity (excluding general partnerships and joint ventures). This is the general rule. Peanut growers are allowed an additional \$125,000 payment limitation, and the spouse of a farmer is entitled to an additional \$125,000 payment limit if the spouse is enrolled at the local Farm Service Agency (FSA) office. The limit applies to all PLC, ARC, marketing loan gains, and loan deficiency payments.

Note: A farmer that files a tax return as married filing jointly can potentially double the payment limit. Indeed, in a community property state (AZ, CA, ID, LA, NV, NM, TX, WA and WI) each spouse typically reports exactly one-half of the joint income on a separate return. This makes each spouse potentially eligible to receive payments, subject to the \$900,000 AGI limit. In separate property states, the \$900,000 limit could come into play more often. Also, if a joint return exceeds the AGI limits, a certification statement from a CPA or an attorney can be provided that specifies the manner in which income would have been declared and reported had the spouses filed two separate tax returns. The statement must also certify that the total allocations of income are consistent with the information that supports the filed joint tax returns.

The payment limit is applied at both the entity level (for entities that limit liability) and then the individual level (up to four levels of ownership). Thus, general partnerships and joint ventures have no payment limits. Instead, the payment limit is calculated at the individual level. However, an entity that limits the liability of its shareholders/members is limited to one payment limitation. That means that the single payment limit is then split equally between the shareholders/members.

The AGI Limitation

To be eligible for a payment limit, an AGI limitation must not be exceeded. That limitation is \$900,000, and applies to commodity programs, conservation programs and disaster programs.

The AGI limitation is an average of the three prior years, with a one-year delay. In other words, farm program payments received in 2022 are based off the average of AGI for 2018, 2019 and 2020.



Note: While FSA had not treated the I.R.C. §179 deduction as allowed against AGI for S corporations and LLC's taxed as partnerships, but did allow it for C corporations and individuals, beginning with 2017 crop year the deduction has been allowed against AGI for all entities. It took threatened litigation to get FSA to change its position on this issue.

The AGI limitation, which does not apply for crop insurance purposes, applies to *both* the entity and the owners of the entity.

Example. Assume that FarmCo receives \$100,000 of farm program payments in 2015. FarmCo's AGI is \$850,000. Thus, FarmCo is entitled to a full payment limitation. But, if one of FarmCo's owners has AGI that exceeds the \$900,000 threshold, a portion of FarmCo's payment limit will be disallowed in proportion to that shareholder's percentage ownership. So, if the shareholder with income exceeding the \$900,000 threshold owns 25 percent of FarmCo, FarmCo's \$100,000 of farm program payment benefits will be reduced by \$25,000.

Attribution Rule. Under a rule of direct attribution, individuals and entities are credited with both the amount of payments received directly and also the amount received indirectly by holding an interest in an entity receiving payment. In general, payments to a legal entity (defined as an individual, a partnership, a limited liability company or a corporation) are attributed to the persons who have a direct or indirect interest in the legal entity. But, payments made to a joint venture or general partnership are determined by multiplying the maximum payment amount by the number of persons and entities holding ownership interests in the joint venture or general partnership. That means that joint ventures and partnerships are not subject to the attribution rules.

Note: The direct attribution rule originated in the 2008 Farm Bill and operates as a payment limitation for a farming operation and for each member of the farming operation. The rule tracks payments to legal entities through (up to) four levels of ownership. This means that if another entity has any ownership interest in the farming operation receiving payments, the payments to the farming operation are reduced by a proportionate percentage of that indirect interest. Whether or not direct attribution exists is measured every June 1.

As applied to marketing cooperatives, the attribution rules apply to the producers as persons, and not to the cooperative association of producers. Also, children under age 18 are treated the same as the parents. It is also assumed that if one parent has filled their payment limit, payments made to a child could be attributed to the parent that has not filled their payment limit. For payments made to a revocable trust, they are attributed to the trust's grantor. As applied to irrevocable trusts and estates, the Ag Secretary is directed to administer the rules so as to ensure "equitable treatment" of the beneficiaries.

What (or Who) is a "Person"?

Definition of "person." The definition of a "person" under the payment limitation rules is the key to proper structuring of the farming business for maximum payment limits. The definition of "person" is contained at 7 C.F.R Sec. 1400.3. "Persons" may be individuals, corporations, limited liability companies, and certain other business organizations (such as trusts, estates, charitable organizations, and states and their agencies), but general partnerships, joint ventures, and similar "joint operations" may not be "persons." Thus, individuals, along with entities that limit liability, can be a separate person entitled to a payment limit. But other business structures that don't limit liability are not a separate person for payment limitation purposes. This means that C corporations, S corporations and Limited Liability Companies (i.e., any type of entity that limits liability) all have *one* payment limitation.

Note: Almost all farming operations are either sole proprietorships, joint operations, corporations or a family operation involving multiple adult family members.



The Farm Service Agency (FSA) then implements the direct attribution rule down to the shareholders/members to the fourth level for each of the respective entities. Thus, the entity has a limitation, and then each member has a limitation. For these entities, if benefits are sought in the name of an entity and there are four shareholders or members of the entity, for example, there is a single payment limit. However, general partnerships, joint ventures, cooperative marketing associations, and other entities that don't limit liability are not eligible for "person" status, but the members are.

As a general rule, for farming operations other than those that are small, 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 member* of a partnership or joint venture 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 an entity that doesn't limit liability than is a farming operation conducted by an entity that does limit liability.

Note: With no limitation on liability comes joint and several liability. Farmers will generally not be comfortable with that, but it can be addressed by having the general partnership farming operation consist of single-member limited liability companies (in states where the governing LLC statute provides for charging orders) or other types of limited liability structures in lieu of individuals.

"Separate and distinct" requirement. Each "separate person" must have a "separate and distinct" economic investment in the farming operation. The "separate and distinct" requirement is measured by a three-part test.

- (1) Each separate person must have a separate and distinct interest in the land or the crop involved;
- (2) Each separate person must exercise separate responsibility for the separate interest; and
- (3) Each separate person must maintain funds or accounts separate from that of any other individual or entity for that interest.

Note: General partnerships and joint ventures may satisfy these requirements on behalf of their members.

Farmers and farm families sometimes jointly purchase inputs or exchange equipment or services. While this is permissible under the rules, farming operations that are separate have to stay that way – separate and distinct. Thus, it is important to make sure that transactions are done at arm's-length and a paper trail is created that clearly shows that separate farming operations are, indeed, separate and that each one meets all of the applicable requirements. Care should be taken to avoid a USDA argument that there is a commingling of funds between farming operations. Promptly paying for joint purchases is a good idea, as is making sure any equipment exchanges are equivalent. The idea is to avoid the appearance that one farming operation is responsible for what another farming operation is doing.

In addition, to be a "separate person," that "person" must "[m]aintain funds or accounts separate from that of any other individual or entity for such interest [in the land or crop involved]." This requirement is a prohibition against commingling of funds. It is not a bar on "financing." The rules on financing are complex. In general, financing restrictions are in the payment limitation and payment eligibility rules as part of the definitions of "capital," "equipment," and "land" and apply to "actively engaged in farming" determinations, not "person" determinations.

Illustrative Case

In a case involving a Montana farming operation, *Harmon v. United States Department of Agriculture*, No. 14-35228, 2016 U.S. App. LEXIS 23105 (9th Cir. Dec. 22, 2016), the plaintiff received federal farm program



payments from 2005 through 2008. The USDA determined that the plaintiff was not a separate “person” from his LLC which *also* received farm program payments for the same years. As a result, the USDA required the plaintiff to refund to the government the payments that he had received. The plaintiff disagreed with the USDA finding and exhausted his administrative remedies with the USDA to no avail. In court, the trial court upheld the USDA’s determination on summary judgment.

On appeal, the appellate court affirmed. The court noted that the plaintiff was required to show that he was “actively engaged in farming” and that he was a “separate person” from the LLC. The court determined that the definition of “person” applied to all of part 1400 of the Code of Federal Regulations (C.F.R.). That’s the part of the C.F.R. containing the “separate person” rules. As a result, the USDA’s interpretation of its own regulation defining “person” for payment limitation purposes that is set forth in 7 C.F.R. Sec. 1400.3 was consistent with the regulation and not plainly erroneous. The court also determined that substantial evidence supported the conclusion that the plaintiff was not a separate person from his LLC due to many unexplained transfers or loans between the plaintiff and the LLC without accompanying documentation. That suggested a commingling of funds, as did the making of operating loans back and forth between the plaintiff and the LLC. As such, the appellate court believed it was not possible to determine the true assets and liabilities of either the plaintiff or the LLC.

The appellate court also believed that the plaintiff had not made a good faith effort to comply with the per-person payment limitations, was not a separate person from the LLC and was entitled to only one payment limit instead of two. Also, the finality rule which makes a determination by a state or county FSA final and binding 90 days from the date an application for benefits was filed did not bar the FSA from evaluating the plaintiff’s program eligibility because the determination was based on misrepresentations that the plaintiff should have known were erroneous. On the application, the plaintiff had represented that he provided all of the capital and labor on his farm and didn’t receive any operating loans from related entities. In addition, while the decision of the Director of the USDA National Appeals Division did not meet the 30-day deadline, it was not void because the statute at issue (7 U.S.C. Sec. 6998(b)(2)) contains no remedy for failure to comply.

Observation: A key problem with the Montana farming operation was its structure. The LLC was a “person” under the rules, so the individual had to meet the tests for being a “separate person” from the LLC. He couldn’t do that with the result that only a single payment limitation applied. A better approach would have been to set the farming operation up as a general partnership. The general partnership would not have qualified as a “separate person,” but the individual farmer could have as a single-member LLC. That still would have resulted in one payment limitation, but additional family members could have been added as members with each having their own single-member LLC. That structure might also help address problems with commingling of funds with the operating entity.

In any event a professional that understands the rules can help to create a structure that can result in compliance with the rules and keep the farming operation from becoming tangled in needless litigation. That’s particularly the case for medium and larger-sized farming operations where the payment limit is in play.

Conclusion

In Part Three later this week, I will take a look at the management and recordkeeping requirements and planning issues for structuring the farm business.

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