POLICY MINUTE

Payment Limits and Commodity Programs

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As producers are completing sign-up for the farm programs under the 2002 Farm Bill, they are beginning to see the impact of payment limit changes made in the new law. At the same time, the Commission on the Application of Payment Limitations for Agriculture is requesting public input through March 24 on a review of payment limitations for commodity programs.

Recent inquiries suggest there are several questions about how the new payment limits and rules work. The following discussion of payment limits and rules is based on information from USDA available at www.usda.gov.

Commodity Programs and Payment Limits

Marketing Loans. Producers can receive benefits under the marketing loan program on their actual production through loan deficiency payments (LDPs) or marketing loan gains (MLGs). Remember that there is a loan rate in each county set by USDA and a posted county price (PCP) in each county based on daily national market prices adjusted back to the county level.

When and if the daily PCP is below the loan rate, producers can claim an LDP equal to the loan rate minus the PCP. As an alternative, producers can take out a loan and then repay the loan at any time at the lesser of the loan rate plus interest or the PCP. If the producer repays the loan with cash when the PCP is below the loan rate, the interest is forgiven and the difference between the loan rate and the PCP is realized as a MLG. Both LDPs and MLGs count against the payment limit on benefits under the loan program of $75,000 per person or entity per program year.

Producers can avoid the impact of this limit in two ways. If a producer takes out a loan and does not want to repay the loan at the loan rate plus interest, the producer can hold the loan until maturity (9 months) and then forfeit the grain to the government without being subject to the $75,000 limit. A second option involves repaying the loan with generic certificates. When the PCP is below the loan rate, a producer can purchase generic certificates from USDA with cash and then use the generic certificates to repay the loan at the PCP. This method results in the same gain as if the producer repays the loan at the PCP using cash, but the use of generic certificates does not count against the payment limit either.

Direct Payments. By comparison, direct payment limits are very straightforward. Producers qualify for direct payments based on their acreage base and direct payment yield, which are fixed at sign-up. And, since the payment rate is fixed, the exact payment level is known for the life of this farm program. The limit on these direct payments is $40,000 per program year per person or entity.

Counter-Cyclical Payments. Similar to the calculation of direct payments, counter-cyclical payments are based on the producer's acreage base and counter-cyclical payment yield. However, the actual payment rate can vary from year to year in relation to that marketing year's national average price. Payments made under the counter-cyclical payment program are limited to $65,000 per person or entity per program year.

Eligibility Rules: Spouses and Three Entities

The payment limits appear to simply sum up to $180,000 per person, but the rules on payment limits and the number of entities under which a producer can collect payments are complex. In

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addition, there are always questions about whether a spouse can or cannot be considered a separate "person" for payment eligibility purposes.

First, USDA defines a "person" as "an individual, including individuals in a general partnership or joint venture; an entity, such as a corporation, limited partnership, trust, or other similar entities; and a state, including its political subdivisions and agencies." And, existing farm program rules have generally combined husbands and wives as one "person" for payment limitation purposes. However, according to USDA, "if the requirements for spouses to be considered separate 'persons' are met and the spouses have requested to be considered separate 'persons,' the spouses may be considered separate 'persons.'"

Given the definitions, a "person" is eligible to receive farm program payments as part of up to three entities. A "person" is eligible for payments as one entity for all of the holdings they own solely or for which they have majority control. The individual is also eligible for payments in up to two other entities, such as corporations, limited partnerships, or trusts in which they control 50 percent or less of the entity. If an individual controls more than 50 percent of an entity, that entity generally would be combined with the individual's other personal holdings in the first entity.

If you consider the case where an individual qualifies for the full payment limit in one entity such as a sole proprietorship and qualifies for exactly half the payment limit due to a 50 percent share of two other entities, then the individual has effectively qualified for double the individual payment limit or $360,000. Although this double limit is widely mentioned, remember that it is only reached if the individual caps out payments in each part of the program in each of the three entities and the individual controls 100 percent of the first entity and exactly 50 percent of the other two entities.

Adjusted Gross Income Limitation

The 2002 Farm Bill included a new adjusted gross income (AGI) restriction for program eligibility. Any individual or entity is ineligible for program benefits if their three-year average AGI is greater than $2.5 million unless at least 75 percent of their AGI came from agricultural activities. Note that the AGI restriction applies to both the individual and the entity. If the entity is ineligible, there are no payments. If the entity is eligible, but a shareholder of the entity is ineligible, payments to the entity are reduced by that person's share of the entity.

Although this *Policy Minute* issue has focused on commodity program limits, it is important to note that the AGI restriction actually applies to both commodity and conservation programs. As to a definition, the AGI comes directly from the individual's tax return or from a similarly appropriate measure for other entities such as corporations and trusts.

Economic Effects

There are potentially significant effects on management decisions and business structure in response to the program payment limits and rules. It is readily apparent that the profitability of an agricultural operation or enterprise that is eligible for program benefits can be significantly greater than those for an equally efficient but ineligible operation. As such, payment limits may artificially limit the size of an operation to one that is just small enough so as to avoid sacrificing any potential program payments.

Given this situation, it is not surpirsing that operations that want to grow but are constrained by payment limits will look at their business structure and consider establishing multiple entities or formal husband-and-wife business relationships to comply with the program rules.

Another area of significant impact is with lease arrangements. Tenants that are at or near the payment limit would prefer crop-share or custom-farming arrangements to transfer payments to an eligible landlord. On the other hand, landlords that are at the limit or are ineligible will be looking to use more cash rental arrangements to shift payments to the tenant.

The discussion suggests that the economic impacts and appropriate role of program payment limits are complex questions. It is exactly these questions that the Commission will be examining and reporting on later this year.