

Federal Farm Programs: Organizational Structure Matters – Part Three

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Overview

In this final part of a three-part series on federal farm programs, the focus is on the “active personal management,” issues associated with maintaining good records, and planning implications for farms seeking to maximize payments.

Organizing the farm business with federal farm program payments in mind – it’s the topic of today’s post.

The Active Personal Management Requirement

Three-part test for “active engagement.” Under 7 C.F.R. Part 1400, a person must be “actively engaged” in farming to receive farm program payments. To satisfy the “actively engaged in farming” test, three conditions must be met.

- The individual's or entity's share of profits or losses from the farming operation must be commensurate with the individual's or entity's contribution to the operation.
- The individual's or entity's contributions must be “at risk.”
- An individual must make a significant contribution of land, capital or equipment (the “left-hand” requirement) and active personal labor or active personal management (i.e., the “right-hand” requirement).

For a general partnership, each member is treated separately for purposes of the active engagement test. Thus, each partner with an ownership interest must contribute active personal labor and/or active personal management to the farming operation on a regular basis. It is also important that the contribution be identifiable and documentable, as well as separate and distinct from the contributions made by any other partner. Any partner that fails to meet the active engagement requirement criteria is not eligible to participate in the federal farm programs.

Note: The payment of a guaranteed payment (i.e., “salary”) to a partner for providing active labor or management can bar the recipient partner from qualifying for payments. A guaranteed payment for services could mean that the partner does not satisfy the requirement of having made a qualified contribution of active labor or management and may disqualify the partner for a payment.

As noted above, a corporation is treated as a “person” for payment limitation purposes that is eligible for a single payment limit if each member with an ownership interest in the corporation makes a significant contribution of active personal labor or active personal management. In the context of a corporation, it does not matter if a member is compensated for contributions of active personal labor or management. But, it is still required that management or labor be performed on regularly, be identified and be documented. A



shareholder's contribution of labor or management must also be separate and distinct from the contributions of other shareholders or members. In addition, the contribution of *all* corporate members must be significant and commensurate with contributions to the farming operation.

If any member of the corporation fails to meet the labor or management contribution requirements, any program payment or benefit to the corporation will be reduced by an amount commensurate with the ownership share of that member. An exception applies if (a) at least 50% of the entity's stock or units is held by members that are "actively engaged in providing labor or management" and (b) the total annual farm program payments received collectively by the stockholders or members of the entity are less than one payment limitation.

Note: A corporation can pay a salary to owners.

Some farming operations are placed in trust for estate planning and business succession planning purposes. For purposes of the farm programs, a revocable trust is treated as the grantor. An irrevocable trust must satisfy the same requirements as does a decedent's estate. In addition, the interest of the beneficiaries of an irrevocable trust that provide active labor or management must be at least half of the trust's income interest.

Note: While a revocable trust need not obtain an employer identification number (EIN), an irrevocable trust must do so. Additionally, trusts must provide a tax identification number and in some cases this will come up with FSA in the context of a joint revocable trust where both spouses, as income beneficiaries are seeking program benefits.

A decedent's estate can meet the active engagement test for two program years after the year of the decedent's death if the estate makes a significant contribution of land, capital equipment (or a combination thereof). The executor or the heirs collectively must make a significant contribution of active personal labor or active personal management (or a combination thereof) to the farming business. The estate must also satisfy the profit (or loss) sharing rule and at-risk rule must also be satisfied. If the estate remains open for more than two program years post-death, the FSA must be satisfied that the estate remains open for reasons other than to receive program payments.

One spouse's satisfaction of the active engagement test requirement allows the other spouse to meet the test. If the non-participating spouse meets the ownership requirement with respect to land capital or equipment.

If a child under age 18 as of June 1 of a program year receives payments, the payment are attributed to the child's parent (or a person appointed by a court). A child under age 18 that is farming on their own is not subject to this rule (if certain other requirements are satisfied).

As for the requirement that a capital contribution be made, the contributed capital must come from a fund or account that is separate and distinct from any other person or entity that has an interest in the farming operation. The source of the capital can be via either a direct contribution of cash or the funds may be borrowed (carefully). For contributions that derive from borrowed funds, the funds must not be a result of any loan that is made to or guaranteed by or co-signed by or secured by any other person, legal entity or joint operation that has an interest in the farming operation and the other person (or entity) must not have such an interest.

Note: Cross-collateralization clauses are frequently encountered in the ag borrowing context. John Deere in particular has a rather egregious clause (from a farm borrower's perspective) as does the Small Business Administration. Those clauses will likely not be waived. Similarly, security and guarantee clauses will likely not be waived. A solution might be to put both the farm operating entity and the farmland into a general partnership (with each partner in an entity that limits liability).



What is "management"? Active personal management" is defined as significant contributions of management activities that are performed on a regular, continuous and substantial basis to the farming operation – basically the [I.R.C. §1402](#) test for self-employment tax purposes. In addition, the management activities must represent at least 25 percent of the total management time that is necessary for the success of the farming operation on an annual basis, or represent at least 500 hours of specific management activities annually.

Multiple "person" determinations? The rules also restrict the number of persons that may qualify for payment by making a significant contribution of active personal management. For this purpose, the limit is one person *unless* the farming operation is large or complex. A "large" farming operation is one that has crops on more than 2,500 acres (planted or prevented from being planted). If the acreage limitation is satisfied, an additional person may qualify upon making a significant contribution of active personal management. If the farming operation satisfies another test of being "complex," an additional payment limit may be available. This all means that, for large *and* complex, farming operations, a total of three payment limits may be obtained. The determination of whether a farming operation is "complex" is made by the State FSA Committee.

Special rules. Special rules apply to tenant-operated farms and family-owned operations with multiple owners. In some situations, a person meeting specified requirements is considered to be actively engaged in farming in any event. For example, a crop-share or livestock-share landlord who provides capital, equipment or land as well as personal labor, or active personal management meets the test. But, a cash rent landlord does not meet the test nor does a crop share landlord if the rent amount is guaranteed. Also, if one spouse meets the active engagement test, the other spouse is deemed to meet the test.

Exemption for family operations. The active personal management test applies to *non-family* general partnerships and joint operations that seek to qualify more than one farm manager based solely on providing management or a combination of management and labor (another rule). However, it does not apply to farming operations where all of the partners, stockholders or persons with an ownership interest in the farming operation (or any entity that is a member of the farming operation) are "family members." For this purpose, "family member" means a person to whom another member in the farming operation is related as a lineal ancestor, lineal descendant, sibling, spouse or otherwise by marriage. Legally adopted children and step-children count as "family members."

The rule also doesn't come into play where only one person attempts to qualify under the rule or when combined with a contribution of labor. The rule also doesn't apply to farming operations that are operated by individuals or entities other than general partnerships or joint ventures.

Record-Keeping Requirements

When multiple payments are sought for a farming operation under the active management rule, the operation must maintain contemporaneous records or logs for all persons that make any contribution of management. Those records must include, at a minimum, the location where the management activity was performed, and the amount of time put into the activity and its duration. In addition, every legal entity that receives farm program payments must report to the local FSA committee the name and social security number of each person who owns, either directly or indirectly, any interest in the entity. Also, the entity must inform its members of the payment limitation rules.

The FSA Handbook (5-PL, Amendment 3) specifies that the farming operation must maintain contemporaneous records or logs for *all* persons that make management contributions. The records must provide: (1) the location (either on-site or remote) where the management activity was performed; (2) the time spent on the activity and the timeframe in which it occurred; and (3) a description of the activity. FSA



Handbook, Paragraph 222A. It is important that the records be maintained and be timely made available to the FSA for their review upon request. *FSA Handbook, Paragraph 222B.* The FSA provides a Form (CCC-902 MR) to track and maintain all of the necessary information. Note that these are the present references to the applicable FSA Handbook Paragraphs and Form. Those paragraph references and Form numbers can change. FSA modifies its handbook frequently; Forms are modified and numbers often are changed. Practitioners and their farm clients must be diligent in monitoring the changes.

Two things happen if the necessary records aren't maintained – (1) the person's contribution of active personal management for payment eligibility purposes will be disregarded; and (2) the person's payment eligibility status will be re-determined for that particular program year.

Planning Implications

The “substantive change” rule. In general, any structural change of the farming or ranching business that *increases* the number of payment limits must be bona fide and substantive and not a “scheme or device.” See, e.g., *Val Farms v. Espy, 29 F.3d 1570 (10th Cir. 1994)*. In addition, reliance on the advice of local or state USDA officials concerning the payment limitation rules is at the farmer or rancher's own risk. But the substantive change rule does not apply to spouses. Thus, for example, a spouse of a partner that is providing active management to a farm partnership can be added to the partnership and automatically qualify as a partnership member for FSA purposes. However, a “substantive change occurs when a “family member” is added to a partnership unless the family member also provides management *or* labor.

Note: As a farming operation grows and want to add substantially more acres, consideration may need to be given to the creation of an additional entity. One approach might be to put all of the farming entities into a general partnership with the “farmer” as the general partner.

"Scheme or device." The USDA is adept at alleging that a farming operation has engaged in a "scheme or device" that have the purpose or effect of evading the payment limitation rules. But this potential problem can be avoided if multiple payments are not sought, such as by having one manager for each entity engaged in farming. Of course, this is not a concern if all of the members of a multi-person partnership are family members. If non-family members are part of the farming operation, perhaps they can farm individually or with other non-family members that can provide labor to the farming business. That might be a safe approach.

"Combination" rule. There is also a “combination” rule that can apply when the farming business is restructured. If the rule applies, it will result in the denial of separate “person” status to “persons” who would otherwise be eligible for a separate limit.

Entity type based on size. From an FSA entity planning standpoint, the type of entity structure utilized to maximize payment limits will depend on the size/income of the operation.

For smaller producers, entity choice for FSA purposes is largely irrelevant. Given that the limitation is \$125,000 and that payments are made either based on price or revenue (according to various formulas), current economic conditions in agriculture indicate that most Midwestern farms would have to farm somewhere between 3,000 and 4,000 acres before the \$125,000 payment limit would be reached. Thus, for smaller producers, the payment limit is not likely to apply and the manner in which the farming business is structured is not a factor.

For larger operations, the general partnership or joint venture form is likely to be ideal for FSA purposes. If creditor protection or limited liability is desired, the partnership could be made up of single-member LLCs. For further tax benefits, the general partnership's partners could consist of manager-managed LLCs with bifurcated interests.



Conclusion

Farm program payment limitation planning is a complicated mix of regulatory and administrative rules and tax/entity planning. It's not an area that a producer should engage in without counsel if maximizing payments in conjunction with an estate/business plan is the goal. Unfortunately, few practitioners are adept at navigating both the tax planning rules and the FSA regulatory web. This makes it important that professionals advising farm clients on farm business organization and the associated tax rules work as a team to produce the best result for clients.

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