

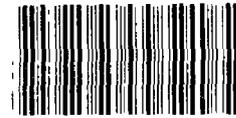
GAO

Report to the Honorable
Silvio O. Conte, House of Representatives

September 1987

FARM PAYMENTS

USDA's Proposed Changes to the \$50,000 Payment Limit Could Be Improved



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United States
General Accounting Office
Washington, D.C. 20548

**Resources, Community, and
Economic Development Division**

B-225866

September 11, 1987

The Honorable Silvio O. Conte
House of Representatives

Dear Mr. Conte:

In your letter of May 13, 1987, you requested that we review the U.S. Department of Agriculture's (USDA) report to the Congress on the \$50,000 per person payment limitation.¹ USDA's report contains legislative and administrative proposals intended to discourage reorganizations of farming operations that had the effect of avoiding the payment limitation by adding new "persons" to farming operations. At that time, as part of another ongoing review, we were evaluating USDA's report and have since published our findings.² This report summarizes the key points of that review and, as you requested, contains our proposed legislative language to enhance the effectiveness of USDA's proposals, where appropriate.

USDA is authorized by the Agricultural Act of 1949 as amended to make direct income support payments to assist farmers under its annual farm programs. The Congress limited such payments to farmers to \$50,000 per person to reduce costs and prevent farmers from benefiting excessively. The current \$50,000 per person payment limit was established in 1980 and extends through 1990. In addition, there is a separate annual limit of \$50,000 per person for the long-term conservation reserve program that was established by the Food Security Act of 1985. While separate, this limit uses the same legislative and regulatory provisions to determine who or what constitutes a person for payment limitation purposes.

Under existing legislation and regulations, persons are defined for payment limitation purposes as individuals, members of joint operations, or entities such as limited partnerships, corporations, associations, trusts, and estates that are actively engaged in farming. As such, a reorganization that adds a new person or persons to a farming operation can result in greater payments because each new person can qualify for up to \$50,000 in payments. For example, a producer who raises enough crops

¹Report to the Congress by the Secretary of Agriculture with Respect to the Implementation of the Maximum Payment Limitation, March 10, 1987

²See Farm Payments: Basic Changes Needed to Avoid Abuse of the \$50,000 Payment Limit (GAO, RCED-87-176, July 20, 1987).

to earn \$100,000 in payments can receive only \$50,000 because of the payment limit. However, if that producer could reorganize the operating structure of that farm by taking in a partner, they could each receive up to \$50,000 in payments, or a total of \$100,000. (See app. I for additional details.)

In summary, we found that USDA's proposals would be effective in reducing avoidance of the payment limit. However, with certain revisions, USDA's proposals can be made even more effective. The adoption of USDA's proposed legislation, with our suggested revisions, will discourage many farm reorganizations designed to avoid the payment limitation and will reduce future government farm program payments. Congressional action on the proposed legislation is particularly important because, although USDA can implement some of its proposals under existing legislative authority, agency officials are reluctant to make any changes until the Congress reaches a consensus on what changes USDA should make. (See app. II for additional details). Draft legislative language to implement our suggested revisions to USDA's proposal is included in appendix III.

USDA's Proposals Are a Major Improvement Over Current Law and Regulations

In its March 1987 report to the Congress, USDA proposed a number of legislative and administrative changes to reduce avoidance of the payment limit by producers participating in USDA's farm programs. These proposals eliminate the advantage of adding new "persons" to a farming operation by incorporating or adding members to a joint operation—the methods used most frequently to avoid the limit.

Essentially, the changes proposed by USDA will reduce reorganizations to avoid the \$50,000 limit because payment limits for each individual and the number of individuals actively engaged in farming, not the type of organizational structure, will be the driving force in applying the payment limit. One specific change will reduce the advantage of adding new members to increase the payment limit for an entity's operation, which is now possible for joint operations, by limiting payments to the persons actively engaged in farming. Another proposed change will reduce the advantage of creating corporations that qualify as separate persons by attributing payments for an entity to the owners and counting these payments against the owners' individual payment limits. USDA also proposes making other rules more restrictive, such as the rule for combining entities with common ownership.

With two exceptions, USDA can implement its proposed changes under existing legislative authority. These exceptions involve proposals for determining an entity's payments on the basis of the number of its members actively engaged in farming and for combining entities with common ownership. Making these two changes requires legislative authorization. Agency officials stated, however, that they did not want to make any of the proposed changes until the Congress reaches a consensus about what changes USDA should make.

USDA's Proposals Still Have Some Loopholes

USDA officials stated that they intended for their proposal to limit total payments to any individual to the \$50,000 annual limit established in law, whether these payments were from the individual's own farming operations or were attributed to the individual from legal entities in which the individual shares ownership. However, we found that USDA's proposals will not always accomplish this. Specifically, USDA's proposals would allow an individual to own portions of a number of corporations and receive payments from those corporations in excess of \$50,000 as long as the individual has no farming interest outside the corporations.

USDA's proposals also do not address avoidance of the payment limit through the division and lease of land to investors not otherwise engaged in farming. Under current rules the investors' involvement in farming can be limited to investing capital and signing agreements to lease the land, rent equipment, and hire management and labor. Individual investors can qualify as separate persons and receive up to \$50,000 each, even though their only contribution to farming may be investment capital (which in some cases the investors borrow using the anticipated government payment as collateral). Under USDA's proposals, individual investors will continue to qualify as separate persons, even though their only contribution to farming may be investment capital.

Appendix III contains draft legislative language to tighten the loopholes we identified and to bring payment limitation rules relating to the conservation reserve program into conformity. USDA officials generally agree that our proposals would tighten these loopholes.

To prepare this report, we used our July 1987 report (see p. 1) which analyzed the types of reorganizations related to the \$50,000 payment limitation; identified the provisions in existing law and regulations that allowed these reorganizations; and determined how these provisions could be changed to reduce avoidance of the payment limit without

interfering with farmers' need to reorganize for tax, estate planning, and other legitimate business purposes. That report also analyzed, commented on, and suggested changes to the Secretary of Agriculture's March 10, 1987, report to the Congress, which recommended changes to the payment limitation. For this report, we drafted legislative language that incorporates the changes we believe are necessary to enhance the effectiveness of USDA's proposed changes. We conducted our review from May through June 1987 at USDA headquarters in Washington, D.C.

We discussed this report with USDA officials, and incorporated their comments where appropriate. However, as agreed with your office, we did not obtain official agency comments on a draft of this report.

We are sending copies of this report to the Director, Office of Management and Budget; the Secretary of Agriculture; and other interested parties. Copies will be provided to others upon request.

Major contributors are listed in appendix IV.

Sincerely yours,

A handwritten signature in black ink that reads "Brian P. Crowley". The signature is written in a cursive style and is underlined.

Brian P. Crowley
Senior Associate Director

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Abbreviations

GAO	General Accounting Office
RCED	Resources, Community, and Economic Development Division
USDA	Department of Agriculture

Current Law and Regulations Make It Relatively Easy to Avoid the Payment Limit¹

USDA is authorized by the Agricultural Act of 1949, as amended, to make direct income support payments to farmers under annual commodity and acreage reduction programs for wheat, feed grains, cotton, and rice. Since 1973, these payments have been made in the form of deficiency payments. Deficiency payments are based on the difference between the government-established target price for a commodity and the higher of the commodity's average market price or its loan rate. In 1986, for example, participating corn producers received \$0.63 per bushel in deficiency payments based on the difference between the government-established target price of \$3.03 and the original loan rate of \$2.40, which was higher than the market price, for each bushel produced.

In addition, beginning in 1978, land diversion payments were added under acreage set-aside provisions covering specific program crops. Diversion payments compensate farmers who agree to take a percentage of their acreage out of production for the commodities that they would have grown on the idled acres. In 1986, a diversion payment of \$0.73 per bushel was paid to participating corn producers to compensate them for acreage voluntarily idled. Total combined deficiency and diversion payments are limited under current law to a maximum of \$50,000 per person per year.

Under existing law and regulations, producers can avoid the \$50,000 payment limitation by reorganizing their farming operations in a manner that results in new persons for payment limitation purposes. The most frequent methods used to avoid the payment limit were for two producers who are already at the payment limit to form a corporation that qualifies for its own \$50,000 payment limit or by adding a new member, who may or may not be actively engaged in the actual farming operation, to a joint venture or partnership. While the rules relating to corporations and joint operations were used most frequently to avoid the payment limit, other rules, such as the basic definition of who or what constitutes a person, were also used.

¹This information was previously reported in *Farm Payments: Basic Changes Needed to Avoid Abuse of the \$50,000 Payment Limit* (GAO RCED-87-176, July 20, 1987).

Use of Corporation and Joint Operation Rules to Avoid the Payment Limit

We found that it is relatively easy to increase the number of persons for payment limitation purposes by incorporating. The Secretary of Agriculture, as required by the Agriculture and Consumer Protection Act of 1973 (Public Law 93-86), defined a corporation as a separate person if no stockholder owns or controls more than 50 percent of the stock. In addition, each corporation is considered a separate person from any other corporation provided the same two or more individuals do not own or control more than 50 percent of the stock in the corporations. By using a combination of two stockholders per corporation, each of whom owns exactly 50 percent of the stock, three individuals—A, B, and C—can form three corporations—AB, BC, and AC. The three individuals and three corporations would then qualify for a total of six payments.

Joint operations, such as general partnerships or joint ventures, can also be used to increase the number of new persons on a farming operation. USDA regulations provide that the individual members of a joint operation, not the joint operation, are separate persons. To qualify as a separate person with a separate \$50,000 payment limit, each member must make contributions of either capital, land, equipment, labor, or management to the joint operation in proportion to their share of the payments from the joint operation. As a result, joint operations can increase the number of payment limits for their operations simply by adding additional members, even if those members are not actively engaged in the actual farming operation. For example, a four-member general partnership can increase the payment limits for its operation from four to five (i.e., from \$200,000 to \$250,000) by adding a fifth general partner, provided the fifth partner's share of the payments is in proportion to that partner's contributions to the partnership, which may consist only of capital.

Other Rules That Contribute to the Avoidance of the Payment Limit

While the provisions relating to corporations and joint operations have been used most often to avoid the payment limit, other rules also have been used. These include the basic definition of who or what constitutes a person as well as rules relating to minor children, custom farming, substantive change, and entities with common ownership.

Basic Definition of a Person for Payment Limitation Purposes

The basic definition of a person for payment limitation purposes is any individual or legal entity that (1) has a separate and distinct interest in the land or crop, (2) exercises separate responsibility for that interest, and (3) is responsible for farming costs related to the interest from a fund or account separate from that of any other individual or entity.

This definition allows avoidance of the payment limit through the division of land into parcels that earn payments at or near the limit and the cash lease of these parcels to investors not otherwise engaged in farming. The investors' involvement in farming can be limited to investing capital and signing agreements to lease the land, rent equipment, and hire management and labor. In some cases, the investors borrowed the investment capital using the anticipated crop or government payment as collateral. This type of reorganization can result in a significant increase in the number of new persons and the payment limit for an operation. For example, we found one instance where a management firm used this method to increase the payment limit from \$50,000 to \$1,400,000 by leasing land it managed to 28 investors.

Minor Children

USDA regulations require that minor children 17 years of age or younger be combined with their parents and treated as one person for payment limitation purposes. However, minor children can qualify as separate persons if they have a farming operation and a residence or guardianship separate from their parents. In its March 10, 1987, report to Congress on the payment limitation, USDA noted that parents were establishing separate residences for the children or relinquishing legal guardianship so that their minor children could qualify as separate persons for payment limitation purposes.

Custom Farming

Custom farming is the hiring of others to perform services on a farm, such as harvesting a crop, on a unit of work basis (e.g., \$100 per acre harvested). In its report to the Congress regarding the payment limitation, USDA described the following situation involving custom farming. An individual rented a portion of his land to four individuals who had not farmed before. He then formed a corporation with the four individuals and transferred ownership of his equipment to the new corporation, which custom farmed for himself and the four new individuals. The original individual and the four new individuals qualified as producers and separate persons, even though the corporation was farming the

land. This effectively increased the number of persons for payment limitation purposes from one to five and the total payment limit from \$50,000 to \$250,000.

Substantive Change

A substantive change in operations is required in any farm reorganization that increases the number of persons with separate payment limits. USDA payment limitation rules identify several actions that constitute substantive change, including a 20-percent increase or decrease in the land involved and a change from share lease to cash lease or vice versa.² Therefore, operations that are incorporating or adding new members can meet the substantive change rule by simply reducing the amount of land farmed or, if land is leased, by changing the type of lease. For example, we found a case where a father and his two sons, who qualified as three persons, reorganized their operation to add three more family members for a total of six persons for payment limitation purposes. The substantive change, which agency officials cited as justification for the increase in persons, was a 35-percent decrease in the amount of land farmed. In effect, government program payments on this operation could double, while the amount of land being farmed declines by one-third.

Entities With Common Ownership

Because of legislative restrictions on the treatment of corporations, USDA combines two or more corporations owned by the same two or more individuals for payment limitation purposes only when those individuals own "more than 50 percent" of the corporations. This permits the use of corporations in the manner described on page 8 where three individuals increased payment limits for their operation to six by forming three new corporations because none of the six persons owned "more than 50 percent" of the corporations. The three new corporations would have resulted in only one additional person rather than three, if, for example, USDA could combine entities where the same individual(s) owns "50 percent or more" rather than "more than 50 percent" of two or more entities. This would occur because each of the individuals owns 50 percent of several corporations. Therefore, these corporations could be combined for payment limit purposes until there was only one corporate entity that qualified for a payment. There would always be that one

²In a cash lease arrangement, the lessee pays the land owner a fixed sum, either in cash or commodities, and retains all of the federal payments. In a share lease arrangement, the lessee shares the crop and associated federal payments with the land owner.

**Appendix I
Current Law and Regulations Make It
Relatively Easy to Avoid the Payment Limit**

entity remaining because the proposed rule combines the entities with common ownership into one person for payment limitation purposes.

USDA's Proposals Are a Major Improvement Over Current Law and Regulations¹

In its March 1987 report to the Congress, USDA proposed a number of changes to reduce avoidance of the payment limit. USDA's proposals eliminate the advantage of incorporating or adding members to a joint operation to avoid the limit. USDA's proposals also include changes that will make other rules that contribute to avoidance of the limit, such as the rule for combining entities with common ownership, more restrictive. While USDA's proposed changes will eliminate most existing ways to avoid the payment limitation, they are not as effective as they could be. For example, the changes will not prevent the division and lease of land to investors not otherwise engaged in farming who can still qualify for payments.

Principal Thrust of USDA's Proposals

The principal thrust of USDA's proposals eliminates the advantage of incorporating or adding members to a joint operation to avoid the limit. USDA plans to accomplish this by

- treating all entities the same, as opposed to the current situation where a corporation is one person separate from its members while a general partnership is two or more persons, depending on the number of partners;
- determining the payment limit for each entity on the basis of the number of its members "actively engaged" in the entity's farming operation, with actively engaged defined as a significant independent contribution of capital, land, or equipment and labor or management;
- attributing payments for the entity to the individual payment limits of its members on the basis of the members' interest (ownership);² and
- limiting total payments for an individual to \$50,000, whether the payments are from their own farming operation or attributed to them from an entity, such as a corporation, in which they have an ownership interest.

These changes will reduce reorganizations to avoid the \$50,000 limit because individual payment limits and the number of individuals actively engaged in farming, not the type of organizational structure, will be the driving force in applying the payment limit. Specifically, these changes will reduce the advantages of (1) adding members to

¹This information was previously reported in *Farm Payments: Basic Changes Needed to Avoid Abuse of the \$50,000 Payment Limit* (GAO RCED-87-176, July 20, 1987).

²Attribution to all owners in some situations would create an unacceptable administrative burden for USDA, especially in the case of a publicly-held corporation with hundreds or thousands of stockholders. USDA's proposal would limit attribution to those individuals owning 10 percent or more of an entity in such situations.

increase the payment limit for an entity's operation, which is now possible for joint operations, by limiting payments to the persons actively engaged in farming and (2) creating corporations that qualify as separate persons by attributing payments for an entity to the owners and counting these payments against the owners' individual payment limits.

USDA also proposes making the payment limitation rules for minor children, custom farming, substantive change, and entities with common ownership more restrictive. Specifically, USDA proposes making the following changes in these rules.

- Minor children who can now be separate persons in several situations would always be combined as one person with their parents in all situations, except when the child maintains a separate household and carries out the actual farming operations on a farm in which the parents have no interest.
- Individuals or entities who use the same custom farming organization and who are now separate persons would be combined as one person if the owners of the organization that does their custom farming have any interest in their land or crop.
- The substantive change rule that now allows an increase in the number of persons when there is a 20-percent increase or decrease in the land involved would be changed to require that (1) the amount of land being farmed must increase before the number of persons can increase and (2) the number of new persons added would be limited by the payments that result from the increase. For example, if enough crops are grown on the added land to qualify for an additional \$100,000 in payments, only two new persons—each with a \$50,000 limit—could be added. In addition, the rule that now allows an increase in the number of persons in a reorganized farming operation when a different land lease arrangement is used would be changed to allow an increase in the number of persons only if the new person(s) is the landowner and the change is from a cash to a share lease arrangement.
- Finally, the rule for combining entities with common ownership would be changed so that entities will be combined as one person when the same one or more individual(s) owns or controls 50 percent or more of the entities,³ rather than when “the same two or more” individuals own or control “more than 50 percent” of the entities.

³USDA's proposal actually states, however, that this will occur when two or more persons own 50 percent or more of the entities, but USDA officials intended for this to read as shown above.

USDA can implement all of these changes under its existing legislative authority, except for determining an entity's payments on the basis of the number of its members actively engaged in farming and for combining entities with common ownership. USDA officials stated, however, that they did not want to make any of these changes until the Congress reaches a consensus about what changes USDA should make. USDA can change its rules for combining entities with common ownership only if the Congress removes the legislative restrictions on the treatment of corporations for payment limitation purposes.

Before USDA can implement its proposal, the Congress will have to (1) eliminate existing legislative requirements on the treatment of corporations for payment limitation purposes and (2) authorize payment limits for legal entities on the basis of the number of their members actively engaged in the farming operation. Under existing legislation, USDA must consider a corporation as a separate person for payment limitation purposes provided that

- no stockholder owns more than 50 percent of the corporation's stock (otherwise the corporation and the stockholder are combined as one person), and
- the same two or more stockholders do not own more than 50 percent of two or more corporations (otherwise the corporations with common ownership are combined as one person).

This restriction effectively prevents USDA from changing the manner in which a corporation is treated for payment limitation purposes. The Congress would also have to authorize the determination of payment limits for entities on the basis of the number of members actively engaged in the entities' farming operations, as existing law does not provide for this.

USDA's Proposals Still Have Some Loopholes

USDA officials stated that they intended that total payments to any individual would be limited to the \$50,000 limit established in law, whether these payments were from the individual's own farming operations or attributed from legal entities in which the individual shares ownership. However, we found that USDA's proposed amendment to the Food Security Act of 1985 will not limit payments attributed to a member of an entity if the entity qualifies as a separate person under the current rules unless these individuals have other farming interests outside of the entity.

For example, four individuals form a corporation to operate a farm on which three of those persons meet USDA's definition of being actively engaged in farming. The three individuals, who are actively engaged in the corporation's farming operation, also have farming interests of their own outside the corporation that qualify them as separate persons, but the fourth individual does not. Under USDA's proposal the corporation will qualify for up to \$150,000 in payments (\$50,000 x 3 members actively engaged in farming). The payments will then be divided among the 4 owners of the corporation (\$37,500 each). The three owners who are considered as persons for payment limitation purposes have individual \$50,000-per-person payment limits. However, under the proposed and current rules, the fourth owner who has no farming interest outside the corporation does not qualify as a person and does not have an individual payment limit because he does not have a separate interest in the crop, which is one of the basic requirements under the rules. In this case the corporation would be considered to have the only interest in the crop. The reason the other three individuals have a payment limit is that they have other farming interests where they have a separate interest in the crop. As such, the fourth individual could own portions of a number of corporations and receive payments from those corporations in excess of \$50,000. USDA can correct this problem by including these individuals in its definition of a person.

We also found that USDA's proposals do not address avoidance of the payment limit through the division and lease of land to investors not otherwise engaged in farming. Therefore, individual investors will continue to qualify as separate persons, even though their only contribution to farming may be investment capital, which in some instances comes from a loan secured by the government payments they are receiving on the farming operation. USDA could have addressed this method of avoidance by applying its proposed definition of "actively engaged in farming" to individual producers as well as members of an entity.

USDA officials did not apply the proposed definition of "actively engaged in farming" to individuals because this would preclude payments to land owners who share-rent their land. However, USDA can reduce avoidance of the limit through the division and lease of land without affecting these landowners by requiring that the person leasing land but not the landowner also make a substantive contribution of owned land or owned equipment and personal labor or active management, in addition to capital, to the farming operations that include the leased land.

USDA's Proposed Amendment to Section 1001(5) of the Food Security Act of 1985, as Amended, With Necessary Revisions to Close Loopholes Identified by GAO

(Necessary revisions are in **bold type**)

A BILL

To provide for the fair and equitable application of the maximum limitation on farm program payments that may be received by a person.

Be it enacted by the Senate and the House of Representatives in Congress assembled, that section 1001(5) of the Food Security Act of 1985 is amended by **inserting at the end of subparagraph (A) the following new sentence: "Such regulations shall provide that a producer who rents or leases land from an individual or entity must be combined as one person for payment limitation purposes with the individual or entity from whom the land is rented or leased unless the producer makes a substantial contribution of owned land or owned equipment and personal labor or active personal management to the farming operation that includes the rented or leased land."** and by striking subparagraph (B) and inserting in lieu thereof the following new subparagraphs (B), (C), and (D):

"(B) In applying the limitation provided for by this section, the Secretary shall—

"(i) provide for similar treatment of all entities;

"(ii) except as provided in clause (iii), determine the amount of payments that may be received by any entity based upon the number of members of the entity who are determined to be actively engaged in farming;

"(iii) consider any entity that is conducting a farming operation independently of all its members to be a separate person **and combine as one separate person all entities that are owned or controlled by the same one or more individual(s)**;

"(iv) attribute all payments received by an entity to the members of the entity that have an interest in the entity, such attribution to be based upon the member's interest in the entity, **provided that total payments attributed to a member of an entity may not exceed the payment limits provided for by section 1001(1) and (2) when added to payments received by that member as a separate person or to payments attributed to that member from**

**Appendix III
USDA's Proposed Amendment to Section
1001(5) of the Food Security Act of 1985, as
Amended, With Necessary Revisions to Close
Loopholes Identified by GAO**

another entity or other entities in which that member has an interest; and

“(v) consider an individual or entity to be actively engaged in farming if such individual or entity has made a significant contribution (determined based upon the total value of the farming operation) of (I) land, cash or equipment, and (II) labor or management to the farming operation.

“(C) For the purpose of this section the term ‘entity’ means a corporation, trust, estate, limited partnership, general partnership, joint venture, charitable organization and, except as provided in subparagraph (A), any other entity or association

“(D) The Secretary may determine not to attribute payments to a member of an entity as provided for in subparagraph (B) (iv) if it is determined that—

“(i) such member’s interest in the entity is less than 10 percent; and

“(ii) attribution of such payments to such member would have little or no impact on the implementation of the limitation provided for by this section ”

SEC. 2. The amendments provided for by this act shall be effective with respect to the 1988 through 1990 crops of wheat, feed grains, upland cotton, extra long staple cotton, rice, and honey.

SEC. 3. Section 1234(f) of the Food Security Act of 1985 is amended by striking paragraph (2) and inserting in lieu thereof the following:

“(2) The provisions of section 1001(5) of this Act shall be applicable in applying the limitation provided for in this section.”

SEC. 4. The amendments provided for in section 3 of this Act shall be effective with respect to contracts entered into on or after the date of enactment of this Act.

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