

**FAIRNESS AND TAXATION: THE LAW OF DEFERRED
INCOME RECOGNITION FOR THE MEMBERS OF
AGRICULTURAL COOPERATIVES**

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The Internal Revenue Code (“Code”) currently provides the individual farmers of agricultural cooperatives several methods for deferring the recognition of income. These provisions are significant both for the sheer number of cooperatives and cooperative members they affect and because cooperative transactions often spread from one taxable period to the next. The current approach to income recognition established by the Code, Internal Revenue Service (“IRS”) Rulings, and judicial decisions seeks to balance two competing fairness concerns: (1) promoting the timely payment of taxes and the avoidance of wrongful deferral and (2) ensuring taxpayers actually have funds available to pay their tax liabilities.¹ Developing a legal framework that properly balances these concerns has proven difficult, as the treatment of cooperative payments is complicated by the doctrine of constructive receipt, treatment of the principal-agent relationship, enactment of the Installment Sales Act (“ISA”),² and the idiosyncrasies of the institution itself. Given the number of transactions at issue and the minute transactional details that elicit different treatment, it is necessary to sort out the rules of deferral. This Article examines the different interpretations of income recognition in the context of agricultural cooperatives and identifies an approach that is consistent with the language of the Code and legislative history.

Any discussion on the rules of income recognition starts with the principle that taxpayer liability is based on earnings for the current taxable period.³ This principle is consistent with both fairness concerns mentioned above in that it establishes a common timetable for taxation and ensures that taxpayers have funds available to pay taxes. As with any general principle, however, there are exceptions, and legitimate arguments support deferral in certain situations. The strongest supporting argument is that of practicality, since many cooperative transactions occur over an extended period of time. Without applicable exceptions, these taxpayers are at risk of paying taxes on income they have not yet received. The desire to base taxes on actual receipt of income is supplemented by the taxpayer’s desire for certainty. In

1. See generally Note, *Fairness and Tax Avoidance in the Taxation of Installment Sales*, 100 HARV. L. REV. 403 (1986); George Cooper, *The Taming of the Shrewd: Identifying and Controlling Income Tax Avoidance*, 85 COLUM. L. REV. 657 (1985).

2. I.R.C. § 453 (2000).

3. See I.R.C. § 451(a) (2000) (“The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.”).

situations where farmers have little or no knowledge as to what their income will be, deferral allows for more accurate planning than is otherwise possible.⁴ These practical concerns regarding farmer taxation are enhanced by the general support for agricultural cooperatives as an essential part of the American economy and way of life.⁵ Signs of such support can be found in the legislative history of related acts and in the historical treatment of such associations.⁶

Despite the benefits for farmers and cooperatives, there are problems raised by the deferral of income. Since deferral essentially operates as a government loan in the form of unpaid taxes, there is a significant incentive on the part of taxpayers to engineer transactions sufficient to meet the standards for deferral. Such agreements engender the inefficient operation of the tax system by making transactions more complicated and increasing the litigation required to resolve issues of timing. In addition, there is potential inequity in allowing one taxpayer to defer income simply by creating certain types of transactions. The desire to tax the income generated in a taxable period has been strong enough to create a presumption⁷ for recognizing income even if not actually received and has resulted in the doctrine of constructive receipt.⁸

This Article examines the application of the principles of income recognition and deferral to agricultural cooperatives and suggests a resolution to current inconsistencies in the law. Recent decisions have brought into question the ability of cooperative members to utilize both

4. The issue of accurate tax planning is especially significant in the context of farmers, who predominantly must report their income as self-employed individuals. Under the current tax rules, these individuals are required to pay taxes on income estimates and may face penalties for the failure to do so. See Internal Revenue Service, Self-Employment Tax, <http://www.irs.gov/businesses/small/article/0,,id=98846,00.html> (last visited June 19, 2006).

5. Support for cooperatives can be seen not only in the tax treatment of individual farmers, but in the general desire to preserve a way of life. See Alex E. Snyder, *Saving the Family Farm through Federal Tax Policy: Easier Said Than Done*, 62 WASH. & LEE L. REV. 729 (2005); U.S. DEPT. OF AGRIC., A TIME TO ACT: A REPORT OF THE USDA NATIONAL COMMISSION ON SMALL FARMS (1998).

6. See generally Snyder, *supra* note 5; Jon K. Lauck & Edward S. Adams, *Farmer Cooperatives and the Federal Securities Laws: The Case for Non-Application*, 45 S.D. L. REV. 62 (2000).

7. A presumption in favor of recognizing income in the year of receipt can be found in the primary Tax Code provision governing cash method taxpayers. See I.R.C. § 451(a) (2000).

8. Though not codified, the constructive receipt doctrine is established in the regulations to Code § 61. See Treas. Reg. § 1.61-4(b) (as amended in 1997). See also Pamela Baker, *Pension, Profit-Sharing, Welfare, and Other Compensation Plans: Constructive Receipt*, AMERICAN LAW INSTITUTE – AMERICAN BAR ASSOCIATION CONTINUING LEGAL EDUCATION 681 (2003) (discussing the concept of constructive receipt).

the ISA and deferred income agreements. This Article asserts that cooperative members can and should be able to take advantage of such options. Part I provides a general background on agricultural cooperatives and sets out the current legal framework for income recognition and deferral. Part II analyzes the current state of the law in regard to the treatment of cooperatives and identifies the features of that framework in need of clarification. The article concludes in Part III by identifying a clarified approach to income recognition that is consistent with both the language of the Code and the historical legislative treatment of cooperatives.

I. UNDERSTANDING AGRICULTURAL COOPERATIVES AND CURRENT TAX LAW

Comprehension of the nature of the cooperative and its distinctive characteristics is essential to understanding the related laws of income recognition and their implications. The characteristics and operations of the cooperative can be distinguished from traditional business arrangements, and the Code has historically recognized this unique structure. Once a general background is established, both of the major exceptions to income recognition – constructive receipt and installment agreements – will be discussed in turn.

A. *Strength in Numbers: The Role of the Cooperative*

There are over four thousand agricultural cooperatives in the United States, made up of nearly four million members, generating over 100 billion dollars in annual revenue.⁹ These associations operate as businesses owned by, controlled by, and generating profits for their members, who are responsible for delivering their agricultural product to the cooperative.¹⁰ The rationale behind pooling the interests of the members is to accumulate bargaining power, lower overhead costs, and generally allow for modes of production that are otherwise not possible on an individual basis. In terms of procedure, each member commits to providing a certain amount of a commodity that is ultimately processed, marketed, and/or sold by the cooperative. Once the farmer delivers the

9. See U.S. DEP'T OF AGRIC., UNDERSTANDING COOPERATIVES: FARMER COOPERATIVE STATISTICS, COOPERATIVE INFORMATION REPORT 45, SECTION 13 (December 1996), available at <http://www.rurdev.usda.gov/rbs/pub/cir4513.pdf>.

10. See THE NATIONAL AGRICULTURAL LAW CENTER, COOPERATIVES – AN OVERVIEW, <http://www.nationalaglawcenter.org/assets/overviews/cooperatives.html> (last visited Feb. 12, 2006) (discussing basic cooperative principles).

product to the cooperative, he or she has very little say in terms of quantity, price, and the ultimate destination of the goods. Payments are made by the cooperative to its individual members based on their proportionate share of product provided to the cooperative relative to the income received by the cooperative for the product sold. Generally, there are two types of payments a farmer receives from the cooperative: mandatory and discretionary. Upon delivery, farmers generally receive part payment for their product, i.e. a mandatory payment.¹¹ Because the net earnings, and thus member proceeds, cannot be calculated until the end of the operating year, cooperative members may also be eligible for discretionary payments in the form of patronage refunds. Patronage refunds represent the difference between a member's rightful share and the amount previously paid in mandatory payments. The payment to and subsequent recognition of discretionary payments to the farmer is of interest here.

The cooperative acts as a conduit between its members and the ultimate buyers. In these associations, farmers pool their products in such a manner that it is impossible to distinguish amongst the products of each member. Other unique characteristics of this organizational structure include the large number of otherwise unrelated and unconnected members and the fact that the members do not have direct contact with buyers. Congress addressed the uniqueness of this structure in Subchapter T of the Code,¹² which provides deductions for institutions "operating on a cooperative basis."¹³ In addition to these provisions, I.R.C. § 521 allows for the deductions of dividend payments made by cooperatives based on capital stock.¹⁴ The combined effect of these provisions is that the cooperative institution itself is essentially subject to flow-through taxation, and gross income is only claimed on the returns of the individual members. Though Subchapter T provides for the general treatment of cooperative income, these institutions and their members are still subject to the other provisions of the Code. Thus, a question of tax law not covered in this subchapter remains bound to other Code provisions and judicial decisions.¹⁵

11. Mandatory payments to farmers may be guaranteed via federal loans. *See* DOUG O'BRIEN ET AL., NATIONAL AGRICULTURAL LAW CENTER, THE FARMER'S LEGAL GUIDE TO PRODUCER MARKETING ASSOCIATIONS 60-63 (2006), available at http://www.nationalaglawcenter.org/assets/articles/obrien_producermarketing_book.pdf.

12. I.R.C. §§ 1381-88 (2000).

13. I.R.C. § 1381(a)(2) (2000).

14. *See* I.R.C. § 521(b)(2) (2000) (stating the exemption of farmer cooperatives "shall not be denied any such association because it has capital stock").

15. Subchapter T governs the treatment of gross income in the context of cooperative

The unique tax treatment of cooperative income has not been extended by certain courts¹⁶ to rules of income recognition for individual members, where principles of agency have been allowed to overshadow the plain language of the Code. For reasons to be discussed, the validity of deferred payment agreements and ISA transactions has not been adequately understood or applied by the IRS or the courts in the context of dispositions between cooperatives and their members. The difficulty in establishing a consistent approach to this issue can be attributed to the implications of the unique cooperative structure, the presence of seemingly inconsistent judicial decisions, and competing notions of what constitutes fairness to the taxpayer relative to other non-cooperative member taxpayers.

B. Avoiding Avoidance: The Policy and Rules of Income Recognition

The ubiquitous problem regarding income recognition and deferral is that of tax avoidance. Courts and the legislature can attempt to alleviate this risk by enforcing more stringent standards, though ultimately, the potential for abuse is inherent in any system that permits deferral.¹⁷ The irony of the fairness concern, which forces taxpayers to pay timely taxes, is that deferral methods are permitted in order to overcome a different inequity, that of requiring income recognition without realization.¹⁸ The Code attempts to balance both of these interests.

The general rule for recognizing income can be found in I.R.C. § 451(a), which provides that “[t]he amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless . . . such amount is to be properly accounted for as of a different period.”¹⁹ While this rule incorporates very general language, it does constitute a presumption for recognition in the year of receipt.

organizations. Its purpose is not to establish a completely independent legal framework for the taxation of such institutions. See I.R.C. §§ 1381-88 (2000).

16. See *Scherbart v. Comm’r*, 453 F.3d 987 (8th Cir. 2006); *Scherbart v. Comm’r*, 87 T.C.M. (CCH) 1418 (2004).

17. Note, *supra* note 1, at 406, 422; See *Cooper, supra* note 1, at 663-67.

18. See David F. Shores, *Closing the Open Transaction Loophole: Mandatory Installment Reporting*, 10 VA. TAX REV. 311, 311 (1991) (“The historical purpose of section 453 is to alleviate the hardship of paying an immediate tax on a transaction which produces no cash at the time of sale, and, if the buyer defaults, will never produce cash.”). Shores goes on to assert that the risks inherent in installment deferral are so minimal that taxpayers should not have the ability to opt out of such treatment. *Id.*

19. I.R.C. § 451(a) (2000).

Support for deferral methods originated from the recognition that the receipt of income from the sale of goods and products may occur over a period of time. Thus, conflicts may arise with the general policy goal of not facilitating tax deferral or avoidance. There are several common arguments against tax deferral. To begin with, it encourages unnecessary and inefficient transactions between parties attempting to take advantage of loopholes in the system.²⁰ Avoidance also generates horizontal inequities amongst individuals in the same earnings bracket because one taxpayer is paying taxes at a relatively lower rate. The benefits of avoidance do not belong solely to the seller, however. In a deferral agreement, the buyer of the product is allowed full depreciation allowance upon the receipt of property, even though full consideration for that property has not been provided.²¹ While these might seem like significant policy concerns, it is important to remember that the question here is one of deferral of tax, not complete avoidance of tax. The potential inequity of paying taxes one year later only relates to the difference in the value of money from one year to the next.

The issue of income recognition is applicable only to the cash method taxpayer, and the Code provides that farmers retain the right to choose that method. A farmer using the accrual method, on the other hand, uses inventories to determine gross income, not income that is actually or constructively received.²² Use of the accrual method avoids the issue of determining a date of receipt, and therefore renders moot the rules of income recognition previously discussed.²³ For cash method taxpayers, “all items which constitute gross income (whether in the form of cash, property, or services) are to be included for the taxable year in

20. See Note, *supra* note 1.

21. *Id.* at 406-07 (“An installment buyer can purchase property without investing any cash, simply by promising to pay the purchase price at some future date specified in the installment note. Nevertheless, he is granted a full step-up basis and therefore allowed immediately to take depreciation deductions based on the full amount of the purchase price.”).

22. See Treas. Reg. § 1.61-4(b) (as amended in 1997) (discussing the gross income of farmers using the accrual method of accounting). The basics for cash method accounting for farmers can be found in the same provision. See Treas. Reg. § 1.61-4(a) (as amended in 1997).

23. The regulations to § 451 clarify income recognition under the accrual method:

Under an accrual method of accounting, income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. Therefore, under such a method of accounting if, in the case of compensation for services, no determination can be made as to the right to such compensation or the amount thereof until the services are completed, the amount of compensation is ordinarily income for the taxable year in which the determination can be made.

Treas. Reg. § 1.451-1(a) (as amended in 1999).

which they are actually or constructively received.”²⁴ The cash method generally provides more flexibility regarding recognition and deferral.²⁵ Because of the risk of improper deferral, I.R.C. § 448 requires certain entities to report income using the accrual method.²⁶ However, farming businesses are expressly excluded from this provision.²⁷ An inference that can be drawn from that exclusion is that an individual farmer retains the option of choosing the cash method over the accrual method and of deferring income by appropriately delaying receipt.²⁸ Though it might seem like a small matter, the ability of the farmer to choose an accounting method has implications for the availability and the validity of income deferral.

Though a farmer retains the right to elect the cash method and to defer income in certain situations, he or she also carries the burden of showing that there is an acceptable accounting method to support that delay.²⁹ A frequently litigated issue for both cooperative members and non-members relates to what exactly constitutes receipt. Whereas a taxpayer has an obligation to report income he or she *actually* receives, there is greater room for disagreement regarding the *constructive* receipt of income.³⁰ IRS regulations state that a taxpayer has an obligation to declare constructive income “in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year”³¹ However, income will not be held to have been constructively received where “the taxpayer’s

24. Treas. Reg. § 1.446-1(c)(i) (as amended in 2007). This method requires a farmer to report any income that he receives in the form of cash or the fair market value of other property or services.

25. John F. Cooper, *The Economic Benefit Doctrine: How an Unconditional Right to a Future Benefit Can Cause a Current Tax Detriment*, 71 MARQ. L. REV. 217, 219 (1988) (“As the time of actual receipt may be pre-arranged by taxpayers, the cash method is viewed as more susceptible to manipulation than the accrual method.”).

26. I.R.C. § 448(a) (2000) (requiring corporations, partnerships with corporations as partners, and tax shelters to use the accrual method).

27. I.R.C. § 448(b)(1) (2000).

28. The ability to choose between cash and accrual methods is provided by § 446. See I.R.C. § 446(a) (2000) (“Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.”). The ability to select amongst methods is based on the reality that no single method of accounting can be proscribed for all taxpayers. See Treas. Reg. § 1.446-1(a)(2).

29. See I.R.C. § 451(a) (2000).

30. The constructive receipt doctrine is well established. See, e.g., Baker, *supra* note 8; Johnson v. Comm’r, 184 F.3d 786, 788 (8th Cir. 1999); United States v. Pfister, 205 F.2d 538, 540 (8th Cir. 1953).

31. Treas. Reg. § 1.451-2(a) (as amended in 1979).

control . . . is subject to substantial limitations or restrictions.”³² Thus, an important question in income recognition cases is whether there were “substantial limitations and restrictions” on the receipt of income. Taxpayers have the ability to voluntarily enter into agreements that meet this requirement. Such agreements, which delay the recognition of income, are referred to as “deferred payment agreements,” and the traditional test for upholding such agreements is that the contract must be a bona fide arm’s length agreement and must also be entered into before the crop is delivered to the purchaser.³³ Analyzing constructive receipt in the context of these agreements raises issues relating to both agency relationships and the special treatment of cooperatives.

1. The Impact of the Agency Relationship

The concept of agency arises in many areas of the law and has implications for both cooperatives and income recognition. The Restatement of Agency defines agency as a “fiduciary relation that arises when one person (a “principal”) manifests assent to another person (an “agent”) that the agent shall act on the principal’s behalf and subject to the principal’s control, and the agent manifests assent or otherwise consents so to act.”³⁴ The general view is that an agent acts as an intermediary between the seller and the buyer in a transaction, which is why many judicial decisions have identified a principal-agent relationship between the cooperative and its members.³⁵ Indeed, the cooperative acts as a conduit between its members and the ultimate buyers in that it does not generate independent revenue. However, there is a clear difference from the traditional agency relationship in that the cooperative is not subject to the control of any individual member.³⁶

32. *Id.* The parameters of “substantial limitations or restrictions” are set out in examples illustrating what is *not* a substantial limitation or restriction.

33. See Rev. Rul. 58-162, 1958-1 C.B. 234 (stating the status of the farmer’s contract as an arm’s length agreement, which did not entitle the farmer to payment until a fixed date in the subsequent year, did not constitute constructive income); *Schniers v. Comm’r*, 69 T.C. 511, 516 n.2 (1977); *Reed v. Comm’r*, 723 F.2d 138, 143 (1st Cir. 1983). In addition to the cases dealing with the deferral of income from one year to the next, the IRS has issued a private letter ruling establishing that deferral agreements cannot be created to defer income over multiple periods. See I.R.S. Priv. Ltr. Rul. 80-01-001 (Sept. 4, 1979).

34. RESTATEMENT (THIRD) OF AGENCY § 1.01 (2006).

35. See 18 AM. JUR. 2D, *Cooperative Associations* § 39 (1985) (“In most jurisdictions, unless it is clear that the parties to a cooperative marketing agreement intend an outright sale of the members’ products to the association, the association is regarded as the agent of its members for the sale of their products.”).

36. See DONALD A. FREDERICK, U.S. DEPT. OF AGRIC., CO-OPS 101: AN INTRODUCTION TO COOPERATIVES (2001), <http://www.rurdev.usda.gov/rbs/pub/cir55/cir55rpt.htm> [hereinafter CO-OPS

After a farmer delivers his product, the cooperative has the authority to produce, market, and sell that product in a manner it determines best for the members as a whole. The individual farmer lacks the control typically granted to the principal. It is this difference from the traditional relationship that presents analytical problems in applying agency decisions to the context of the cooperative.

The recognition of a principal-agent relationship has major tax implications with regard to the ability to defer income. The most significant is the rule that the receipt of income by the agent constitutes the receipt of income by the principal.³⁷ This rule has been strictly adhered to³⁸ and is based on the idea that the use of an agent, acting as a conduit, should not be an excuse to defer income that rightfully belongs to the principal. Permitting such deferral transactions between interested parties only increases the opportunity for wrongful deferral. The following examples illustrate the impact of the agency relationship on income recognition.

a. Revenue Ruling 79-379

A relevant application of agency principle in the agricultural context is illustrated by Revenue Ruling 79-379,³⁹ which involved the sale of cattle to a licensed dealer for an amount to be determined at a later auction. The dealer and the farmer agreed, regardless of the time of auction, that the dealer would hold the proceeds of the sale until the following taxable year. The IRS rejected this deferral agreement, stating the principal-agent relationship “precludes deferral by a cash basis principal of income actually or constructively received by an agent through the establishment of a deferred payment agreement.”⁴⁰ In finding that a principal-agent relationship existed, the IRS focused on

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37. See *Maryland Cas. Co. v. United States*, 251 U.S. 342, 347 (1920); *United States v. Pfister*, 205 F.2d 538, 541 (denying deferral where taxpayer requested proceeds to be sent by mail after the sale had been made by the agent in the previous year).

38. This principle has been upheld even where the “agent specifically agrees not to distribute the income to the principal until the following year.” *Crimmins v. United States*, 655 F.2d 135, 138 (8th Cir. 1981). Another barrier to deferral has been the determination that contractual rights constitute income where a fair market value can be established for that right. The most cited example of this principle is *Warren Jones*. *Warren Jones Co. v. Comm’r*, 524 F.2d 788 (9th Cir. 1975). Similarly, another IRS Ruling held that where a payment is made available prior to the time of actual receipt, it is includable in income in the current year. See *Rev. Rul. 68-44*, 1968-1 C.B. 191.

39. *Rev. Rul. 79-379*, 1979-2 C.B. 204.

40. *Id.*

the dealer's lack of risk in the transaction as opposed to the farmers, the fact that the cattle remained insured by the farmer, and the close relationship between the farmer and dealer. The Ruling is a classic example of how the IRS prohibits wrongful deferral in the context of agency, and it poses a significant obstacle to cooperative members, given that the agency relationship between the cooperative and its individual members is well established.⁴¹

b. *Warren v. United States*⁴²

While Revenue Ruling 79-379 constitutes the standard approach to receipt of income by an agent, some courts have been even more aggressive in preventing wrongful deferral. *Warren v. United States* involved the delivery of cotton to a gin, which proceeded to prepare the cotton for sale as well as seek out potential buyers. As in the Revenue Ruling discussed above, the parties agreed that the farmer would not receive the proceeds until the subsequent year. The court focused on the gin's secondary role of seeking out buyers in determining there was a principal-agent relationship, and it distinguished common deferral agreements between a farmer and buyer from agreements between a farmer and an agent. In regard to a deferral agreement between the farmer and an agent, the court stated that "a self-imposed limitation does not serve to change the general rule that receipt by an agent is receipt by the principal."⁴³ This self-imposed standard, originally recognized in *Williams v. United States*,⁴⁴ is distinct from the "substantial limitation" standard identified in the regulations⁴⁵ and is intended to be more stringent.⁴⁶ Even if an agreement could be said to impose a substantial limitation on the receipt of funds by the principal, the rule from *Warren* dictates the income must still be recognized because such a limitation is self-imposed. Thus, under this standard, deferral contracts between a principal and agent that are not part of the sales transaction between the

41. See 18 AM. JUR. 2D, *Cooperative Associations* § 39 (1985). Recognition of this dilemma is also evidenced in the Congressional Record. See 126 CONG. REC. 96 (daily ed. Oct. 1, 1980) (statement of Senator Dole).

42. 613 F.2d 591 (5th Cir. 1980).

43. *Id.* at 593.

44. 219 F.2d 523 (5th Cir. 1955) (denoting the initial declaration of the principal in a case involving a timber sale to a lumber company by an independent seller that attempted to create an escrow account with a bank to defer income).

45. Treas. Reg. § 1.451-2(a) (as amended in 1979).

46. See *Arnwine v. Comm'r*, 696 F.2d 1102, 1111 (5th Cir. 1983) (illustrating the distinction between the substantial limitation and self-imposed standards through the court's independent assessment of each).

buyer and seller are prohibited.⁴⁷ The Fifth Circuit revisited the issue of income recognition from a gin several years later in *Arnwine v. Commissioner*.⁴⁸ After establishing the presence of a principal-agent relationship,⁴⁹ the court examined the receipt of income issue under both the substantial limitation and self-imposed limitation standards. It found that the farmer would have been required to recognize the income under either standard.⁵⁰ The decisions in *Warren* and *Arnwine* have started to gain momentum in other courts, including the Tax Court.

c. *Scherbart v. Commissioner*⁵¹

The *Warren* and *Arnwine* decisions constitute strong evidence that any time an agency relationship exists, deferral agreements will be heavily scrutinized. Consequently, cases like *Scherbart* have appeared that provide the members of farmer cooperatives with little optimism for tax relief. *Scherbart* involved the delivery of corn to a cooperative that first processed the corn before selling the product. The members received mandatory payments for the corn delivered and discretionary “value-added” payments based on the profits from processing the corn. Subsequent to receiving the mandatory payments for delivery, but before the close of the fiscal year, the taxpayer elected to receive his “value-added” payments in the following year. The Commissioner rejected this deferral attempt. In its analysis, the Tax Court made quick work of the deferral contract argument by focusing on the agency relationship and the self-imposed limitation standard of *Warren*. The focus on agency was so great that the court ignored precedent supporting different treatment regarding cooperatives and statutory support for deferral in the ISA. The *Scherbart* decision has the potential to be interpreted as a preference for agency so strong as to render irrelevant the implications

47. *Id.* at 1109. In other words, deferral will be prohibited where the only restriction on the principal’s access to funds from the sale is based on the agreement between the principal and the dealer.

48. *Id.* at 1102.

49. The *Arnwine* decision should be noted for its more aggressive approach to agency. Even where the gin performed many more services for the buyer than the seller, the court found a principal-agent relationship. *See id.* at 1104-20. In a cautionary tone, the Court stated the “moral of the story is that when it comes to deferring federal income tax liability, loosely defined relationships are dangerous and may be fatal.” *Id.* at 1104.

50. *See id.* at 1119-32. The court believed that there was no evidence that the taxpayer and the agent intended to be bound by the deferral agreement.

51. *Scherbart v. Comm’r*, 87 T.C.M. (CCH) 1418 (2004).

of the ISA. On appeal, the Eighth Circuit sustained the Tax Court decision while reiterating many of the same arguments.⁵²

The problem in applying agency cases to agricultural cooperatives – as in *Scherbart* – is that none of the cases previously mentioning agency involved a cooperative. The deferral contracts of *Warren*, *Arnwine*, and *Williams* all dealt with the sale of farm products, but they were of the standard one-to-one, buyer-agent-seller variety. Cooperative transactions are inherently different in that members have no direct transactions with the many purchasers of their products nor do they have control over who those purchasers are. The question is whether this distinction is significant enough to merit different treatment in regard to recognizing income.

2. The Unique Treatment of Cooperatives

Despite the linkage between cooperatives and the concept of agency, the IRS has dealt specifically with the application of the doctrine of constructive receipt to the deferred payment contracts of farmer cooperatives. In Revenue Ruling 73-210,⁵³ a cooperative member was permitted to defer income payments received from the cooperative until the year of actual receipt, even though he would have been entitled to an advance payment under a preexisting marketing agreement. The bylaws of the cooperative allowed members to defer this advance payment by entering into a supplemental agreement with the cooperative. The IRS upheld the ability of the taxpayer to defer the recognition of income, even though he was entitled to advance payment, so long as it was subject to a substantial limitation. The Ruling established a standard that deferral will be allowed for agricultural cooperatives where (1) there is a bona fide, arm's length⁵⁴ deferred payment agreement (2) entered into before the cooperative member had an unqualified right to receive payment.

52. *Scherbart v. Comm'r*, 453 F.3d 987 (8th Cir. 2006).

53. Rev. Rul. 73-210, 1973-1 C.B. 211 (“Proceeds received in January by a cash method farmer under a deferred payment contract entered into with a cooperative before the delivery of cotton in the prior year are includible in the farmer's gross income in the year received even though, under a preexisting marketing agreement with the cooperative, he would have been entitled to an advance payment equal to the government loan value of his cotton upon its delivery.”).

54. See *Schniers v. Comm'r*, 69 T.C. 511, 518 (1977) (stating challenges over the bona fide nature of a deferred payment agreement must show that the deferred payment agreements were shams and that the parties never intended to be bound by them); *Oliver v. United States*, 193 F.Supp. 930, 935 (E.D. Ark. 1961) (defining an arm's length transaction as “a good faith business transaction between parties, each acting voluntarily for his own self-interest, without giving an unnecessary advantage to the other, in a manner consistent with prevailing business practice”).

Revenue Ruling 73-210 is significant because of the refusal to apply the self-imposed limitation standard that had been applied to principal-agent transactions for the twenty years since *Williams*, even though it was well established that cooperatives generally maintain an agency relationship with their members. The competing interpretations of this decision are that either the IRS simply forgot to discuss the role of this standard in regard to agricultural cooperatives, or they intended to make a distinction between traditional agency transactions and those of a cooperative with its members. The IRS has yet to overturn this Ruling, yet subsequent cases like *Scherbart*, which involved similar fact patterns, failed to even mention the Revenue Ruling. Thus, the Ruling continues to offer a glimmer of hope for cooperative members wishing to enter into deferral agreements. Before discussing the validity of such a reading, however, a more significant provision must be discussed.

C. Recognizing Income under the Installment Sales Act

Independent of the doctrine of constructive receipt, taxpayers are allowed to validly defer the recognition of income under the ISA.⁵⁵ The ISA is an extremely broad set of provisions originally enacted to simplify installment sales and increase the availability of installment reporting.⁵⁶ To begin with, if a transaction meets certain requirements, the ISA *requires* the use of the installment method unless the taxpayer properly elects not to report under that method.⁵⁷ In addition, the lack of an express limitation on the application of I.R.C. § 453 implies that it is meant to operate independently of I.R.C. § 451 and the rules of constructive receipt.⁵⁸ The issues of agency and substantial limitations on receipt are moot in the context of the ISA. The important question for cooperative members is whether their transactions with the cooperative fall under the statutory definition of an installment sale, thus providing an alternative method for deferral.

The Code defines an installment sale as “a disposition of property where at least 1 payment is to be received after the close of the taxable

55. See I.R.C. § 453 (2000) (establishing the circumstances in which the installment method of account is required).

56. See Shores, *supra* note 18, at 315-316.

57. See I.R.C. § 453(a) (2000) (“Except as otherwise provided in this section, income from an installment sale shall be taken into account for purposes of this title under the installment method.”).

58. For evidence that the Act is meant to be read in isolation from other sections, see I.R.C. § 453(a) (2000) (“except as otherwise provided in this section”). There have also been judicial interpretations of the ISA which support the same conclusion. See *Applegate v. Comm’r*, 94 T.C. 696, 704 (1990).

year in which the disposition occurs.”⁵⁹ This seems simple enough, though I.R.C. § 453(b)(2)(A) creates an exception for “dealer dispositions,” which include “[a]ny disposition of real property which is held by the taxpayer for sale to customers in the ordinary course of the taxpayer’s trade or business.”⁶⁰ This would appear to exclude farm produce, though I.R.C. § 453(l)(2)(A)⁶¹ provides an exception to the dealer disposition rule for “any property used *or produced* in the trade or business of farming.”⁶² Though it occurs in a roundabout manner (as an exception to the exception), installment reporting on farm produce is explicitly included in I.R.C. § 453. This conclusion is supported in the regulations: “A farmer who is not required under his method of accounting to maintain inventories may report the gain on the installment method under section 453.”⁶³ Interpreting the ISA in the context of cooperative members reveals that in order to be eligible for installment reporting, a taxpayer must establish that there has been a disposition of farm property that is used or produced in the trade or business of farming.⁶⁴ This would appear to create a rather significant opportunity for deferral in regard to income from cooperatives – a fact supported in the regulations.

However, there are several interpretations of the Code that may prevent deferral. It could be argued that the delivery of a product to a cooperative is not technically a sale, making the ISA irrelevant, because the member does not receive payment until the cooperative processes and sells it. The notion that the ISA is inapplicable is strengthened by language in I.R.C. § 453(c). That provision states that income recognition is to be based on the “proportion of the payments received . . . which the gross profit (realized or to be realized when payment is completed) bears to the total contract price.”⁶⁵ A strict

59. I.R.C. § 453(b)(1) (2000). *See also* I.R.C. § 2032(a)(e)(4) (2000) (defining farm as “stock, dairy, poultry, fruit, furbearing animal, and truck farms, plantations, ranches, nurseries, ranges, greenhouses or other similar structures used primarily for the raising of agricultural or horticultural commodities, and orchards and woodlands”); I.R.C. § 2032(a)(e)(4) (2000) (defining farming purposes as “cultivating the soil or raising or harvesting any agricultural or horticultural commodity (including the raising, shearing, feeding, caring for, training, and management of animals) on a farm”).

60. I.R.C. § 453(l)(1)(B) (2000).

61. I.R.C. § 453(l)(2)(A) (2000) (“The term ‘dealer disposition’ does not include farm property,” which is “the disposition on the installment plan of any property used or produced in the trade or business of farming (within the meaning of § 2032A(e)(4) or (5))” (punctuation omitted).

62. *Id.*

63. Treas. Reg. § 15a.453-1(b)(4) (as amended in 1994).

64. *See* I.R.C. §§ 453(b)(1), 2032(e)(4), 2032(e)(5) (2000).

65. I.R.C. § 453(c) (2000).

reading of this language implies that installment sales are applicable only to the apportionment of profit and cost, not merely to deferral. Another barrier to ISA application by cooperative members lies in judicial decisions regarding the laws of agency, which several courts have allowed to overshadow the application of the ISA. Court decisions like *Warren* and *Scherbart*, as well as IRS Revenue Ruling 79-379, have rejected deferral under the ISA by reading “dispositions” to mean only “sales,” while at the same time focusing heavily on the nature of the principal-agent relationship.⁶⁶ The next section considers the source of these interpretations and the reasons for rejecting them.

II. DISTINGUISHING THE LAW OF INCOME RECOGNITION IN COOPERATIVES

It is one task to identify the complexity of the law, yet it is quite another to set about resolving that complexity. This article asserts that payments to cooperative members merit treatment different from traditional deferral principles and suggests an approach for doing so. In arguing for the recognition of a different standard, not only must cooperative members argue for the overall validity of the deferral arrangements, but must also battle over which cooperative transactions merit that treatment. As will be shown, both the institutional significance of the cooperative and evidence of legislative intent indicate they should prevail in this argument.

A. *The Institutional Significance of the Cooperative*

The starting argument for providing limited tax benefits to the cooperative and its members is that the institution itself is one worth saving. In the era of agribusiness,⁶⁷ where size and consolidation rule the industry, the cooperative provides a means of survival for the small farmer.⁶⁸ These farmers play an important role in contributing to the overall production of food, maintaining crop diversity, and supporting rural communities that might otherwise be forgotten.⁶⁹ Certainly, there is a subjective basis behind any such preference; however, the significant amount of continued support for these institutions is a reality

66. *Scherbart v. Comm’r*, 87 T.C.M. (CCH) 1418 (2004) (rejecting the deferral of income for taxpayers that had agreed to have year-end value-added payments distributed in the subsequent tax year).

67. See *Snyder*, *supra* note 5, at 734-41.

68. See *Snyder*, *supra* note 5; U.S. DEPT. OF AGRIC., *supra* note 5, at 96-97.

69. See CO-OPS 101, *supra* note 36.

worth noting.⁷⁰ A strict interpretation of tax provisions relating to the cooperatives is counter to this legislative preference because it limits the incentive to operate under such business structures.

The more significant argument for preferential tax treatment relates to the structural dynamics of the organization itself.⁷¹ Cooperatives are unique in that both operations and disbursements are centered around the role of the individual member and not the overall performance of the institution. Focus is on *use* instead of *investment*.⁷² Therefore, even though the agency label has been applied to the cooperative/farmer relationship,⁷³ several traditional characteristics of agency relationships are absent in this context. First, the one-to-one-to-one, producer-agent-buyer structure is simply inapplicable. The cooperative does play the role of intermediary; however, it does so between two ambiguous collections of buyers and sellers. Each individual member first provides a generic product to the cooperative. In some instances, the cooperative then processes, markets, and sells the product in the manner most beneficial to the cooperative as a whole, not any individual member. Second, the cooperative does not generate independent income outside of financing its own expenses.⁷⁴ These structural characteristics provide the foundation for the unique tax treatment of these as set out in Subchapter T⁷⁵ and § 521⁷⁶ of the Code. There is reason to believe these same interests also justify a unique treatment of income deferral for cooperative members.

The pattern of payment from the cooperative to its individual members must also play a role in the treatment of income. Generally, the farmer is entitled to a mandatory payment based on the amount of product delivered and, subsequent to delivery, a discretionary payment based on his proportionate contribution relative to the overall revenue of the cooperative.⁷⁷ Depending on the harvesting and processing schedule of the crop, these payments can extend from one year to the next as the

70. See generally Snyder, *supra* note 5; Lauck & Adams, *supra* note 6.

71. While the interest in preserving the small farm is a significant one, the primary reason for the unique treatment of cooperatives lies in their unique structure. See DONALD A. FREDERICK, INCOME TREATMENT OF COOPERATIVES: BACKGROUND, COOPERATIVE INFORMATION REPORT 44, 86 (2005) [hereinafter INCOME TREATMENT] (“Cooperatives are given different tax treatment because of their distinctive form of operation, not because they are thought to deserve special privileges.”).

72. See CO-OPS 101, *supra* note 36, at 9.

73. See 18 AM. JUR. 2D, *Cooperative Associations* § 39 (1985).

74. See CO-OPS 101, *supra* note 36.

75. I.R.C. §§ 1381-88 (2000).

76. I.R.C. § 521 (2000).

77. See INCOME TREATMENT, *supra* note 71.

product is sold. A common practice is for the cooperative to make a mandatory payment based on federal fund loan rates to the member upon delivery at a percentage of the previous year's rate.⁷⁸ If the farmer's appropriate profit share ends up being greater than that amount, a patronage refund (or value-added payment) will make up the difference. Because most mandatory payments are agreed upon prior to delivery and payment often accompanies the cooperatives receipt of the product, mandatory payments represent a less significant problem in terms of recognition than later discretionary payments, which are dependent on the cooperative generating a surplus or profit for its members.

A tougher question is raised by the second form of payment to cooperative members: patronage refunds based on surplus (or net earnings) at the end of the year. It is a reality of the industry that commodity prices can fluctuate widely from year to year and even within the production year itself.⁷⁹ Since it is not the cooperative but its individual members that recognize the gains and losses from production, the impact of the unknown factors of price and cost is distributed to those members. In most cases, this distribution occurs in the form of a year-end patronage refund.⁸⁰ Treatment of refunds can be tricky, since the farmer is unable to ascertain not only the amount of the return but also whether it will occur at all. These uncertainties occur every year and present a problem for many small farmers who are required to estimate their taxes quarterly as self-employed individuals.⁸¹ A cooperative member that is unable to validly defer these payments loses the ability to accurately estimate his or her income and may be subject to estimated tax penalties.⁸²

In establishing the tax treatment of cooperative members, consideration must be given to both the extrinsic value of the institution and its internal dynamics. These concerns have not been lost on Congress or the IRS, which have a history of protecting the cooperative

78. The Federal Loan program constitutes a significant source of income for farmers. See O'BRIEN, *supra* note 11.

79. See 4-25 AGRIC. LAW § 25.03 (2005).

80. See INCOME TREATMENT, *supra* note 71.

81. See Internal Revenue Service, *Self-Employment Tax* (June 19, 2006), <http://www.irs.gov/businesses/small/article/0,,id=98846,00.html>; Internal Revenue Service, *Estimated Tax* (September 1, 2007), <http://www.irs.gov/businesses/small/article/0,,id=110413,00.html>.

82. The most recent summary of penalties for failure to properly account for estimated taxes in the context of self-employed individuals can be found at I.R.S. Publication 505. Internal Revenue Service, *Publication 505, Tax Withholding and Estimated Tax* (2007), <http://www.irs.gov/publications/p505/index.html>.

and its individual members. However, several court decisions, such as the Eighth Circuit in *Scherbart*, completely ignored such considerations.

B. The Legislative Preference to Maintain Cooperatives

The seemingly incompatible collection of rulings and enactments constitutes a significant barrier in determining the validity of any deferral agreement. However, the legislative history of the ISA and Congress' refusal to either alter the ISA or overrule Revenue Ruling 73-210 suggests that the coexistence of these acts is the more cogent conclusion. To begin with, Revenue Ruling 73-210 seemingly established that a deferred payment contract between a cooperative and an individual member is valid so long as there is a bona fide agreement made before the farmer had an unqualified right to payment.⁸³ The IRS has yet to overturn this Ruling despite the fact it contains a standard distinct and different from the self-imposed limitation identified in *Williams*, *Warren*, and *Scherbart*. Second, Congress' enactment of the ISA in 1980 specifically allowed for the dispositions of farm property to be included.⁸⁴ The ISA was enacted with complete knowledge of the traditional agency relationship identified amongst cooperatives and their members, yet Congress chose to reference Revenue Ruling 73-210 specifically, as opposed to more restrictive agency or court interpretations. In *Scherbart*, the Eighth Circuit ignored the legislative history and took a very narrow approach to the meaning of the term "disposition" as contained in the ISA. This leads to two possible inferences. First, decisions subsequent to Revenue Ruling 73-210 and the ISA have impliedly limited their application, making the cooperative subject to the same restrictions as traditional agency relationships. Alternatively, the distinctive aspects of the Ruling and the Act separate them from the aforementioned decisions, which means *Scherbart* was improperly decided and therefore should not be followed. Statements from the Congressional Record and related Congressional actions shed light on determining which inference should prevail.

Evidence of a preference for cooperatives is found in the Congressional Record, the most significant of which comes from the Senate Committee Report on the ISA:

Under the bill, gain from the sale of property which is not required to be inventoried by a farmer under his method of accounting will be

83. Rev. Rul. 73-210, 1973-1 C.B. 211.

84. See I.R.C. § 453(l)(2)(A) (2000).

eligible for installment method reporting. . . . The committee also intends that deferred payment sales to farmer cooperatives are to be eligible for installment reporting as under present law.⁸⁵

Of significance in this excerpt is Congress' decision to cite to Revenue Ruling 73-210, despite the fact that the agency standard of *Williams* and *Warren* was already established. Two comments from the floor debates also illustrate the intended impact on farmers. The first comment is from the bill's original proponent, Senator Long: "[T]he committee . . . clarified the language of the bill to make sure that the farmer qualifies for installment method reporting for a deferred payment sale of a crop which is not required to be inventoried under the farmer's method of accounting."⁸⁶ The second comment is from Iowa Senator, Bob Dole:

Also of importance to farmers is that the bill assures that a farmer will be able to take advantage of the installment sale method, either under the general provision or under the special rule for dealers. This should be obvious to everyone, but recent Internal Revenue Service pronouncements have left the issue in doubt.⁸⁷

If unclear about the manner in which Revenue Ruling 73-210 and the ISA are to interact with the rule of agency in income recognition, these statements at a minimum recognize a role for each.

In addition to Congressional statements regarding the ISA, there is a body of evidence illustrating Congress' preference for the cooperative.⁸⁸ While these examples do not constitute a dispositive partiality for cooperatives, they do illustrate the type of benefits currently being provided. The first piece of evidence relates to the cooperative itself and the flow-through treatment of cooperative income generated by Subchapter T and I.R.C. § 521. Based on the recognition that cooperative income is primarily distributed back to its members, qualified cooperatives are allowed to write-off essentially all operating expenses and payments to members, whether mandatory or discretionary.⁸⁹ In regard to the tax benefits of the individual members,

85. S. REP. NO. 96-1000, at 8 (1980) (citing Rev. Rul. 73-210, 1973-1 C.B. 211).

86. 126 CONG. REC. 96 (daily ed. Oct. 1, 1980) (statement of Senator Long).

87. *Id.* (statement of Senator Dole). The Ruling to which the Senator refers to as creating doubt about the application of the ISA to farmer cooperatives is Revenue Ruling 79-379. Rev. Rul. 79-379, 1979-2 C.B. 204.

88. For a discussion of the current benefits available to the individual farmer, see generally RON DURST & JAMES MONKE, EFFECTS OF FEDERAL TAX POLICY ON AGRICULTURE (2001); Snyder, *supra* note 5, at 744-45, 750, 756 (analyzing the effectiveness of such provisions).

89. There is a clear distinction to the tax treatment of corporations, which are required to be

I.R.C. § 2031(c) allows for a qualified conservation easement deduction, I.R.C. § 40 provides for an ethanol producers credit, and I.R.C. § 2032A permits a special-use valuation option.⁹⁰ Outside of taxation, Congress has recognized a need to exempt cooperative members from antitrust prosecution.⁹¹ The enactment of the Capper-Volstead Act⁹² reflected the unique structure of the cooperative, most notably the potential swings in profitability and the lack of farmer bargaining power in the market.⁹³ These and similar provisions have had the influence of not only preserving the family farm from one generation to the next, but also of ensuring the effective operation of these institutions.⁹⁴

The lesson to be garnered from this evidence in regard to the interpretation of deferred payment contracts and the ISA is that courts should not use traditional agency standards to preclude traditional cooperative transactions from income deferral. The approach in cases like *Scherbart* has the effect of rendering the ISA irrelevant, which is clearly not the intent of Congress. Arguably, the text of the ISA remains ambiguous enough to allow for judicial discretion, though that does not merit its complete disregard. In this instance, as most others, the availability of an option that is both consistent with the text of the statute and furthers legislative intent should make for an easy choice. This did not occur in *Scherbart*. Therefore, further consideration of income deferral is justified.

III. IDENTIFYING ACCEPTABLE STANDARDS FOR INCOME RECOGNITION

Determining standards for income recognition demands consideration of all the issues discussed above. It is apparent that there is a historical legislative preference for farmer cooperatives, though it remains unclear how and if that preference extends to the law of income

taxed on institutional income. *See* I.R.C. § 11 (2000). Because a cooperative technically does not retain sales revenue other than to cover operating expenses, the concept of taxing cooperative income makes little sense.

90. I.R.C. §§ 2031(c), 40; 2032A (2000).

91. For discussion on the antitrust implications of cooperatives, see Stephen J. Hawke, *Antitrust Implications of Agricultural Cooperatives*, 73 KY. L. J. 1033, 1034-35, 1037-38, 1041-42 (1984).

92. 7 U.S.C.A. §§ 291, 292 (West 2007). *See also* Shannon L. Ferrell, *New Generation Cooperatives and the Capper-Volstead Act: Playing a New Game by the Old Rules*, 27 OKLA. CITY U. L. REV. 737, 744 (2002); David P. Claiborne, *The Perils of the Capper-Volstead Act and Its Judicial Treatment: Agricultural Cooperation and Integrated Farming Operations*, 38 WILLAMETTE L. REV. 263, 267 (2002).

93. *See* Ferrell, *supra* note 92, at 744.

94. *See* Snyder, *supra* note 5, at 744-45, 750, 756 (analyzing the effectiveness of such provisions).

recognition. The assertion here is that it does, and both the ISA and rules of deferral agreements can be tied together in a manner satisfying principles of fairness. In determining an argument for income recognition, a cooperative member should first attempt to meet the statutory requirements of the ISA, which provides the most tangible source of support for deferral. If these requirements cannot be met, the secondary approach is to establish the validity of a deferred payment agreement. In most circumstances, however, the arguments for deferral in either case are one and the same.

A. Sticking to the Plain Meaning of the Installment Sales Act

The most compelling evidence a taxpayer interested in deferral can provide is that he meets the statutory requirements of the ISA, which codifies such actions. If the requirements are met, the statute requires that a taxpayer use the installment method⁹⁵ of reporting to defer the gain on a disposition of property until payment is actually received. This treatment of income is necessary regardless of whether a fair market value would otherwise make the disposition includable in gross income.⁹⁶ A significant aspect of this statute is that it *requires* the deferral of income for applicable transactions, and the taxpayer must take affirmative action to opt out of such treatment.⁹⁷ As described above in Section I.C., a cooperative member wishing to defer income under the ISA must establish that there is (1) a disposition (2) of farm property (3) that is used *or produced* in the trade or business of farming.⁹⁸ These elements are discussed in turn.

It is natural to presume that an installment sale act would apply strictly to such transactions – sales. However, an important aspect of the ISA definition of an installment sale is its application to any *disposition* of property, and not merely sales. A disposition is defined as an “act of

95. See I.R.C. § 453(a) (2000).

96. See I.R.C. § 453(b)(1) (2000). The mandatory use of the installment sales method runs counter to the traditional principle that income must be recognized where a fair market value can be established. See *Warren Jones v. Comm’r*, 524 F.2d 788, 793 (9th Cir. 1975). Under an installment agreement, the seller may be acutely aware of the market value of the interest gained in a transaction, yet he is still required to report that income over a period of time.

97. I.R.C. § 453(d) (2000). It is also important to note that the ISA is only applicable to cash method taxpayers. See FREDRICK, *supra* note 71, at 14.

98. See *supra* Section I.C. These requirements are derived from several provisions within I.R.C. § 453. While (b)(1) establishes the general rule for applicable transactions, I.R.C. § 453(b)(2)(A) creates an exception for “dealer dispositions.” Additionally, I.R.C. § 453(1)(2)(A) creates an exception to the dealer disposition exception for any property used or produced in the trade or business of farming.

transferring something to another's care or possession . . .; the relinquishing of property."⁹⁹ While a sale does constitute one form of disposition, the latter applies to a broader variety of transactions, including will bequests, gifts, and the cancellation of debt.¹⁰⁰ Evidence of this distinction can be found elsewhere in the Code in § 1001,¹⁰¹ a provision dealing with gains and losses resulting from a "sale or other disposition." It is not a stretch to deduce that farmer deliveries to a cooperative in exchange for mandatory payments, which also create the possibility of future discretionary payments, even though not sales, could constitute a disposition of the property. In fact, there is evidence in the regulations and the legislative history that these are precisely the kind of transactions Congress meant the ISA to cover.¹⁰²

In addition to the disposition requirement, only certain property is eligible for installment reporting under the ISA. While the ISA is broadly inclusive, it does exclude dealer dispositions of personal property.¹⁰³ However, I.R.C. § 453(l)(2)(A) provides an express exception to the dealer disposition exception for "property used or produced in the trade or business of farming (within the meaning of section 2032A(e)(4) or (5))."¹⁰⁴ Of most interest to cooperative members is the "farming purposes" language of I.R.C. § 2032A(e)(5)(A), which applies to "cultivating the soil or raising or harvesting any agricultural or horticultural commodity (including the raising, shearing, feeding, caring for, training, and management of animals) on a farm."¹⁰⁵ Produce harvested throughout the year certainly fits this requirement, and is also consistent with the language of I.R.C. § 453(l)(2)(A) that requires the property be "used *or produced* in the trade or business of farming."¹⁰⁶ This final requirement clearly reflects the intent of Congress to incorporate the members of farmer cooperatives.

Opponents to such a broad interpretation of the ISA will note that there must be some limit to the ability of individuals to defer taxes. However, there is clear evidence in both I.R.C. § 453 and its

99. BLACK'S LAW DICTIONARY 211 (2d Pocket Ed. 2001).

100. See Edward J. Roche, Jr., *Dispositions of Installment Obligations*, 41 TAX L. REV. 1, 35-37 (1985); BORIS I. BITTKER & MARTIN J. MCMAHON, JR., FEDERAL TAXATION OF INDIVIDUALS § 41.4 (2d ed. 2006).

101. I.R.C. § 1001 (2000).

102. See *supra* Section II.B.

103. See I.R.C. § 453(b)(2)(A) (2000).

104. See *supra* note 61.

105. I.R.C. § 2032A(e)(5)(A) (2000). The other mentioned section could also be interpreted to include the products produced on a farm. See *supra* note 59 and accompanying text.

106. I.R.C. § 453(l)(2)(A) (2000).

corresponding regulations that payments regarding farm produce are to receive preferential treatment. While this exception applies to many taxpayers, it is important to keep the scope of the issue in perspective. These individuals are not wrongfully taking advantage of the system in order to avoid taxation altogether; they are merely taking advantage of a Code provision that allows for later recognition. Still, situations may arise that do not merit installment reporting, and the farmer should be able to depend on case law to validly defer income in those instances.

B. The "Substantial Limitation" of Deferred Payment Contracts

Outside of the ISA, the focus of a farmer wishing to defer income should be on Revenue Ruling 73-210 and its implication that cooperative members merit distinct treatment. In traditional agency relationships, sellers are prohibited from deferring income where the deferral results from a self-imposed limitation.¹⁰⁷ Revenue Ruling 73-210 rejects this standard in the context of cooperative relationships for the more traditional "substantial limitation" language in Reg. 1.451-2(a). That Ruling held that a substantial limitation arises as a result of a deferred payment agreement where there is (1) a bona fide arm's length agreement that is (2) entered into before the farmer had an unqualified right to receive payment.¹⁰⁸ If the taxpayer fails to satisfy the terms of the ISA, appropriately satisfying these two requirements is the final resort for a taxpayer wishing to defer income.

Identifying the existence of a bona fide arm's length agreement is the relatively easier task. Such agreements are defined as "good faith business transaction[s] between parties, each acting voluntarily for his own self-interest, without giving an unnecessary advantage to the other, in a manner consistent with prevailing business practice."¹⁰⁹ The required showing for challenging the validity of a transaction is helpful in identifying the purpose of this requirement; the "evidence must show that the deferred payment agreements were shams, and that the parties never intended to be bound by them."¹¹⁰ Because applicable evidence for this inquiry only relates to shams, most deferral decisions give it relatively little attention.¹¹¹ Another reason for the limited concern is

107. See, e.g., *Warren v. United States*, 613 F.2d 591, 593 (5th Cir. 1980).

108. The standard set forth in Rev. Rul. 73-210, 1973-1 C.B. 211 copies that of Rev. Rul. 58-162, 1958-1 C.B. 234.

109. *Oliver v. United States*, 193 F.Supp. 930, 935 (E.D. Ark. 1961).

110. See *Schniers v. Comm'r*, 69 T.C. 511, 518 (1977).

111. Analysis of whether a deferred payment agreement constitutes a sham typically involves a review of the terms of the contract. See, e.g., *Crimmins v. United States*, 655 F.2d 135, 138 (8th

that the failure to satisfy the second requirement often implies a failure of the first – the presence of an unqualified right before the agreement was entered is strong evidence that the ultimate goal is deferral. Thus, unless there are obvious objections to the agreement, analysis should concentrate heavily on the second requirement.

The second requirement is that the agreement between parties must be made before there is an *unqualified right* to payment. Initially, it is important to identify the transaction in question. “Payment” refers not to the proceeds of the ultimate sale to the cooperative, but to the proceeds the member receives from the sale by the cooperative. The concern is for the farmer’s right to cooperative distributions. Traditionally, the IRS and the courts have been strict about what constitutes an unqualified right, though most agree that the ultimate determination is a question of fact.¹¹² The IRS Ruling setting out this language held that the agreement must be entered into before delivery of the product.¹¹³ Subsequent judicial decisions have held that neither the ability to sell the right to payment¹¹⁴ nor mere promises to enter into an agreement are sufficient to constitute an unqualified right.¹¹⁵ The general principle to be derived from these cases is that while the ability to recover some income or receive promises on delivery will not automatically create an unqualified right, the best approach for individual members is to enter into a scheduled agreement with the cooperative before they make their deliveries.

The characteristics of cooperative distributions must be evaluated in order to understand the impact of these principles. Generally, individual members enter into an agreement outlining the mandatory payment schedule prior to delivery; therefore, it is relatively easy to forecast the schedule of mandatory payments. Few would object to a standard that requires any deferral of mandatory disbursements to be entered into before delivery. However, a more difficult problem is presented in regard to discretionary payments. As mentioned, these distributions are

Cir. 1981); *Schniers*, 69 T.C. at 521. Frequently, the substantive terms of the agreement are found to be legitimate, with the only question of legitimacy relating to the timing of payments to the farmer. As will be discussed, this timing issue is the strongest indication that an agreement is not bona fide and is addressed in the second prong of the deferral inquiry.

112. See *Avery v. Comm’r*, 292 U.S. 210, 214 (1934).

113. See Rev. Rul. 58-162, 1958-1 C.B. 234.

114. See *Patterson v. Comm’r*, 510 F.2d 48, 51 (9th Cir. 1975) (recognizing that it was within the 58-162 taxpayer’s “volition” to sell his right to payment and receive income in the year of delivery, but denying that this ability constitutes an unqualified right).

115. See *Schniers*, 69 T.C. at 511 (taxpayer promised to make sales to a buyer, though neither the sale date, date of payment, nor the method date were determined).

not assured at the beginning of the year and cannot be quantified until the cooperative closes its books for the year. Thus, dividend payments create a great deal of uncertainty for farmers attempting to plan their tax obligations.¹¹⁶ This issue was central to *Scherbart*, in which the deferral agreement was entered into after delivery, but before any refund payment had been quantified or even determined available.¹¹⁷ The Tax Court and the Eighth Circuit, focusing on the agency relationship amongst farmers and cooperatives, stated that such an agreement constituted a self-imposed limitation on the receipt of income, and therefore held the deferral invalid. Neither court even mentioned Revenue Ruling 73-210, nor did they discuss the unique nature of the cooperative/member agency relationship. Failure to address these issues raises serious concerns about the validity of their reasoning contained therein.¹¹⁸

Two bright-line rules could be applied in regard to discretionary payments. The first would be to require agreement to defer before any delivery, and the second would be to require agreement before the identification and calculation of the refund.¹¹⁹ Requiring agreement prior to delivery is an easier standard to enforce, though it provides little benefit to the farmer in terms of planning for taxes at the end of the year. Such a rule locks the farmer into deferral regardless of the market changes that may occur between the time of delivery and payment. On the other hand, requiring agreement only before the identification and calculation of the refund allows for greater certainty by providing more time for the farmer to consider market conditions. This standard would also provide protection from deferral abuse because the fair market value has yet to be established. Even though such an interpretation was

116. The issue of certainty is especially important to the small farmer because of their obligation to estimate income and pay taxes on those estimates. The failure to do so will result in the imposition of penalties. See Internal Revenue Service, *Self-Employment Tax* (June 19, 2006), <http://www.irs.gov/businesses/small/article/0,,id=98846,00.html>; Internal Revenue Service, *Estimated Tax* (September 1, 2007), <http://www.irs.gov/businesses/small/article/0,,id=110413,00.html>.

117. *Scherbart v. Comm'r*, 87 T.C.M. (CCH) 1418 (2004).

118. The problem of deferral was exacerbated by the fact that the cooperative had a fiscal year ending September 30 and the taxpayers were calendar year taxpayers. Thus, the cooperative could close its books and make a discretionary payment before the close of the taxpayers' tax year. If the tax years of the cooperative and the member had been the same, then it is less likely that the deferral issue would arise. The cooperative would not be able to make payment until after the close of tax years for both the cooperative and the member.

119. *Warren Jones v. Comm'r*, 524 F.2d 788, 793 (9th Cir. 1975). A third possible rule would allow agreements so long as they occurred before payment; however, the establishment of the fair market value as well as the promise to pay at that point would contradict a large body of tax law.

rejected in *Scherbart*, it is illogical to state that a farmer has an unqualified right to payment before the cooperative has even determined a refund exists. A reevaluation of that decision is appropriate.

IV. CONCLUSION

The issue of income deferral for the individual members of farmer cooperatives invokes questions related to case law, revenue rulings, the Internal Revenue Code, and the interaction of the three. Currently, there is evidence that the ability of members to validly defer income is being impeded by the focus on traditional agency principles and limiting the potential for deferral, which appears contrary to Congressional intent. This interpretation of the law is unique because the agency treatment of the relationship between cooperatives and farmers is not a recent phenomenon, but one that was in existence before either Revenue Ruling 73-210 or the ISA. Clarifying the reach of each component has been the focus of this Article, and is clearly necessary given the inconsistent messages being sent to farmers and the *Scherbart* court's disregard for IRS and Congressional intent.

This article has recommended that distinct treatment for cooperative members in regard to income recognition is appropriate. Reasons for this treatment go beyond the traditional federal support for cooperatives and focus on the unique characteristics of these associations. The provisions of the ISA were developed with these considerations in mind. In dealing with deferral, both the ISA and the case law of deferral agreements should constitute valid tools for the individual farmer, allowing for deferral in appropriate circumstances.