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## Will Escrow Accounts Defer Income?

-by Neil E. Harl\*

The rapid run-up in commodity prices in recent months has focused attention on the use of escrow accounts to defer income from commodity sales.<sup>1</sup> The majority of the litigated cases have been unsuccessful in deferring income<sup>2</sup> but a few have been successful.<sup>3</sup>

### Nature of the escrow agreement

The litigated cases over the past 30 years have made it clear that the terms of such escrow agreements have a great deal of influence over the issue of when the escrowed payments are subjected to income tax - when payments are made or, later, when funds are paid to the original seller of the commodity. A key issue in determining whether the income can be effectively deferred is whether the escrow agent is considered an agent of the seller of the commodity<sup>4</sup> or is considered an agent of the buyer of the commodity.<sup>5</sup>

### Income tax consequences of the escrow agreement

With a few notable exceptions, which are discussed below, the overwhelming weight of authority has been that receipt by an agent of the taxpayer is considered receipt by the taxpayer. The escrow agreement or other arrangement is not successful in deferring payment until receipt of the payment by the taxpayer from the escrow agreement or other arrangement.<sup>6</sup> Most of the cases were decided by the Fifth and Ninth Circuit Courts of Appeal.<sup>7</sup>

The Eighth Circuit Court of Appeals has reached much the same conclusion under various facts. In *Scherbart v. Commissioner*,<sup>8</sup> a year-end payment from a value-added cooperative which was received by an agent was deemed constructively received by the taxpayer. In *United States v. Pfister*,<sup>9</sup> a sale of livestock under a commission arrangement was held to result in income to the taxpayer upon sale under the theory that the commission firm was an agent of the taxpayer.

Two cases are frequently cited as exceptions to the well-settled rule that receipt by an agent of the seller is considered receipt by the taxpayer-seller. One, *Busby v. United States*,<sup>10</sup> actually involved sale of a cotton crop on a deferred basis with an irrevocable escrow account established by the cotton gin which was acting as the agent of the purchaser, not as agent of the seller, at the time payment was made to the account. In *Reed v. Commissioner*,<sup>11</sup> the escrow agreement was part of a bona fide, arm's length agreement between the purchaser and the seller calling for deferred payment. The arrangement was the result of a modification of the original purchase-sale agreement. The court stated ". . . a deferred escrow arrangement that is not part of a bona fide agreement between the

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buyer and the seller-taxpayer, but rather is a 'self-imposed limitation' created by the seller-taxpayer, is legally ineffective to shift taxability on escrowed funds one year to the next.

Therefore, both the *Reed* case as well as the *Busby* case are not inconsistent with the prevailing view that an escrow account with the escrow agent acting for or as an agent of the seller of the commodity is unlikely to be successful in deferring income.

### An alternative

The enactment of an amendment to the Internal Revenue Code in 1980<sup>12</sup> allows taxpayers who are not required to include an item in closing inventory (such as farmers on the cash method of accounting) to sell commodities under an installment sale arrangement which assures a deferral if done properly.<sup>13</sup> That approach makes use of the installment sale rules<sup>14</sup> which otherwise cannot be used to defer inventory-type property or property held for sale in the ordinary course of business. The provision was enacted in 1980 as an amendment to the *Installment Sales Revision Act of 1980*<sup>15</sup> as a Congressional response to issuance of a 1979 private letter ruling.<sup>16</sup> That ruling held that if a contract that farm taxpayers entered into for sale of their commodities could be assigned at fair market value at year-end, that value must be taken into account in the year of sale.<sup>17</sup>

For those who worry about the possibility of default in payment by the purchaser of the commodity, however, the installment sale alternative may not be acceptable.

### Conclusion

Agreements between the seller and an escrow agent who is acting for the seller of the commodity are clearly ineffective to defer income. Payments by the buyer of grain made to the escrow account are also deemed income to the taxpayer-seller at the same time.

For an escrow agreement set up with the escrow holder acting as agent of the purchaser, the agreement must be drafted with great care and even then a challenge is possible.<sup>18</sup>

### ENDNOTES

<sup>1</sup> See Maurer and Harl, "Using Escrow Accounts and Letters of Credit to Assure Payment Under Credit Sales Agreements," 14 *J. of Agr. Tax. & L.* 3 (1992). See generally 4 Harl, *Agricultural Law* § 25.03[2] (2010); Harl, *Agricultural Law Manual* § 4.01[1][b][ii] (2010); Harl, *Farm Income Tax Manual* § 2.08[2], 2.03 (2011 ed.).

<sup>2</sup> E.g., *Williams v. United States*, 219 F.2d 523 (5th Cir. 1955) (escrow arrangement unilateral and not product of bona fide arm's length negotiation).

<sup>3</sup> See *Reed v. Comm'r*, 723 F.2d 138 (1st Cir. 1983) (escrow agreement part of bona-fide arm's length agreement).

<sup>4</sup> E.g., *Arnwine v. Comm'r*, 696 F.2d 1102 (5th Cir. 1983), *rev'g*, 76 T.C. 532 (1981).

<sup>5</sup> E.g., *Busby v. United States*, 679 F.2d 48 (5th Cir. 1982) (sale of cotton crop on deferred basis with irrevocable escrow account established by cotton gin with no right by taxpayer to funds until following year; escrow was effective in deferring income).

<sup>6</sup> See *Arnwine v. Comm'r*, 696 F.2d 1102 (5th Cir. 1983), *rev'g*, 76 T.C. 532 (1981) (cotton gin, acting on behalf of the seller insofar as distribution of proceeds of crop sales, received proceeds which were income to the producer-seller); *Williams v. United States*, 219 F.2d 523 (5th Cir. 1955) (receipt by agent was receipt by principal; escrow arrangement unilateral and not product of bona fide arm's length negotiation); *Warren v. United States*, 613 F.2d 591 (5th Cir. 1980) (cotton gin acted as taxpayer's agent in collecting and holding proceeds of cotton sale). See also *P.R. Farms, Inc. v. Comm'r*, 820 F.2d 1084 (9th Cir. 1982), *aff'g*, T.C. Memo. 1984-549 (sale of fruit by agent; proceeds includible in taxpayer's income in year of sale even though not remitted to taxpayer until later year).

<sup>7</sup> See notes 2-6 *supra*.

<sup>8</sup> 453 F.3d 987 (8th Cir. 2006), *aff'g*, T.C. Memo. 2004-143.

<sup>9</sup> 205 F.2d 538 (8th Cir. 1953), *rev'g*, 102 F. Supp. 640 (D. S.D. 1952).

<sup>10</sup> 679 F.2d 48 (5th Cir. 1982).

<sup>11</sup> 723 F.2d 138 (1st Cir. 1983).

<sup>12</sup> I.R.C. § 453(b)(2)(B).

<sup>13</sup> See note 1 *supra*.

<sup>14</sup> I.R.C. § 453(a).

<sup>15</sup> Pub. L. No. 96-471, § 2, 94 Stat. 2247 (1980), amending I.R.C. § 453(b).

<sup>16</sup> Ltr. Rul. 8001001, Sept. 4, 1979.

<sup>17</sup> See *Warren Jones Co. v. Comm'r*, 524 F.2d 788 (9th Cir. 1975), *rev'g and rem'g*, 60 T.C. 663 (1973), *non-acq.*, 1980-1 C.B. 2.

<sup>18</sup> See Maurer and Harl, note 1 *supra*.