

Using Escrow Accounts and Letters of Credit to Assure Payment Under Credit Sales Agreements*

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Concern over nonpayment by buyers of farm commodities under deferred payment arrangements has caused farmers to consider ways to assure that payment under such credit sales contracts will be made. This article discusses two devices for making payment to the farmer more certain—escrow accounts and letters of credit.

Introduction

In a credit sale contract, legal title and physical possession of agricultural products are transferred from the farmer to the purchaser, but the farmer's receipt of the sale proceeds is delayed (deferred payment contracts), or the receipt of the sale proceeds and the pricing of the agricultural product are delayed (deferred pricing or price later contracts). The flexibility inherent in these agreements provides benefits to both farmers and purchasers. The farmer assumes the risk of an unsecured creditor of the buyer from the time of delivery of the agricultural product to the actual receipt of the sale proceeds by the farmer and, if the buyer experiences financial difficulties, the farmer may not be able to collect the sale proceeds.

To illustrate one way the farmer could be victimized, assume that (1) a grain elevator operator is financially troubled and is organized as a corporation so that its owners have limited liability and (2) the financial institution that furnishes the operator with a secured line of credit has decided to call its loan due, sell off the collateral to repay as much of the loan as possible, and proceed against the individual owners who have personally guaranteed the operator's repayment of the line of credit. If the individual guarantors are responsible for the day-to-day operations of the operator, from the time they learn that the secured lender may foreclose on the loan until the foreclosure terminates their ability to do business, the guarantor-operators have the incentive to buy grain under credit sale contracts, deliver the warehouse receipts for that grain to the secured lender to increase the amount of collateral, and thereby decrease the deficiency for which the guarantors will be personally liable under the guarantees. The farmers, as unsecured creditors, might never be paid for the grain. Similarly, when there are no guarantors, before the secured lender forecloses under its line of credit, it may have the incentive to encourage the elevator operator to buy grain under credit sales contracts and deliver the warehouse receipts for the grain to the secured lender. This maneuver improves the position of the secured lender at the expense of the farmers who sold grain using credit sales contracts.

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Concern over nonpayment has caused farmers to consider ways to assure that payment under the credit sales contract will be made. Two devices for making payment to the farmer more certain are escrow accounts and letters of credit. Each of these devices could serve as the mechanism for direct payment of the farmer or could secure the purchaser's payment obligation under the credit sales contract.

From the perspective of the farmer, these devices raise concerns involving bankruptcy law and income tax law. First, if the purchaser files for bankruptcy law and income tax law. First, if the purchaser files for bankruptcy, will the sale proceeds be subject to the claims of the trustee and, as a result, will the farmer be treated as an unsecured creditor? Second, will the device chosen make payment to the farmer so certain that the sale proceeds will be treated as taxable income in the year that the agricultural products were delivered to the purchaser?

Bankruptcy Concerns

Escrow Agreement

Generally, the use of escrow agreements in connection with credit sales contracts raises two legal questions in the bankruptcy context. First, is the escrow agreement an "executory contract" that the trustee may reject under 11 U.S.C. § 365(a)? Second, are the escrow funds property of the estate under 11 U.S.C. § 541(a)(1) and thus subject to the claims of the trustee in bankruptcy ahead of the claims of the farmer-seller?

The Escrow Agreement Is Not an Executory Contract

The case law indicates that an escrow agreement is not an executory contract subject to acceptance or rejection in bankruptcy, regardless of whether the escrow agreement is intended as a payment mechanism or as security.

Escrow agreement as payment mechanism

When the farmer and purchaser intend the escrow account to be the source of payment for the farmer, they presumably agree that the sale proceeds from the agricultural product are to be placed in an unconditional and irrevocable escrow account¹ and that, on or after the specified date, the escrow agent releases those proceeds to the farmer. In *In re Newcomb*,² the escrow account was established as a payment mechanism. The debtors agreed to deposit the amount of a judgment entered against them into an escrow account and, in return, the Farmers Home Administration (FmHA) agreed not to levy on the judgment during the debtors' appeal. Under the escrow agreement, if the debtors lost their appeal of the judgment, the escrow agent would deliver the escrow funds and interest to the FmHA. The debtors lost their appeal on July 15, 1982, and filed for bankruptcy on August 12, 1982. The debtors' trustee argued that the escrow agreement was an "executory contract" and could be rejected by the trustee. The Eighth Circuit held that the escrow agreement was not an "executory contract" because (1) the agreement was more than a contract; it was a way to convey property, and the ultimate grantee acquired an

¹ The deposit of the sale proceeds into the escrow account would not be a preferential transfer so long as the funds are exchanged for new value and the exchange is substantially contemporaneous. See 11 U.S.C. § 547(c)(1).

² 744 F.2d 621, 624 (8th Cir. 1984).

interest in property when the funds were deposited in escrow,³ and (2) alternatively, even if the escrow agreement were a “contract,” it was not “executory” in the sense that performance remained due on both sides at the time of the bankruptcy petition, because payment of money was all that remained to be done.⁴

Escrow account as security

When the farmer and the purchaser intend the escrow agreement to create a security interest related to the purchaser’s payment obligation under the credit sales contract, the escrow agreement still is not an “executory contract.” In *In re Cedar Rapids Meats, Inc.*,⁵ the debtor established an escrow account to secure its obligation to pay workers’ compensation claims. The bankruptcy court followed the reasoning in *In re Newcomb* and concluded that the escrow agreement was not an “executory contract.” As an additional rationale, the bankruptcy court stated that, even if the escrow agreement were an executory contract, rejection of the escrow agreement was not appropriate because it would fail the test of benefiting the unsecured creditors.⁶ The unsecured creditors would not have benefited, because the escrow funds were not property of the estate or, alternatively, if the funds were property of the estate, they were subject to a perfected security interest.⁷

Escrow Funds Are Not Property of the Estate

A number of cases have address the issue of whether a trustee can claim property held in escrow as property of the debtor’s estate,⁸ although none of the cases involves a debtor that had purchased agricultural products under a credit sales contract. Courts confronted with this issue begin analyzing the nature and extent of the debtor’s interest in the escrow property with reference to the applicable state law and the terms of the escrow agreement.⁹ Some courts have gone so far as to state that whether the escrow property is property of the debtor’s estate “depends entirely on the nature and circumstances of the escrow agreement.”¹⁰

³ *Id.* at 624.

⁴ *Id.*

⁵ 121 B.R. 562, 573-574 (Bankr. N.D. Iowa 1990).

⁶ *Id.* at 574.

⁷ *Id.*

⁸ In certain circumstances, escrow funds are not property of the estate. E.g., *In re Newcomb*, 744 F.2d 621 (8th Cir. 1984); *In re Knox Kreations*, 656 F.2d 230 (6th Cir. 1981); *In re Cedar Rapids Meats, Inc.* 121 B.R. 562 (Bankr. N.D. Iowa 1990); *In re Agsy*, 120 B.R. 313 (Bankr. S.D. N.Y. 1990); *In re Sun*, 116 B.R. 767 (Bankr. D. Haw. 1990); *In re Dolphin Titan Int’l*, 93 B.R. 508 (Bankr. S.D. Tex. 1988); *Creative data Forms, Inc. v. Pennsylvania Minority Business Dev. Auth.*, 72 B.R. 619 E.D. Pa. 1985); *In re Palm Beach Heights Dev. & Sales Corp.*, 52 B.R. 181 (Bankr. S.D. Fla. 1985); *In re Coco*, 67 B.R. 365 (Bankr. S.D. N.Y. 1986); *In re. O.P.M. Leasing Servs., Inc.*, 46 B.R. 661 (Bankr. S.D. N.Y. 1985); *In re Lenk*, 44 B.R. 814 (Bankr. W.D. Wis. 1984) *aff’d*, 46 B.R. 867 (W.D. Wis. 1985); and *F/S Computer Corp.*, 38 B.R. 384, 390 (Bankr. W.D. Pa. 1984). Other courts have ruled that funds held in an escrow account are property of the estate. E.g., *In re Missionary Baptist Found. Of Am., Inc.*, 792 F.2d 502 (5th Cir. 1986); *In re Nield*, 95 B.R. 259 (Bankr. D. Me. 1989); *In re Leff*, 88 B.R. 105 (Bankr. N.D. Tex. 1988); *In re World Communication, Inc.*, 72 B.R. 498 (D. Utah 1987); *In re Berkley Multiunits, Inc.*, 69 B.R. 638 (Bankr. M.D. Fla. 1987); *In re Haynes*, 35 B.R. 32 (Bankr. M.D. Tenn. 1983); *In re Turner*, 29 B.R. 628 (Bankr. D. Me. 1983); and *In re Heckler Land Dev. Corp.*, 15 B.R. 856 (Bankr. E.D. Pa. 1981).

⁹ E.g., *In re Missionary Baptist Found. Of Am., Inc.*, and *In re Newcomb*, note 8 *supra*.

¹⁰ *In re Cedar Rapids Meats, Inc.*, 121 B.R. at 567, *quoting In re Sun*, 116 B.R. at 771, *quoting In re World Communications, Inc.*, 72 B.R. at 498.

Escrow agreement as payment mechanism

Although an analysis of property interests under local law and the escrow agreement can be detailed and complex, it is relatively straightforward when an unconditional and irrevocable escrow agreement has been established as a payment mechanism. Under an unconditional and irrevocable escrow agreement, the purchaser-debtor has no rights, contingent or otherwise, in the funds once they are delivered to the escrow agent. Accordingly, there are no rights in the fund for the trustee to claim. For example, in *In re Newcomb*, when the bankruptcy petition was filed, all that remained to be done under the escrow agreement was the payment of the escrow funds to the FmHA. In that case, the debtor had no rights in the funds and, thus, the funds were not property of the estate.¹¹

In a price later contract, since the amount placed in escrow must be an estimate of the final selling price, it is likely that either a deficiency or a surplus will exist once the price is established in accordance with the terms of the contract. Before pricing, the purchaser-debtor has a contingent interest in the escrow funds. After pricing, the contingency is resolved and the excess to be refunded to the purchaser-debtor can be determined. The trustee cannot bootstrap this contingent interest into something greater and claim a right to all of the escrow funds.¹² In *Cedar Rapids Meats, Inc.*¹³ and *In re Dolphin Titan*,¹⁴ the debtors had established escrow funds to pay workers' compensation claims. Each court held that the trustee would be entitled to the remainder of the funds after all workers' compensation claims had been paid, but the contingent remainder did not allow the trustee to claim the entire fund. Accordingly, the trustee could get the remaining funds when it established that all prior claims had been paid in accordance with the terms of the escrow agreement. Similarly, in a price later contract, once pricing had occurred, the elevator operator's trustee in bankruptcy could prove that excess funds were present in the escrow account and subject to its residual claim.

When a deficiency occurs after the price is settled and the elevator purchaser has the obligation to deliver more money into escrow, that transfer of additional funds might be an avoidable transfer if it is made on or after ninety days before the filing of the petition.¹⁵ Alternatively, the price later contract could require the purchaser to pay the deficiency directly to the farmer when the funds are released from escrow.¹⁶

¹¹ This conclusion is supported by the reasoning of the court in *In re Missionary Baptist Foundation of America, Inc.*, the leading case in which escrow funds were held to be property of the estate. In that case the court distinguished a line of cases that held that the escrow accounts were not property of the debtor's estate by stating that in those cases

the contingency which would wipe out the debtor's interest in an escrow fund occurred prior to bankruptcy. Hence, at the date of bankruptcy, no contingent interest existed which might accrue to the debtor's estate.

792 F.2d at 506. Similarly, the purchaser-debtor's interest in the sale proceeds is extinguished when they are deposited in the irrevocable, unconditional escrow account.

¹² See *In re N.S. Garrott & Sons*, 772 F.2d 462 (8th Cir., 1985) (Section 541 was cont created to enlarge the debtor's rights against others beyond those existing at the commencement of the case).

¹³ 121 B.R. 562.

¹⁴ 93 B.R. 508.

¹⁵ See 11 U.S.C. §§ 547(b) (preferential prepetition transfer) and 549 (post-petition transfer). The ninety-day period may be extended by one year if the seller is an "insider" pursuant to 11 U.S.C. § 547(b)(4)(B). Sellers whose relationship with a cooperative elevator goes beyond that of seller-buyer may be "insiders."

¹⁶ The bankruptcy conclusions herein with respect to the escrow funds would apply to the partial escrow. With

Escrow account as security

When the escrow account serves as security for the payment obligation under the credit sales contract, it is possible for the farmer to have a perfected security interest in the funds deposited in the escrow account. First, the escrow agreement should satisfy the requirements for creating an enforceable security interest set forth in the Uniform Commercial Code.¹⁷ Second, to perfect the security interest in the money or instruments deposited in the escrow account, the escrow agent should serve as a bailee that has been notified of the farmer's security interest in the escrow funds.¹⁸ The court in *In re Cedar Rapids Meats, Inc.* relied on *In re Copeland*¹⁹ and *In re Rolain*,²⁰ stating that the law "is very clear that an escrow agent serving both parties can qualify as a bailee/agent under [Section] 9-305."²¹

Accordingly, the escrow agreement should be carefully drafted to provide for the creation of a security interest and should clearly state that the escrowee is serving as escrow agent for both the farmer and the purchaser²² and as a bailee with notice of the farmer's security interest.

Letter of Credit

Bankruptcy issues are not present when an unconditional letter of credit²³ or a standby letter of credit is used to assure that the farmer-seller gets paid. Under an unconditional letter of credit, the issuing bank is the source of funds to pay the farmer. Under a standby letter of credit, if the buyer files for bankruptcy or otherwise defaults, the issuing bank is required to pay the farmer. In either case, the bankruptcy of the elevator operator does not disrupt payment. Therefore, the creditworthiness of the buyer is no longer important to the farmer.²⁴ Instead, the farmer is concerned with the financial viability of the issuing bank, because the bank has assumed the credit risk that the elevator operator will not be able to reimburse it for paying under the letter of credit.

Income Tax Concerns

Substantial authority supports the proposition that a cash method farmer is permitted to delay recognition of income from the sale of agricultural products by entering into a deferred payment contract with the buyer, provided that the contract is part of a bona fide arm's-length

respect to the portion of the deferred payment obligation not covered by escrow, however, the farmer would assume the risk that the buyer could not pay.

¹⁷ See, e.g., Iowa Code §§ 554.9105(1)(l) and 554.9203(1) (1991).

¹⁸ See, e.g., Iowa Code §§ 554.9304(1) (security interest in money or instruments is perfected only by secured party taking possession) and 554.9305 (secured party is deemed to have possession of collateral held by a bailee with notice of the security interest) (1991).

¹⁹ 531 F.2d 1195 (3d Cir. 1976).

²⁰ 823 F.2d 198 (8th Cir. 1987).

²¹ 121 B.R. at 571.

²² If the escrow agent is only an agent for the farmer, income tax problems may result.

²³ For purposes of this article, an unconditional letter of credit means a letter of credit under which the issuing bank will pay directly to the farmer on the date specified in the letter of credit, with the purchase price determined in accordance with the credit sales contract. As a "condition," an issuing bank may require the farmer to surrender the letter of credit and credit sales contract.

²⁴ The farmer is assuming credit risk regarding the elevator if the letter of credit covers less than 100 percent of the deferred payment obligation.

transaction and the farmer has no legal right to demand and receive payment until the following year.²⁵ Nevertheless, the hostility of the Internal Revenue Service (IRS) to this technique of tax deferral has caused this area of law to be difficult to predict.²⁶ The issue addressed here is whether the use of an escrow account or letter of credit to assure payment of the obligation under the credit sales contract jeopardizes the deferral of taxable income.

A farmer selling under a credit sales contract has two choices as to how to report the gain from the sale. First, gain from the sale of grain or livestock by a farmer is eligible for installment sales method reporting as gain from a nondealer sale of personal property, even though such property is held for sale by the farmer,²⁷ provided the farmer is on the cash method of accounting and at least one payment is received by the farmer after the year in which the disposition occurs.²⁸ Second, the farmer may elect out of installment sales method reporting.²⁹

Installment Sales Method Reporting Under Internal Revenue Code Section 453

A farmer may use installment sales method reporting if at least one payment for the agricultural product is received after the tax year in which the product is disposed. The critical question under Section 453 of the Internal Revenue code (the Code) is: When does the farmer receive payment?³⁰ If a farmer receives payment in the year in which the agricultural product is sold, then there is no tax deferral benefit with respect to that payment. “Payment” does not include the receipt of evidence of indebtedness of the purchaser regardless of whether payment is guaranteed by a third party,³¹ provided that the evidence of indebtedness is not payable on demand or readily tradable.³² When the seller has no legal right to accelerate payment under a credit sales contract, the test of not being payable on demand should be satisfied.³³ Also, when the credit sales contract cannot be assigned or transferred, it appears that it is not “readily tradable.”³⁴

Escrow

From an example in the temporary regulations, it appears that the fair market value (FMV) of a credit sales contract that is secured by an escrow account is treated as taxable income

²⁵ See *Crimmins v. United States*, 655 F.2d 135 (8th Cir. 1981); *Kasper v. Banek*, 214 F.2d 125 (8th Cir. 1954); *Amend v. Comm’r*, 13 T.C. 178 (1949), *acq.* 1950-1 C.B. 1; Rev. Rul. 58-162, 1958-1 C.B. 234; Rev. Rul. 73-210, 1973-1 C.B. 211; *Farmer’s Tax Guide*, IRS Publication No. 225, at 8 (for 1991 returns). See also *Maples* “Deferral of Crop Proceeds,” 15 *Tax Adviser* 26-29 (Jan. 1984).

²⁶ For example, in Letter Ruling 8001001, the IRS stated that the taxpayer recognized as taxable income in the year of sale the fair market value (FMV) of the taxpayer’s rights under deferred payment contracts. The contracts (1) deferred actual receipt of the proceeds from the sale of grain for two years; (2) were assignable; (3) were acceptable collateral for loans in the farmer’s area; and (4) would have been paid in full by the purchaser at the time of the sale if the taxpayer had not requested deferral. As a result of this letter ruling, it is prudent to use nonassignable and nontransferable contracts that defer payment for only one year.

²⁷ I.R.C. § 452(b); Temp. Reg. § 15A.453-1(b)(4).

²⁸ I.R.C. § 453(b)(1).

²⁹ I.R.C. § 453(d).

³⁰ I.R.C. § 453(c); Temp. Reg. § 15A.453-1(b)(3).

³¹ I.R.C. § 453(f)(3).

³² I.R.C. § 453(f)(4).

³³ See Temp. Reg. § 15A.453-1(e)(1).

³⁴ *Id.*

in the year that the credit sales contract was received.³⁵ Use of an escrow account as the primary mechanism of payment, rather than only as security, would probably be viewed as receipt by the farmer “of an evidence of indebtedness of a person other than the person acquiring the property from the taxpayer”³⁶ and, thus, would probably be treated as taxable income in the year the escrow account was established. Accordingly, a farmer planning to use the installment sales method of reporting income for a credit sales agreement should not use an escrow account either as a direct payment mechanism or as security for the payment obligation.³⁷

Letter of Credit

Under the installment sales method, the deferral of income tax liability can be accomplished by using a nonassignable credit sales contract secured by a standby letter of credit. A standby letter of credit³⁸ is a third-party guarantee³⁹ and, therefore, does not cause the credit sales contract and standby letter of credit to be “payment” when received. In contrast, receipt of an unconditional letter of credit as the primary means of payment probably would be viewed as “payment” under Section 453 of the Code because the unconditional letter of credit appears to be an evidence of indebtedness of a third party.⁴⁰

Election Out of Installment Sales Method

When a farmer elects out of the installment sales method of reporting,⁴¹ the question becomes: What rules should be applied to the reporting of income from the sales contract? The most obvious possibilities are (1) the temporary regulations that purport to govern situations in which the election has been made⁴² and (2) the body of law applicable to deferred payment obligations before the Installment Sales Revision Act of 1980⁴³ became effective.⁴⁴

Temporary Regulations Section 15A.453-1(d)(2)

Temporary Regulations Section 15A.453-1(d)(2) is a good example of the hostility of the IRS towards the use of deferred payment arrangements to defer tax liability. It states that a cash

³⁵ Temp. Reg. § 15A.453-1(b)(5) *Example (8)*.

³⁶ Temp. Reg. § 15A.453-1(b)(3)(i).

³⁷ If a farmer uses an escrow account and the IRS asserts that the escrow account constitutes payment, the farmer could rely on certain cases arising under former Section 453 that hold that an escrow account is not payment. Those cases, however, are outnumbered by cases reaching the opposite holding.

³⁸ Temp. Reg. § 15A.453-1(b)(3)(iii) defines a standby letter of credit as—
a non-negotiable, nontransferable (except together with the evidence of indebtedness which it secures) letter of credit, issued by a bank or other financial institution, which serves as a guarantee of the evidence of indebtedness which is secured by the letter of credit. Regardless of whether the letter of credit explicitly states it is non-negotiable and nontransferable, it will be treated as non-negotiable and nontransferable if applicable local law so provides. The mere right of the secured party (under applicable local law) to transfer the proceeds of a letter of credit is disregarded in determining whether the instrument qualifies as a standby letter of credit. A letter of credit is not a standby letter of credit if it may be drawn upon in the absence of default in payment of the underlying evidence of indebtedness.

³⁹ Temp. Reg. § 15A.453-1(b)(3)(i).

⁴⁰ *Id.*

⁴¹ For a discussion of problems related to using the installment sales method, such as alternative minimum tax, see Harl, “Deferred Payment Contracts,” 1 Agric. L. Dig. 1 (1990).

⁴² See Temp. Reg. § 15A.453-1(d)(2).

⁴³ Pub. L. No. 96-471, § 2, 94 Stat. 2247 (1980).

⁴⁴ Another possibility is that a new body of law will be developed to treat deferred payment obligations that are within the statutory definition of “installment sales” and for which an election out has been filed.

method taxpayer must treat as an amount realized in the year of sale the FMV of the obligation,⁴⁵ regardless of any restrictions on transferability contained in the agreement or imposed by local law. Consequently, little tax deferral benefit would exist if the temporary regulation is applied literally to the credit sales contracts of farmers who have elected out.

There is, however, a serious question as to whether the IRS would apply the general language of the temporary regulation to a farmer who has sold agricultural products under a credit sales contract. No letter ruling or published decision applies the temporary regulation to credit sales contracts concerning agricultural products, and the Farmer's Tax Guide⁴⁶ still advises cash method farmers who sell grain under a bona fide arm's-length deferred payment contract to include the sale proceeds in income for the year in which payment was received.

In addition, Temporary Regulations Section 15A.453-1(d)(2) may be invalid for exceeding the scope of authority granted for the prescription of regulations that are necessary or appropriate to carry out the provisions of Section 453 of the Code.⁴⁷ The temporary regulation may overreach because it purports to define the tax consequences for transactions not covered by Section 453 because of an election out. Presumably, electing out of Section 453 means electing treatment under the provisions of the Code that would be applicable if Section 453 did not exist and does not mean electing treatment under a regulation that purports to cover all situations for which an election out has been filed. Otherwise, the IRS could use the temporary regulation to negate applicable statutory provisions and case law. There is no authority explicitly addressing the validity of the temporary regulation. Although a number of private letter rulings addressing whether a taxpayer may revoke the election out of installment sales reporting imply that there is no tax deferral if the election out has been made, the issue has not explicitly been raised. Thus, whether the temporary regulation determines the tax treatment of farmer credit sales contracts for which an election out has been made is subject to doubt.

Pre-1980 Rules

If a farmer has elected out of installment sales reporting and the temporary regulation is not applicable or is invalid, the question raised is: What rules are applicable to farmer credit sales contracts? One could turn to the body of law applied to deferred payment arrangements that were not installment sales under former Section 453. Within that body of law that arose prior to the Installment Sales Revision Act of 1980, there are three theories under which the farmer may be required to recognize income when the sale proceeds are delivered to the escrow agent or when the taxpayer receives the letter of credit. First, an agent of the taxpayer may receive the sale proceeds on behalf of the taxpayer. Second, the taxpayer may "constructively receive" the sale proceeds when they are deposited in escrow or the letter of credit is issued.⁴⁸ Third, the economic benefit or cash equivalency doctrine⁴⁹ may be applicable.

⁴⁵ Temp. Reg. § 15A.453-1(d)(2)(ii)(A).

⁴⁶ Farmer's Tax Guide, note 25 *supra*, at 8.

⁴⁷ I.R.C. § 453(j)(1).

⁴⁸ I.R.C. § 451(a); Treas. Reg. § 1.451-1(a).

⁴⁹ Some courts and commentators view the economic benefit doctrine as essentially the same as the cash equivalency doctrine. Comment, "The Doctrine of Cash Equivalency," 22 U.C.L.A. L. Rev. 219 n.40 (1974). Others say the doctrines are not coextensive, but overlap. Cooper "The Economic Benefit Doctrine: How an

The principles of constructive receipt and of agency have been applied to deferred payment arrangements entered into by farmers since these arrangements first came under scrutiny by the IRS.⁵⁰ By comparison, the application of the cash equivalency doctrine to farmer credit sales contracts is relatively recent.⁵¹

Agency

A seller seeking to defer recognition of tax on sale proceeds must be careful that the proceeds do not come within the control of the seller's agent because of the general rule that receipt by an agent is receipt by the principal. The agency problem usually arises when the farmer delivers the product to a third party who arranges a sale to the ultimate purchaser and who receives the sale proceeds and holds them under a deferred payment agreement with the farmer.⁵²

The courts generally agree that an escrow agent, solely as a result of acting in that capacity, is not the seller's agent for income tax recognition purposes.⁵³ The agency issue should not arise when (1) a farmer sells product to a buyer in an arm's-length agreement; (2) the buyer is the bona fide purchaser and not a commission agent or other type of intermediary that could be viewed as an agent of the farmer; (3) the sale proceeds are deposited with the escrow agent by the buyer; and (4) the escrow agreement clearly states that the escrowee is acting as the escrow agent for both the farmer and buyer.

With respect to letters of credit, the same principles apply, except that the concern that the escrow agent might be the agent of the farmer does not exist.

Constructive receipt of income

The constructive receipt doctrine is described in Treasury Regulations Section 1.451-2(a) as follows:

Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made

Unconditional Right to a Future Benefit Can Cause a Current Tax Detriment," 71 Marq. L. Rev. 217, 231 n.61 (1988) (hereinafter Cooper).

⁵⁰ Amend v. Comm'r, 13 T.C. 178 (1949), *acq.* 1950-1 C.B. 1, is the first case holding that a farmer may defer tax liability with a deferred payment contract. United States v. Pfister, 205 F.2d 538 (8th Cir. 1953), holds that receipt of sale proceeds by a farmer's agent is receipt by the farmer for tax purposes.

⁵¹ See Watson v. Comm'r, 613 F.2d 594 (5th Cir. 1980) (cash equivalency doctrine applied to a letter of credit received by a seller of cotton).

⁵² Arnwine v. Comm'r, 696 F.2d 1102 (5th Cir. 1983) (cotton gin acted as farmer's agent in collecting and holding the proceeds of the cotton sales; therefore, deferred payment agreement between farmer and gin did not defer income recognition); Warren v. United States, 613 F.2d 591 (5th Cir. 1980) (cotton gin arranged sale of cotton as farmer's agent and held proceeds until following year pursuant to agreement with farmer; income recognition not deferred); United States v. Pfister, 205 F.2d 538 (8th Cir. 1953) (commission company was farmer's agent; therefore, farmer received income when commission company received payment on December 24, not on January 1, when farmer found check in mailbox). Compare Busby v. United States, 679 F.2d 48, 50 (5th Cir. 1982) (finding of fact that cotton gin was purchaser's agent not clearly erroneous, farmer did not recognize income until paid sale proceeds by escrow agent); Crimmins v. United States, 655 F.2d 135 (8th Cir. 1981) (finding of fact that cattle marketing agency was bona fide purchaser of livestock and not consignee-agent of farmer upheld; therefore, deferred payment agreement deferred recognition of income).

⁵³ Reed v. Comm'r, 723 F.2d 138, 149 (1st Cir. 1983); Johnston v. Comm'r, 14 T.C. 560, 564-565 (1950).

available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.

The requirement of "substantial limitations or restrictions" has been interpreted by the courts to mean that a taxpayer recognizes income upon receipt of an unqualified, vested right to immediate payment.⁵⁴ A provision that payment will not be made before a certain date contained in a bona fide arm's-length agreement has been held to be a substantial limitation on the receipt of payment.⁵⁵

Escrow agreement

A substantial limitation on the receipt of funds exists when an escrow agreement is the source of the provision prohibiting payment before a specified date. For example, in *Busby v. United States*,⁵⁶ a cotton farmer and the buyer's purchasing agent established an irrevocable escrow account for the deposit of the proceeds from the sale of cotton. Once the deposit was made, the only condition upon the farmer's receipt of those proceeds was the passage of time. The deferred payment arrangement was the result of an arm's-length agreement and was held by the court to shift the income to the next year. Similarly, in *Reed v. Comm'r*, the court held that the seller would not recognize the taxable income until the funds were payable from the escrow account when (1) the only condition on the seller's receipt of the sale proceeds from shares of stock was the passage of time; (2) the seller did not have the unqualified right to demand immediate payment; and (3) the escrow agreement was the product of bona fide arm's-length negotiations.⁵⁷

Letter of credit

Applying the same principles of constructive receipt to a credit sales agreement and the corresponding letter of credit that are the result of bona fide arm's-length negotiations, the seller is not required to recognize income upon receipt of the letter of credit, provided that it can be drawn upon only after a certain date and, thus, does not give the seller an unqualified, vested right to immediate payment.

Beyond constructive receipt

⁵⁴ See *Reed v. Comm'r*, 723 F.2d at 142; *Ross v. Comm'r*, 169 F.2d 483, 490 (1st Cir. 1948). For a discussion of the constructive receipt analysis set forth in *Reed*, see Note, "Reed v. Commissioner: The Validity of Tax Deferral Through the Use of a Bona Fide, Arms-Length Agreement," 15 Sw. U.L. Rev. 615-636 (1985).

⁵⁵ See the cases and authorities cited in note 25 *supra*. But see *Estate of Sidney B. Bette*, 36 T.C.M. 1636 (1977), and *William O. Anderson*, 20 T.C.M. 697 (1961), which held that the portion of the proceeds from the sale of stock placed into escrow was not income to the seller, but heavily emphasized the possibility that the seller might never receive those funds because they could be required for payment of certain liabilities. Had the payment of escrow funds been conditioned only on the passage of time, the courts may have ruled that the sale proceeds were constructively received.

⁵⁶ 679 F.2d 48 (5th Cir. 1982).

⁵⁷ *Accord Johnston v. Comm'r*, 14 T.C. 560 (1950) (court agreed with IRS position that proceeds from sale of stock placed in escrow in 1942 were not taxable until 1943).

Money received under a deferral arrangement may be taxable currently even though not constructively received under Regulations Section 1.451-2(a). The principles that go beyond constructive receipt are referred to by the Fifth Circuit⁵⁸ as the equivalent of cash doctrine, by the First Circuit⁵⁹ as the economic benefit doctrine, and by the Ninth Circuit⁶⁰ as a straightforward application of Section 1001 of the Code and related regulations.⁶¹ These approaches distinguish between situations in which the receipt of contractual rights to the future payment of money by a cash method taxpayer should be taxed upon receipt of the rights from those in which it should be taxed upon actual receipt of the money. Under these approaches, there are real differences among the methods of analysis and the results that follow.⁶²

Fifth Circuit and equivalent of cash doctrine

In *Cowden v. Comm’r*, the court stated that if the deferred payment agreement received by the taxpayer in exchange for granting a lease to oil and mineral rights was the “equivalent cash,” it would be taxable in the year received rather than in the year of actual payment. The court articulated the equivalent of cash doctrine, stating that:

if a promise to pay of a solvent obligor is unconditional and assignable, not subject to set-offs, and is of a kind that is frequently transferred to lenders or investors at a discount, not substantially greater than the generally prevailing premium for the use of money, such promise is the equivalent of cash and taxable....⁶³

The court held that whether a right to payment is the equivalent of cash is a question of fact and remanded the case to the Tax Court. The guidelines quoted above can be applied to a credit sales contract and the corresponding escrow agreement or letter of credit.

Escrow agreement

The Fifth Circuit’s version of the equivalent of cash doctrine would not require sale proceeds placed in an unconditional escrow account to be recognized as income when deposited, provided the rights to the account are not assignable. Similarly, if one could not assign the right to payment under a credit sales agreement along with the escrow account that secured such payment, the receipt of this combination of rights would not be recognized as income. Even if these rights were assignable, under the *Cowden* test, if their FMV reflected a large discount, the rights would not be the equivalent of cash and, thus, would not be includable in income. Therefore, under the Fifth Circuit’s view, a deferred payment made from, or secured by, an escrow

⁵⁸ See *Cowden v. Comm’r*, 289 F.2d 20, 24 (5th Cir. 1961).

⁵⁹ See *Reed v. Comm’r*, 723 F.2d 138, 145-148 (1st Cir. 1983).

⁶⁰ See *Warren Jones Co. v. Comm’r*, 524 F.2d 788 (9th Cir. 1975).

⁶¹ One interesting question is what role the cases addressing the payment issue under former Section 453 should play in the analysis. To be eligible for installment sales reporting under former Section 453, the taxpayer could not receive payment of over 30 percent of the sale price in the year of sale. Many cases addressed whether an escrow agreement or letter of credit caused the taxpayer to receive payment in the year of sale and thus exceed the 30 percent limitation. To rely on these cases in the present context would mean equating payment under former Section 453 with the receipt of, depending on the approach used, (1) the “equivalent of cash;” (2) a taxable “economic benefit;” or (3) “property” with an ascertainable FMV.

⁶² See *Davies*, “A Model for Corporate Income Tax,” 124 U. Pa. L. Rev. 299, 320-323 (1975).

⁶³ 289 F.2d at 24.

account can defer tax liability if the documents clearly state that the right to payment may not be assigned and local law permits such a restriction.

Letters of credit

The *Cowden* test for whether rights are the equivalent of cash was applied by the Fifth Circuit to a letter of credit received by the seller of cotton in *Watson v. Comm'r*.⁶⁴ The court held that the unconditional letter of credit used to assure payment under a credit sales agreement would cause the seller to recognize income when the unconditional letter of credit was received. The court upheld the finding that the letter of credit was readily marketable because the Uniform Commercial Code specifically states that the rights to proceeds under a letter of credit may be assigned even though the letter of credit prohibits assignment or transfer.⁶⁵ When a standby letter of credit secures the payment obligation under a nonassignable credit sales contract, a court applying the cash equivalency doctrine could conclude that tax liability would be deferred because (1) the right to payment under the credit sales contract is not assignable and (2) the right to proceeds under the letter of credit, being contingent upon default under the credit sales contract, could not be transferred without a substantial discount.

*Ninth Circuit and Internal Revenue Code Section 1001*⁶⁶

The Ninth Circuit appears to ignore the cash equivalency doctrine and focuses entirely on whether the “property” received has an ascertainable FMV.⁶⁷ In *Warren Jones Co. v. Comm'r*, the Tax Court concluded that the FMV of the contract, was not includable in the amount realized from the sale. The Tax Court had relied on the “equivalent of cash” test set forth in *Cowden* and found that the contract was not the equivalent of cash, because it could not be transferred without a substantial discount (42 percent) from face value. The Ninth Circuit reversed and, although it did not expressly reject the doctrine of cash equivalency, viewed the question as “essentially one of statutory construction.”⁶⁸ The court proceeded to analyze whether the FMV of the real estate contract was to be included in the “amount realized” from the sale under Section 1001(b) of the Code. The court held “that if the [FMV] of a deferred payment obligation can be ascertained, that [FMV] must be included in income under section 1001(b).”⁶⁹ Since the Tax Court had found that the contract had an FMV, the Ninth Circuit held that amount was income when the contract was received.⁷⁰

⁶⁴ 613 F.2d 594 (5th Cir. 1980).

⁶⁵ See Tex. Bus. & Com. Code Ann. § 5.116(b).

⁶⁶ Section 1001 of the Code addresses the gain or loss from the sale or other disposition of property. Section 1001(b) provides—

Amount Realized. The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

⁶⁷ See *Warren Jones Co. v. Comm'r*, 524 F.2d at 793 (applying Sections 1001(a) and 1001(b) of the Code and Reg. § 1.1001-1(a) to a 15-year real estate purchase contract).

⁶⁸ *Id.* at 791 n.6. See Llewellyn, “Promises to Pay in the Future—A Modest Proposal for Reform,” 31 *Miami L. Rev.* 1337 (1977) (argues for explicit rejection of the cash equivalency doctrine).

⁶⁹ 524 F.2d at 793.

⁷⁰ One criticism of the *Warren Jones Co.* decision is that it ignores the difference between the cash method and the accrual method of reporting income. The distinction between the two methods of accounting is the reason for holding that the value of contracts rights to future payment should not be included as an “amount realized” from the sale of property unless those rights are the equivalent of cash. See *Reed v. Comm'r*, 723 F.2d at 147; *Estate of Coid*

For a taxpayer seeking to defer income, the most extreme interpretation one could give *Warren Jones Co.* is that a right may have a reasonably ascertainable FMV even though it is not assignable or transferable by the taxpayer.⁷¹ A slightly more relaxed interpretation would require that the right be assignable by the taxpayer, i.e., that it be marketable in fact to have an ascertainable fair market value.⁷² Indeed, *Warren Jones Co.* had been applied by the IRS to nullify the tax deferral inherent in a deferred payment contract involving farm commodities when the contract is assignable.⁷³

Interpreting *Warren Jones Co.* to mean that rights that have a reasonably ascertainable FMV are taxable when received, regardless of whether those rights are assignable, would eliminate tax deferral for all credit sales contracts, except when the contract presents one of the “rare and extraordinary cases”⁷⁴ when FMV cannot be ascertained.

On the other hand, if *Warren Jones Co.* is interpreted to require that the rights be assignable to be taxed when received, the analysis is essentially the same as that set out in the discussions of *Cowden* above.

*First Circuit and the economic benefit doctrine*⁷⁵

In *Reed v. Comm’r*,⁷⁶ the court stated that the economic benefit doctrine provides for taxation of a contractual right to future payment (1) if the right has an ascertainable FMV and (2) the right is the equivalent of cash. The court summarized the *Cowden* test of cash equivalency as meaning that the contractual promise to pay must be “readily transferable” and added another element by requiring that the parties intend the right to be present payment rather than simply evidence that future payment would be made.⁷⁷ In the context of an unconditional right to future

Hulburt v. Comm’r, 25 T.C. 1286 (1956); Ennis v. Comm’r, 17 T.C. 465 (1951); Johnston v. Comm’r, 14 T.C. 560 (1950).

⁷¹ In cases not addressing gain from the sale of property, receipt of a nonassignable right to future payment has been held to be taxable upon receipt of the right. For example, in *Brodie v. Comm’r*, 1 T.C. 275 (1942), a case arising in the employee compensation context, the court held that a deferred annuity contract was taxable when received even though nonassignable and without surrender value; the amount the employer expended for the annuity was held taxable to the employee in the year expended. Also, the courts applying the economic benefit doctrine in *Anastasio v. Comm’r*, 67 T.C. 814, *aff’d*, 573 F.2d 1287 (2d Cir. 1977) and *Pulsifer v. Comm’r*, 64 T.C. 245 (1975), stated that assignability was not necessary for rights of minors’ to prize money to be taxable in the year the prizes were won and placed in custodial accounts.

⁷² See Davies, “A Model for Corporate Income Tax,” 124 U. Pa. L. Rev. 319-320 (1975).

⁷³ LTR 8001001.

⁷⁴ Regulations Section 1.1001-1(a) states in part, “The fair market value of property is a question of fact, but only in rare and extraordinary cases will property be considered to have no fair market value.”

⁷⁵ The economic benefit doctrine arose in cases addressing the issue of when, under a deferred payment arrangement, does an employee receive compensation for services rendered. See *United States v. Smith*, 324 U.S. 177 (1945). In *Sproull v. Comm’r*, 16 T.C. 244 (1951) *aff’d per curiam*, 194 F.2d 541 (6th Cir. 1952), the Tax Court held that money deposited with a trustee was an “economic or financial benefit” conferred on the employee as compensation in the year the employer made the payment.

⁷⁶ For a criticism of the reasoning applied in *Reed*, see *Cooper*, *supra*.

⁷⁷ 723 F.2d at 147. The additional element concerning intent originates in cases concerning promissory notes or deferral of employee compensation. See, e.g., *Brodie v. Comm’r*, 1 T.C. 275, 283 (1942) (found that company and employee intended amounts expended on annuity contracts to be extra compensation in year expended); *Kniffen v. Comm’r*, 39 T.C. 553 (1962) (delivery of promissory note not intended as payment of the debt); *Williams v. Comm’r*, 28 T.C. 1000 (1957) (note received as security or evidence of indebtedness, and not as payment, is not

payment under an escrow agreement, the court stated that the right would be “the equivalent of cash’ only if the taxpayer received a present beneficial interest in the funds,”⁷⁸ such as the right to receive investment income or interest income, or the right to a letter of credit that would be funded by the escrow.⁷⁹

Escrow agreement

In *Reed*, the court held that the irrevocable and unconditional escrow account established to hold proceeds from the sale of stock was not the equivalent of cash, because it was not readily transferable in commerce and was not intended as present payment, and the taxpayer received no present beneficial interest from the funds. Consequently the court upheld the escrow account as a valid way to defer taxable income.⁸⁰

Letter of credit

Under the economic benefit doctrine set forth in *Reed*, an unconditional letter of credit would not defer tax liability unless the taxpayer could show that the letter of credit was not “intended as present payment of the amount owed, but was merely evidence that payment will be forthcoming in the future.”⁸¹ Like the escrow account used in *Reed*, the letter of credit must be “intended to serve as added assurance that the payment would be made in the next year.”⁸²

If the taxpayer used a standby letter of credit, tax deferral could be supported by the arguments concerning intent as well as the arguments available under the Fifth Circuit view concerning assignability and discounts.⁸³

income). Other courts do not consider the intent of the parties as to present or future payment as relevant in determining income from the sale or disposition of property. For example, in *Watson v. Comm’r*, 613 F.2d 594 (5th Cir. 1980), the court upheld the trial judge’s finding of fact that the letter of credit was readily marketable and stated that the taxpayers’ desire to defer income from the sale of their crop until the following year would not be considered.

⁷⁸ 723 F.2d at 146.

⁷⁹ For example, in *Kuehner v. Comm’r*, 214 F.2d 437 (1st Cir. 1954), the court applied the predecessor of Section 1001 of the Code and ruled that funds placed in escrow were taxable in the year the escrow was created. The irrevocable, assignable escrow account held proceeds from the sale of stock and paid interest on the proceeds to the taxpayer. The court in *Reed v. Comm’r* stated that *Kuehner*’s right to receive interest was a present beneficial interest in the funds that caused the right to future payment to be the equivalent of cash. Similarly, in *Pozzi v. Comm’r*, 49 T.C. 119 (1967), the escrow arrangement was ineffective to defer income because the taxpayer was entitled to interest income.

⁸⁰ One of the unresolved questions raised in the context of analyzing whether escrow accounts defer taxable income is the role of cases arising under former Section 453 of the Code. A number of courts have held that the use of an escrow account resulted in receipt of “payment” and, thus, installment sales reporting was not available to defer gain. E.g., *Trivett v. Comm’r*, 611 F.2d 655 (6th Cir. 1979); *Oden v. Comm’r*, 56 T.C. 569 (1971); *Pozzi v. Comm’r*, 49 T.C. 119 (1967). But see *Grannenmen v. United States*, 649 F. Supp. 949 (E.D. Mo. 1986) (escrow account was security for promissory notes and did not constitute payment; taxpayer allowed to use installment sales reporting to defer gain); *Porterfield v. Comm’r*, 73 T.C. 91 (1979) (escrow account was security and not payment).

⁸¹ 723 F.2d at 147.

⁸² *Id.* at 148.

⁸³ The question is raised of whether cases addressing the “payment” issue under former Section 453 of the Code are useful in determining whether a taxpayer who has elected out of current Section 453 has received a taxable economic benefit. In determining whether the receipt of a letter of credit is “payment” for purposes of the 30 percent limitation in former Section 453, the court in *Griffith v. Comm’r*, 73 T.C. 933 (1980), held that the standby letter of

Conclusion

Although one cannot say with certainty which of the foregoing views would be applied to a credit sales contract and corresponding escrow agreement for a taxpayer who has decided to elect out of installment sales reporting or letter of credit, a prudently constructed deferral arrangement would (1) result from arm's-length negotiations between seller and buyer; (2) provide the escrow agreement or letter of credit only as security and not as a payment mechanism; (3) state that the seller's rights to payment under it were not assignable; (4) recite what benefits accrue to the buyer from the deferral arrangement and that the seller would not have entered into the contract without the deferment of taxable income; and (5) in the case of an escrow account, assure that the seller does not receive a present economic benefit, such as rights to interest or investment income or other present beneficial interest in the account (such as an unconditional letter of credit that would be funded by the account).⁸⁴

credit was payment. Other courts have held that a letter of credit is merely security and not payment. *Sprague v. United States*, 627 F.2d 1044 (10th Cir. 1980); *Korstad v. Comm'r*, 45 T.C. M. 1032 (1983).

⁸⁴ See *Kuehner v. Comm'r*, 214 F.2d 437 (1st Cir. 1954) (agreement entitled seller to investment interest from escrow funds); *Pozzi v. Comm'r*, 49 T.C. 119 (1967) (seller entitled to interest income from escrow funds).