

# ***SCHERBART V. COMMISSONER: DOES AGENCY SWALLOW COOPERATIVE TAXATION?***

## I. INTRODUCTION

Cooperatives have a long (and complex) history in the United States primarily because of their perceived beneficial use in agriculture by combining many small farmers together to increase market power.<sup>1</sup> Many contentious issues have surrounded cooperatives over the years regarding unlawful combinations,<sup>2</sup> anti-trust, and taxation, to name the most frequently raised issues. However, a long-thought-settled tax issue—agency—has resurfaced. The Internal Revenue Service (“Service”) is asserting that the fact that a cooperative is identified, in the marketing agreement or bylaws of a cooperative, as the “sole and exclusive agent”<sup>3</sup> for each member<sup>4</sup> in the marketing of the members’ products, results in a true tax<sup>5</sup> agency<sup>6</sup> relationship between the cooperative and each member.

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<sup>1</sup> They have expanded far beyond the agricultural field; for example, there are also consumer co-ops that include credit unions, child care cooperatives, electric and telecommunications cooperatives, food co-ops, health care co-ops, housing cooperatives, and many more.

<sup>2</sup> See generally Christine A. Varney, *The Capper-Volstead Act, Agricultural Cooperatives, and Antitrust Immunity*, ANTITRUSTSOURCE.COM, [http://www.americanbar.org/content/dam/aba/publishing/antitrust\\_source/Dec10\\_FullSource.authcheckdam.pdf](http://www.americanbar.org/content/dam/aba/publishing/antitrust_source/Dec10_FullSource.authcheckdam.pdf) (last visited Apr. 10, 2013) (providing an excellent summary of the history of the Capper-Volstead Act, 7 U.S.C. §§ 291–292).

<sup>3</sup> From a practical viewpoint the cooperative wants no questions from buyers about its power and authority to market the members’ products. Query: what if the marketing agreement said it was the sole and exclusive agent “collectively for all patrons” in marketing their product?

<sup>4</sup> “Patrons” and “Members” are used interchangeably in this article. See Treas. Reg. § 1.1388-1(e) (noting that one can be a patron and not be a member of a cooperative). The Internal Revenue Code does not define “Patron.”

<sup>5</sup> See *infra* note 50 (as opposed to many lesser agency relationships under general common law); References to “tax agency” in this article means an agency under federal income tax law.

<sup>6</sup> “Agency” issues pervade all areas of business and legal matters. Taxation, state and federal agency penalties, torts, and contracts are areas where it moves front and center; See, e.g., Wanda F. Reed, *Revenue Ruling 77-290 - Recent Interpretations of Agency Law Inequitably Taxes Members of Religious Orders*, 23 Val. U.L. Rev. 179 (1988), available at <http://scholar.valpo.edu/vulr/vol23/iss1/11/>; See also 45 CFR § 160.402(c) (“A cov-

The consequence being that the Service has successfully asserted in the case of *Scherbart*<sup>7</sup> that when such a cooperative has received payment from a buyer, such amount is deemed to be income received<sup>8</sup> by the patrons because of the alleged agency relationship and not under the timing rules for cooperatives in Subchapter T of the Internal Revenue Code.<sup>9</sup> There are two somewhat related issues in these circumstances: (i) the existence of the agency relationship for income tax purposes and (ii) the application of the tax accounting rules under Internal Revenue Code § 451 specifying when income is realized by a taxpayer.<sup>10</sup>

This Article is focused on the federal income taxation rules of cooperatives that are currently contained in Subchapter T of the Internal Revenue Code.<sup>11</sup> Service has exhibited an inconsistent view of the taxation of cooperatives since the beginning of the modern income tax.<sup>12</sup> Initially, the Service, based on administrative pronouncements, found that cooperatives were not taxed if they paid out their patronage.<sup>13</sup> It was not until 1951 that Congress began to provide the initial statutory guidelines for patronage distributions that have become Subchapter T in the current tax code.<sup>14</sup>

This Article specifically examines the agency assertion in connection with the income taxation of cooperatives and their members and con-

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ered entity is liable, in accordance with the *federal common law of agency*, for a civil money penalty for a violation based on the act or omission of any agent of the covered entity, including a workforce member, acting within the scope of the agency . . . emphasis added); See also Ward L. Thomas & Leonard J. Henzke, *Agency: A Critical Factor In Exempt Organizations And UBTI Issues*, Internal Revenue Service Exempt Organization CPE (2002) (discussing the Service's own view about agency).

<sup>7</sup> *Scherbart v. Comm'r*, 453 F.3d 987 (8th Cir. 2006) (affirming T.C. Memo 2004-143).

<sup>8</sup> See *infra* note 126 (following the flawed holding of the case, the IRS argues in audit examinations constructive receipt by the particular member instead of the correct tax principle that actual receipt by an agent is actual receipt by its principal).

<sup>9</sup> See 26 U.S.C. §§ 1381-1388.

<sup>10</sup> See *infra* notes 80 and 120 (particularly regarding self-employment income).

<sup>11</sup> Herein after referred to as "Code."

<sup>12</sup> See generally Donald A. Frederick, *Income Tax Treatment of Cooperatives: Background*, Cooperative Information Report 44, Part 1, at 83 (2005) (discussing the history of the taxation of cooperatives).

<sup>13</sup> *Dr. P. Phillips Cooperative v. Commissioner*, 17 T.C. 1002, 1010 (1951) (holding that "[a]lthough the Commissioner has held that the petitioner is not exempt under section 101 (12) [IRC of 1939], nevertheless he has allowed the petitioner as a cooperative to exclude from income for tax purposes the amounts which it has distributed in cash as patronage dividends. There is no express statutory authority for this action *but for many years the practice has been followed by the Treasury Department and it has received judicial sanction*") (emphasis added); See also I.T. 3208, 1938-2 C.B. 127.

<sup>14</sup> See Revenue Act of 1951, Pub. L. No. 183 §314, 65 Stat. 452 (1951).

cludes that both the Service and the courts that have examined this issue have it wrong. The simple thesis of this Article is that a cooperative cannot be the true tax agent for any particular member when the cooperative is doing business “with or for” its members because of the unique structure and intent of Subchapter T. “With or for” is equivalent to determining whether the income is patronage or non-patronage income.<sup>15</sup> Accordingly, a finding of patronage income necessarily means the cooperative is doing business “with or for” its members.<sup>16</sup>

This agency issue, with respect to the income taxation of cooperatives and their members, was thoroughly examined over sixty years ago, both before Subchapter T was enacted and during its enactment, by the Treasury and commentators.<sup>17</sup> The *Scherbart* court’s inappropriate use of “constructive receipt” in resolving what is really an agency question has muddled the analysis. As will be discussed, “constructive receipt” is logically irrelevant in the true tax agent context.<sup>18</sup>

## II. FRAMING THE ISSUE

This starts with the simple case of the age old (tax) question of when is an entity recognized as separate from its beneficial owners. The Supreme Court has characterized this as a separate entity doctrine with respect to corporations.<sup>19</sup>

In most cases a cooperative is a state law entity/form of doing business authorized under state statutes.<sup>20</sup> By definition, cooperatives are owned

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<sup>15</sup> Carla Neeley Freitag, *U.S. Income Portfolios: Other Pass-through Entities Portfolio 744-2nd: Taxation of Cooperatives and Their Patrons*, Part III, Subsection B(1) (The term “business done with or for” patrons is used four times in the statutory definition of a patronage dividend. For example, § 1388(a)(1) provides that a patronage dividend must be paid by a cooperative on the basis of quantity or value of *business done with or for* its patrons) (emphasis added).

<sup>16</sup> It is telling that the statutory phrase “business done with or for” is to “patrons,” plural not singular, emphasizing that the cooperative is not acting in any capacity for just one patron. If it does, then that singular relationship falls outside the scope of Subchapter T.

<sup>17</sup> See Staffs of the Treasury and Joint Committee on Internal Revenue Taxation, 82d Cong., *The Power of Congress to Tax Cooperatives on Net Margins* (1951); See also George Santayana, *Life of Reason, Reason in Common Sense*, (Scribner, 1905) available at <http://iat.iupui.edu/santayana/content/santayana-quotations> (“Those who cannot remember the past are condemned to repeat it”).

<sup>18</sup> See *infra* Part IV, Subsection C(1).

<sup>19</sup> See JASPER L. CUMMINGS, JR., *THE SUPREME COURT’S FEDERAL TAX JURISPRUDENCE: AN ANALYSIS OF FACT FINDING METHODS AND STATUTORY INTERPRETATION FROM THE COURT’S TAX OPINIONS, 1801—PRESENT* at 429 (ABA Studies in Taxation 2010) (providing an excellent overview of the separateness issue).

<sup>20</sup> See, e.g., VAN P. BALDWIN, *LEGAL SOURCEBOOK FOR CALIFORNIA COOPERATIVES: START-UP AND ADMINISTRATION: A LEGAL GUIDE FOR CO-OPS INCORPORATING AND*

and democratically controlled by their members—the people who use the cooperative’s services or buy its goods—not by outside investors, and cooperative members elect their board of directors from within the membership.<sup>21</sup> Corporations are the most used form of organization for cooperatives and corporate law bears the greatest resemblance to cooperative governance.<sup>22</sup>

If a cooperative is not recognized as an entity separate from its members, then the income will be taxed directly to the members.<sup>23</sup> In most cases, this would generally be the same result under an agency theory.<sup>24</sup> However, if the cooperative is recognized as a separate entity under federal tax law, then the classic issue of the ability of a separate corporate-type entity to choose to make distributions in accordance with Subchapter T to its members (typically cash method taxpayers) will initially control the timing of income to the members.<sup>25</sup>

This Article will demonstrate that the court’s confusion in deciding *Scherbart*, which arrived at the “agency” determination, was based on the difference between state law agency and the federal tax definition of agency.<sup>26</sup>

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OPERATING UNDER THE CALIFORNIA CONSUMER COOPERATIVE CORPORATION LAW (3rd ed. 2009) available at <http://www.cccd.coop/files/LegalSourcebookForCaliforniaCooperatives.pdf>.

<sup>21</sup> See discussion of Rochdale principles *infra* note 37 and accompanying text.

<sup>22</sup> A business entity must be a corporation (or an entity that elect to be taxed as a corporation) to be treated as a nonexempt cooperative under IRC §1381(a)(2).

<sup>23</sup> See Steven Lainoff, Stephen Bates & Chris Bowers, *Attributing the Activities Of Corporate Agents Under U.S. Tax Law: A Fresh Look From An Old Perspective*, 38 Ga. L. Rev. 143, 152-158 (2003).

<sup>24</sup> See *Nat’l Carbide Corp. v. Comm’r*, 336 U.S. 422, 437 (1949).

<sup>25</sup> “Dividends on corporate stock are constructively received when unqualifiedly made subject to the demand of the shareholder.” 26 C.F.R. § 1.451-2(b) (2013). However, there is an application of constructive receipt contemplated by Congress in the context of Subchapter T. In the context of a qualified notice of allocation where the Patron consents to be taxed on income not paid to it, see *infra* note 77, Congress stated: “the patron has in effect acknowledged constructive receipt of the entire amount of the patronage dividend and has voluntarily reinvested the amount of the allocation in the cooperative.” See *Gold Kist v. Comm’r*, 110 F.3d 769, 773 (11th Cir. 1997).

<sup>26</sup> In fact, it appears that this whole line of analysis arose when an appellate court cited dicta in a lower court’s ruling as the holding of the lower court’s case. Since then, it appears that no other court has examined the logical underpinnings of the agency assertion for cooperatives. See *infra* note 105 and accompanying text.

### III. BACKGROUND OF COOPERATIVES

The business motivation for the creation of the common agricultural cooperatives<sup>27</sup> is the ability of farmers to pool production and/or resources for greater efficiency.<sup>28</sup> As a practical matter, it is far too expensive for individual farmers to manufacture products or undertake a service and compete with the larger producers.<sup>29</sup> The theory of a cooperative is that all members will do better financially. However, relative to each other, some members do better than others in a given year because the producers of lower quality products will be entitled to share in the higher quality returns (and vice versa) based on their patronage as opposed to the identifiable products delivered.<sup>30</sup>

There are several types of agricultural service cooperatives including supply cooperatives for the members' own consumption and marketing cooperatives for selling members' production.<sup>31</sup> Supply cooperatives supply their members with inputs for agricultural production, including seeds, fertilizers, fuel, and machinery services. Marketing cooperatives are established by farmers to undertake transformation, packaging, distribution, and marketing of farm products (both crop and livestock) on behalf of their members.<sup>32</sup>

For tax purposes, the concept of "operating on a cooperative basis" is the gatekeeper for enjoying the special tax benefits of Subchapter T. However, the Code and tax regulations do not define that phrase, leaving it to the courts and the Service to flesh out the definition.<sup>33</sup>

There are two main approaches to the meaning of the phrase.<sup>34</sup> One is to look solely within the confines of Subchapter T focusing on how the distributions to patrons are determined and how retains<sup>35</sup> are allocated to

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<sup>27</sup> Scherbart involved an agricultural cooperative.

<sup>28</sup> See DONALD FREDERICK, CO-OPS 101: AN INTRODUCTION TO COOPERATIVES: USDA COOPERATIVE INFORMATION REPORT 55 at 9 (1997) available at <http://www.rurdev.usda.gov/rbs/pub/cir55/cir55rpt.htm>.

<sup>29</sup> See *id.*

<sup>30</sup> See *id.*

<sup>31</sup> See *Co-op Types*, NATIONAL COOPERATIVE BUSINESS ASSOCIATION, <http://www.ncba.coop/ncba/about-co-ops/co-op-types> (last visited January 28, 2013) (discussing types of cooperatives).

<sup>32</sup> See *id.*

<sup>33</sup> See *Certified Grocers of Cal., Ltd. v. Comm'r.*, 88 T.C. 238, 239 (1987).

<sup>34</sup> For purposes of this Article it is assumed that Scherbart would have met the test under either of these standards, although it was never raised by the Service as an issue.

<sup>35</sup> An important distinguishing feature of most agricultural cooperative is the fact that member-patrons help to finance the businesses operation, thereby serving as both customers of, and investors in, the cooperative. Members' investment in the cooperative results from the cooperative's act of retaining a portion of each year's savings or earn-

the patrons (patronage based).<sup>36</sup> The other is to follow the Rochdale Principles set out in the leading case of *Puget Sound Plywood*.<sup>37</sup> There the Tax Court surveyed the history and characteristics of cooperative associations and identified the three guiding principles: 1) subordination of capital; 2) democratic control by the members; and 3) operation at cost, the vesting in and allocation among the members of all fruits and increases arising from their cooperative endeavor.<sup>38</sup>

Pushing the definitional boundary of a cooperative is the possibility that some or all of the “patrons” can be more like investors than cooperative members. It has become an issue for so-called “New Generation Farmers” where the patrons provide little of their own product but buy product from a pool or third parties to satisfy their obligations to deliver product to the cooperative.<sup>39</sup>

#### IV. AGENCY STATUS

As indicated above, one needs to determine if there are differing tests for agency under federal tax law vs. state law.<sup>40</sup>

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ings, declared and allocated as patronage dividends. Such retains are normally referred to as retained patronage dividends and evidenced as qualified written notices of allocation (certificates) in compliance with Subchapter T of the IRS Code.

<sup>36</sup> See *Trump Village v. Comm’r*, T.C. Memo 1995-281 69 T.C.M. 2985, at 2986 (Oct 30, 1995).

<sup>37</sup> *Puget Sound Plywood, Inc. v. Comm’r*, 44 T.C. 305, 306 (1965), (IRS acq.) 1966-2 C.B. 3 (1966) (“a cooperative is an organization established by individuals to provide themselves with goods and services or to produce and dispose of the products of their labor. The means of production and distribution are those owned in common and the earnings revert to the members, not on the basis of their investment in the enterprise but in proportion to their patronage or personal participation in it”).

<sup>38</sup> *Id.* at 307-317 (Rev. Rul. 70-481, 1970-2 C.B. 170, holds that a corporation supplying services to its members at cost and making distributions to each member based on the value of business done with each member was “operating on a cooperative basis” within the meaning of section 1381(a)(2) of the I.R.C.).

<sup>39</sup> See Christopher R. Kelly, Comment, “New Generation” Farmers Cooperatives: The Problem of the “Just Investing” Farmer, 77 N. Dak. L. Rev. 185 (2001); see “From Rochdale Principles to LLCs: The Ongoing Evolution of the Cooperative Structure,” David Shakow, 104 Tax Notes 535 (August 2, 2004) (this is beyond the scope of this paper, however, see *infra* note 140, where such a concern was present for the cooperative involved in the *Scherbart* case).

<sup>40</sup> See *infra* Part IV.B-C. (Also relevant is (i) whether a taxpayer is asserting that an entity is just an agent and therefore no tax is owed by the agent/entity but by the taxpayer or, (ii) whether the taxpayer is trying to avoid an entity being classified as its agent so that income is not directly attributed back to the taxpayer. The first model is the typical one where a corporation is used to avoid usury or hold title to property because of state law considerations but does not want a separate entity for federal tax purposes. The second model is the one at issue in the case at hand. That is, the taxpayer has established

### A. *Misapplication of Agency Concept*

Leading up to congressional action, the agency issue for cooperatives was discussed in the policy discussions concerning the taxation of cooperatives. In the Joint Committee & Treasury analysis done for Congress in 1951,<sup>41</sup> it was noted that many had argued that cooperatives were “tax exempt” because they were not separate entities but merely agents for the cooperative patrons. The analysis stated in its opening paragraph shows the need to resolve this issue in any legislation:

The fact that cooperatives are corporations and that Congress has the constitutional power to tax them as corporations may appear so obvious that discussion of the proposition is unnecessary. However, general statements have been made to the effect that the cooperatives are only agents, partnerships, or trusts, with the implication that they are not entities in their own right capable of having income subject to tax. For this reason it is necessary to establish beyond question the fact that the cooperatives are separate corporate entities which are taxable as such. [...]. It is also well established that a corporation cannot avoid tax by arguing that it is not an entity for tax purposes but is merely an agent of its owner.<sup>42</sup>

The analysis went on to point out the authority for the general rules laid down by the Supreme Court:

As was pointed out above, a cooperative is a separate legal entity and taxable as a corporation. It is of course possible for a cooperative to act for others as an agent. However, in the typical case of a cooperative dealing with its members, it is not acting merely as their agent. As the Supreme Court indicated recently in the case of *National Carbide Corporation v. Commissioner* [...], some of the relevant considerations in determining whether a true agency exists are — whether the corporation operates in the name and for the account of the principal by its actions, transmits money received to the principal, and whether receipt of income is attributable to the services of employees of the principal and to assets belonging to the principal \* \* \*. These considerations appear largely absent in the typical cooperative case. The employees of a cooperative are its employees and not the employees of the alleged principals, the members.<sup>43</sup>

So here is an unequivocal indication that Congress decided that a cooperative taxed under Subchapter T is not a true tax agent of its members. The corollary being that if the cooperative is such a tax agent for a

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(singly or collectively) an entity and wishes it to be recognized as a separate entity for tax purposes).

<sup>41</sup> TREASURY AND THE JOINT COMM. ON INTERNAL REVENUE TAXATION, *The Power of Congress to Tax Cooperatives on Net Margins*, Part three (prepared by the staffs of the Published April 1951).

<sup>42</sup> *Id.*

<sup>43</sup> *Id.*

specific member, then Subchapter T does not apply with respect to that relationship. In accord with this reasoning is the article written by former IRS Commissioner Mortimer Caplin,<sup>44</sup> *Taxing the Net Margins of Cooperative*.<sup>45</sup> In addressing whether the income is the cooperative's income or the patron's, Caplin relies on the standards set forth in *Nat'l Carbide Corp. v. Commissioner*, 336 U.S. 422 (1949) ("*National Carbide*") to establish that cooperatives do not act as agents for tax purposes.<sup>46</sup> Specifically, the acts of the cooperative do not bind the patrons and the cooperatives do not hold themselves out to the customers merely as agents for the patrons.<sup>47</sup>

After Caplin's article, the Supreme Court re-examined the agency test under *Commissioner v. Bollinger*, 485 U.S. 340 (1988),<sup>48</sup> which restated the six *National Carbide* factors.<sup>49</sup> The court stated:

It seems to us that the genuineness of the agency relationship is adequately assured, and tax-avoiding manipulation adequately avoided, when the fact that the corporation is acting as agent for its shareholders with respect to a particular asset is set forth in a written agreement at the time the asset is acquired, the corporation functions as agent, and not principal, with respect to

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<sup>44</sup> See NAT'L TAX EQUALITY ASS'N *National Commission on Food Marketing Warned of Consequences of Further Co-Op Favoritism*, BULLETIN NTEA, (DEC. 1965) (apparently Mr. Caplin was not a great supporter of the structure of Cooperative taxation ultimately adopted since he felt it gave cooperatives too much of a competitive advantage over other corporations).

<sup>45</sup> Mortimer Caplin, Comment, *Taxing the Net Margins of Cooperatives*, 58 Geo. L.J. 6 (1969).

<sup>46</sup> See *Nat'l Carbide Corp. v. Comm'r*, 336 U.S. 422 (1949).

<sup>47</sup> *Comm'r v. Bollinger*, 485 U.S. 340, 344-345 (1988).

<sup>48</sup> *Id.* at 349 (a corporation will be treated as an agent under the following circumstances: (1) "...the corporation is acting as an agent for its shareholders with respect to a particular asset as set forth in a written agreement at the time the asset is acquired, (2) the corporation functions as an agent and not the principal with respect to the asset for all purposes, and (3) the corporation is held out as the agent and not the principal in all dealings with third parties relating to the asset").

<sup>49</sup> *Comm'r v. Bollinger*, 485 U.S. at 346-347 (the Supreme Court addressed how to determine the existence of true agency in the case of a corporate agency. "...[F]our indicia and two requirements of such status, the sum of which has become known in the lore of federal income tax law as the "six National Carbide factors": [1] Whether the corporation operates in the name and for the account of the principal, [2] binds the principal by its actions, [3] transmits money received to the principal, and [4] whether receipt of income is attributable to the services of employees of the principal and to assets belonging to the principal are some of the relevant considerations in determining whether a true agency exists. [5] If the corporation is a true agent, its relations with its principal must not be dependent upon the fact that it is owned by the principal, if such is the case. [6] Its business purpose must be the carrying on of the normal duties of an agent").

the asset for all purposes, and the corporation is held out as the agent, and not principal, in all dealings with third parties relating to the asset.<sup>50</sup>

Therefore, it is quite clear that merely having Bylaws or Marketing Agreements which describe the cooperative as the patron's agent is not sufficient to create a true tax agency relationship.<sup>51</sup> The National Carbide factors need to be met.

### B. State Law

A large part of the confusion in *Scherbart* results from the use of the terms "agent" or "agency" in the marketing agreement describing the relationship.<sup>52</sup> As a general rule of interpretation, state law will define what it means to be an agent and the duties and obligations of an agent. Most states follow the Restatement (Third) of Agency<sup>53</sup> or its predecessor.

Section 1.01 of the Restatement says: "Agency is the fiduciary relationship 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."<sup>54</sup>

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<sup>50</sup> *Id.* at 349.

<sup>51</sup> See *Ward vs. Mgmt. Analysis Co. Emp. Disability Benefit Plan*, 135 F.3d 1276 (9 Cir. 1997); see also *infra* p. 10 and note 54.

<sup>52</sup> *Scherbart v. C.I.R.* 453 F.3d 987 (8<sup>th</sup> Cir. 2006) (in this case the court stated that "[t]he parties agree that MCP acted as Mr. Scherbart's agent for purposes of processing and marketing the corn, and a written agreement between MCP and its members reflects the agency relationship").

<sup>53</sup> See Deborah A. DeMott, Comment, *A Revised Prospectus for a Third Restatement of Agency*, 31 U.C. Davis L. Rev. 1035 (1998) (this article stated, "[r]estatement (Second) has little to say directly about relationships in which the agency relationship is slight (or "thin"). Where the agency serves a very narrowly defined or highly selective purpose, the agency relationship applies to one aspect of the party's relationship but not others. For example, treating a purchaser's "agent" in the typical residential property transaction as the seller's subagent means that the seller's listing agent has an agent (the subagent) who is usually someone else's employee and agent (the real estate firm employing the individual broker who assists the purchaser). The challenge is to fit this relationship into the universe of Restatement (Second) concepts so that the subagent is "under the control" of the seller's listing agent and the seller. This is a vivid example of a highly selective agency relationship. Another is an agreement designating someone as an agent solely for tax purposes" [emphasis added]).

<sup>54</sup> RESTATEMENT (THIRD) OF AGENCY § 101 (2006); see also *infra* p. 10 and note 57 (since a partnership would seem to be the agent for all its partners under this definition, does that mean the partners have "deemed actual receipt" of all payments made to the partnership, bypassing the pass through structure of Subchapter K of the Code?).

Section 1.04 provides: “(1) Co-agents. Co-agents have agency relationships with the same principal. A co-agent may be appointed by the principal or by another agent actually or apparently authorized by the principal to do so.”<sup>55</sup> A variation to these relationships is where the agent has a relationship with many principals, a “co-principal” relationship, so to speak. Agents can represent the interests of more than one principal but requires the disclosure of the fact and informed consent of all principals.<sup>56</sup>

The Ninth Circuit has addressed the issues of the determination of “agency” status in the context of insurance, ERISA, and who is an agent. That court stated:

Whether as between the parties their relationship is one of agency depends on their relations as they in fact exist under the agreement or acts of the parties, and the question is not governed by the stipulations of the parties. Thus, whether a particular relationship is that of agency does not depend on what the parties call it, and the parties cannot, where the relationship is in fact one of agency, change its nature by declaring that it is not an agency, nor can they, by calling their relations one of agency, make it so when it is not so in fact. The surrounding facts and circumstances determine the relationship, regardless of the understanding of the parties as to the exact nature of the relationship . . . .<sup>57</sup>

Turning to cooperatives, it is hard to see how the cooperative can be anything but an agent under state law for all its members given its purpose to act collectively on behalf of all members especially in the marketing of the products delivered to the cooperative by the members.<sup>58</sup> In the *Scherbart* case, the court looked at state law to find an agency relationship without further examining the context of agency in a cooperative setting under federal tax law.

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<sup>55</sup> RESTATEMENT (THIRD) OF AGENCY § 104 (2006).

<sup>56</sup> The familiar case of an attorney having more than one client is an obvious example. RESTATEMENT (THIRD) OF AGENCY § 8.01 (2006) (“An agent has a fiduciary duty to act loyally for the principal’s benefit in all matters connected with the agency relationship”).

<sup>57</sup> *Ward v. Management Analysis Co. Employee Disability Benefit Plan*, 135 F.3d 1276, 1284 (9th Cir. 1998).

<sup>58</sup> See U.S. DEP’T OF AGRICULTURE, UNDERSTANDING COOPERATIVES: AGRICULTURAL MARKETING COOPERATIVES, COOPERATIVE INFORMATION REPORT 45, SECTION 15 (1998), available at [http://www.rurdev.usda.gov/rbs/pub/CIR%2045\\_15.pdf](http://www.rurdev.usda.gov/rbs/pub/CIR%2045_15.pdf) (last visited Jan. 28, 2013) (“A marketing cooperative is a business organization owned by farmers to collectively sell their products. It allows producers to accomplish collectively functions they couldn’t achieve on their own”).

### C. Federal Tax Law

The definition of an agency relationship for federal tax purposes differs from the Restatement of Agency.<sup>59</sup> As noted above, some agency relationships involve multiple agents or principals instead of the classic one-to-one relationship.<sup>60</sup> For example, in the case of a cooperative, there is a “co-principal” relationship between all the members collectively, as the principals, and the cooperative, as the single agent for them.<sup>61</sup> However, carried into the income tax arena, this collective business becomes a partnership for income tax purposes. To wit, if the assumption is made that every dollar collected by the cooperative is nothing more than the collective “deemed actual receipt”<sup>62</sup> by all members, the cooperative is nothing more than a tax partnership arising out of the joint business of the members.<sup>63</sup> The Code itself makes it clear that the partnership tax structure is different from the cooperative tax structure.<sup>64</sup>

While there do not appear to be any federal income tax cases addressing this issue directly beyond the *Scherbart* line of cases, there is an older case from Washington D.C. addressing this issue in a similar tax setting. The case of *Maryland and Virginia Milk Producers’ Ass’n Inc., v. District of Columbia*, 119 F.2d. 787 (D.C. App. Ct. 1941)<sup>65</sup> provides an excellent analysis of the agency issue for cooperatives and their patrons in a tax setting.<sup>66</sup> It stated the facts simply:

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<sup>59</sup> See Ward L. Thomas & Leonard J. Henzke Jr., *Agency: A Critical Factor In Exempt Organizations And UBIT Issues*, INTERNAL REVENUE SERVICE (2002), <http://www.irs.gov/pub/irs-tege/eotopic02.pdf> (“In making the decision on agency, IRS EO staff must apply what amounts to a federal common law of agency, since state law concepts may vary considerably”).

<sup>60</sup> See DeMott *supra* note 53.

<sup>61</sup> Members are not agents for each other since they have no authority to bind anyone in their member capacity. There also does not appear to be any fiduciary duty between the members of a cooperative beyond that applied to closely held corporations and directors. See Douglas Fee & Allan C. Hoberg, *Potential Liability of Directors of Agricultural Cooperatives*, 37 ARK L. REV. 60 (1984).

<sup>62</sup> See *infra* note 127.

<sup>63</sup> See IRS Pub. 541 (“An unincorporated organization with two or more members is generally classified as a partnership for federal tax purposes if its members carry on a trade, business, financial operation, or venture and divide its profits.” therefore, income tax owed by the cooperative would be eliminated since it would be a pass-through entity).

<sup>64</sup> Partnerships are taxed under Subchapter K of the Code while cooperatives are under Subchapter T.

<sup>65</sup> *Maryland and Virginia Milk Producers’ Ass’n Inc., v. District of Columbia*, 119 F.2d. 787 (D.C. App. Ct. 1941).

<sup>66</sup> See *generally id.* (This was a local tax in the District of Columbia on receivables and the crux of the case was who owned them. The court looked at the agency issue to deter-

The distributors contracted that they would “buy \* \* \* from the Maryland and Virginia Milk Producer’s Association, Inc.” and would pay “directly to the Association.” The Association contracted to “supply” the distributors, and to credit them for pasteurized cream returned by them.<sup>67</sup>

The court, in addressing the agency question, looked at the contract between the Association and the distributor/buyers and the contract between the Association and its members in which they agreed to consign their milk and cream to Association to market and sell. This is the classic marketing agreement between a cooperative and its patrons. The court proceeded to analyze the economics of the arrangement in which the funds received by the cooperative are pooled together with respect to all sales awaiting a determination of the amount of profit or loss “collectively” incurred with respect to all products sold (not individually for each producer):

How the Petitioner handled the funds was of crucial importance: Petitioner agreed to “exercise its best efforts to sell at fair prices all the milk and/or cream produced by its members \* \* \* The Association guarantees ultimate payment to the Producer at standard prices prevailing for the time being for each Market Area for like milk and/or cream produced, delivered and sold under like circumstances and conditions \* \* \* for which such distributor or purchaser fails to pay \* \* \* and guarantees the Producer against loss resulting through loss of market or failure of the Association to provide a market to the Producer for his output.” *Thus the amounts which petitioner paid to particular producers had no uniform relation to the amounts which petitioner received from distributors for the milk furnished by the particular producers.* If the distributor who received milk, furnished by a particular producer, failed to pay for it, *the loss was shared by all members.*<sup>68</sup> [Emphasis added]

The court then tried to cast the “light” of reason on the agency question based on the economic relationship of the parties:

In the light of these facts we cannot say that the obligations of the distributors, which purported to belong to petitioner, really belonged not to it but to its individual members. In fact, it is hard to see what is meant by such a statement, for it is hard to see what incidents of ownership petitioner lacked or its individual members possessed.

*If it was only an agent, for whom was it an agent?* The particular member whose milk went to a particular distributor had *no greater economic interest than the other members in the sums which that distributor promised to pay to petitioner.* As far as we can see, the particular member had no greater legal right than the other members in those sums. *It follows that if the several obligations of the distributors were not owned by petitioner they must have been*

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mine if the cooperative possessing the receivables was doing so only as each member’s agent).

<sup>67</sup> *Id.* at 791.

<sup>68</sup> *Id.*

*owned, not by the individual producers severally, but by all of them collectively. Such a view would treat the producers substantially as partners, ignoring the fact that the Association was not a partnership but an incorporated legal entity.* It has been repeatedly held, in Maryland and elsewhere, that a cooperative corporation is an entity distinct from its members. We see no more reason for asserting that all petitioners' individual members owned these accounts than for asserting that all the individual shareholders of a stock corporation own its accounts. Even when a cooperative association's contracts with its milk-producing members have been phrased clearly in terms of agency, it has been conceded that title to the milk passed to the association, and held that the association, and not the member, was the actual seller of the milk which the distributors bought. We think the petitioner acted as a principal and owned the accounts receivable.<sup>69</sup> [Emphasis added]

This may be the best discussion of the essence of the relationship between a cooperative and its Patrons in a tax setting and addresses the agency and ownership of the product issue.<sup>70</sup>

## V. THE STRUCTURE OF SUBCHAPTER T

Only the short overview of Subchapter T will be discussed herein to show how it is designed to recognize that a cooperative is an entity separate from its members and not a mere agency. Many references provide the history of taxation of cooperatives in greater detail.<sup>71</sup> Subchapter T was the culmination of over 40 years of administrative and case development of the taxation of cooperatives.<sup>72</sup>

For non-exempt cooperatives,<sup>73</sup> the rules were designed to accomplish a single level of taxation at either the cooperative or patron level depending on whether the earnings are passed out to the patrons or kept by the cooperative. Towards that end, Subchapter T provides for the cash method<sup>74</sup> of taxing either the cash received by the cooperative and/or distributed to the patron by examining where the cash goes. If retained, the cooperatives pay the tax; if distributed, the patron pays.<sup>75</sup>

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<sup>69</sup> *Id.*

<sup>70</sup> See *infra* Part VI.D. (discussing the ownership issue addressed by *Scherbart*).

<sup>71</sup> See, e.g., Donald A. Frederick, U.S. DEP'T OF AGRICULTURE, INCOME TAX TREATMENT OF COOPERATIVES: BACKGROUND (2005), available at <http://www.rurdev.usda.gov/rbs/pub/cir441.pdf>.

<sup>72</sup> See Revenue Act of 1951, Pub. L. No. 183 §314, 65 Stat. 452 (1951).

<sup>73</sup> 26 U.S.C. § 521 (2012) (provides rules for tax-exempt cooperatives).

<sup>74</sup> While a member can be an accrual taxpayer, the great majority of farmers are cash method taxpayer because of generous provisions for farmers to use the cash method. See I.R.C. § 447 (2012); see I.R.C. § 448 (2013).

<sup>75</sup> As is common in tax law, there is more complexity than this simple general statement. For example, a cooperative cannot deduct a qualified written notice of allocation or a qualified pre-unit retain certificate unless the patrons agree in writing to include such

Subchapter T makes it clear that the system of taxation for cooperatives is based on the cooperative reporting all the gross income from sales “with or for” its members along with all expenses to report at the cooperative level. The mechanism to decide whether the cooperative or the patron has to pay taxes on such net income is based specifically on section 1382 of the Internal Revenue Code (“IRC”) (when the cooperative is taxed) and section 1385 (when the patron is taxed) and they work together in *pari materia*.

Section 1382(a) of the IRC specifies that all gross income is reported by the cooperative. However, in determining its taxable income, it gets to take deductions and adjustments under section 1382(b).<sup>76</sup> The way the cooperative transfers the taxation to the patrons, with respect to patronage dividends and per-unit retains,<sup>77</sup> is specified in section 1382(b) of the IRC.<sup>78</sup>

Correspondingly, the patron’s side of the patron/cooperative transaction is set forth in section 1385(a) of the IRC.<sup>79</sup>

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allocation in income in the year of receipt of the allocation, thereby preserving the single level of tax to one or the other.

<sup>76</sup> Internal Revenue Service, *U.S. Income Tax Return for Cooperative Associations*, U.S. DEP’T OF TREASURY (2011), <http://www.irs.gov/pub/irs-pdf/f1120c.pdf>.

<sup>77</sup> Per-unit retain is a deduction by the cooperative from the proceeds of sale based on the value or quantity of products marketed for the patron. Patronage refunds and per-unit retains are sometimes confused. Patronage dividends are based on net margins generated during the year. Per-unit retains are based on the number, or dollar value, of units marketed. See Agricultural Cooperative Service, *What are Patronage Refunds?*, U.S. DEP’T OF AGRIC. 5-6 (1993), <http://www.rurdev.usda.gov/rbs/pub/cir9.pdf>.

<sup>78</sup> “1382(b) Patronage Dividends and Per-Unit Retain Allocations[.] In determining the taxable income of an organization to which this part applies, there shall not be taken into account amounts paid during the payment period for the taxable year –1382(b)(1) as patronage dividends [ . . . ], to the extent paid in money, qualified written notices of allocation [ . . . ], or other property (except nonqualified written notices of allocation [ . . . ]) with respect to patronage occurring during such taxable year; 1382(b)(2) in money or other property (except written notices of allocation) in redemption of a nonqualified written notice of allocation which was paid as a patronage dividend during the payment period for the taxable year during which the patronage occurred; 1382(b)(3) as per-unit retain allocations [ . . . ], to the extent paid in money, qualified per-unit retain certificates [ . . . ], or other property (except nonqualified per-unit retain certificates [ . . . ]) with respect to marketing occurring during such taxable year; or 1382(b)(4) in money or other property (except per-unit retain certificates) in redemption of a nonqualified per-unit retain certificate which was paid as a per-unit retain allocation during the payment period for the taxable year during which the marketing occurred.” I.R.C. § 1382(b) (2013).

<sup>79</sup> “1385 Amounts Includible In Patron’s Gross Income.

1385(a) General Rule. Except as otherwise provided in subsection (b), each person shall include in gross income –

- (1) the amount of any patronage dividend which is paid in money, a qualified written notice of allocation, or other property (except a nonqualified written no-

So the key to understanding when a patron will be taxed on patronage dividends is:

- When the cooperative pays “during the payment period”;
- When the patron receives or accrues the payment “during the taxable year” of the patron.

This raises the issue of what methods of accounting control the payment and therefore the timing of the receipt or accrual of income under the Code. In *Long Poultry Farms, Inc. v. Commissioner*, 249 F.2d 726 (1957),<sup>80</sup> the United States Fourth Circuit Court of Appeals discussed the tax accounting rules that apply to cooperatives and members in the case of a corporate member on the accrual basis of tax accounting. In that case the patronage refunds were issued in 1953, after enactment of the Revenue Act of 1951.<sup>81</sup> In discussing the Revenue Act of 1951, the court made it clear that when the patron includes the patronage depends on patron’s accounting method:

[. . .] cash basis taxpayers will report as income patronage dividends such as are here involved in the year when payment thereof is received and accrual basis taxpayers will report them as income for the year in which the right to receive payment becomes reasonably definite and certain.<sup>82</sup>

If the cooperative is the true tax agent for the patron, then all this would be irrelevant since the patron already has deemed actual receipt of all proceeds received by its agent and the agent has no income,<sup>83</sup> eliminating the need for a deduction for the cooperative under section 1382(b) of the IRC.

## VI. THE CONFUSION OF SCHERBART

To understand the *Scherbart* case, both at the Tax Court and Appeals Court, one needs to understand the background of a number of prior

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tice of allocation), and which is received by him during the taxable year from an organization described in section 1381(a),

(2) any amount, described in section 1382 (c)(2)(A) [...], which is paid in money, a qualified written notice of allocation, or other property (except a nonqualified written notice of allocation), and which is received by him during the taxable year from an organization described in section 1381(a)(1), and

(3) the amount of any per-unit retain allocation which is paid in qualified per-unit retain certificates and which is received by him during the taxable year from an organization described in section 1381(a).” I.R.C. § 1385(a) (2013).

<sup>80</sup> *Long Poultry Farms, Inc. v. Comm’r*, 249 F.2d 726 (4th Cir. 1957).

<sup>81</sup> Revenue Act of 1951 (PL 82-183) approved Oct. 20, 1951.

<sup>82</sup> *Long Poultry Farms, Inc. v. Comm’r*, 249 F.2d at 731.

<sup>83</sup> See discussion in note 40.

cases involving members of the Minnesota Corn Processors (“MCP”),<sup>84</sup> an agricultural cooperative owned by corn producers for the purpose of marketing and processing corn.

If we look at a standard model of a typical agricultural cooperative, there are a number of farmers who join together in a cooperative to market their products and perhaps acquire supplies for their farm business. This standard model assumes a couple of things:

1. The farmers grow their own products to deliver to the cooperative to meet their patronage obligation; and
2. The farmers are in the trade or business of farming and pay self-employment taxes (“SET”) on the patronage income derived from farming.

The deviations from this standard model that engendered the disputes with the IRS were that some MCP members had retired but remained members of the cooperative and wished to avoid paying SET; and buying product from the cooperative’s product pool to meet their delivery obligation instead of growing the delivered products.

#### A. Self-employment Taxes

The self-employment tax<sup>85</sup> is similar to the Federal Insurance Contributions Act (“FICA”) tax; it is imposed on the earnings of self-employed individuals, such as independent contractors and members of a partnership. This tax is imposed not by the FICA but instead by the Self-Employment Contributions Act of 1954, which is codified as Chapter 2 of Subtitle A of the IRC, 26 U.S.C. § 1401 through 26 U.S.C. § 1403 (the “SE Tax Act”). So the focus is on finding a trade or business and who derived the income therefrom.<sup>86</sup> Since a “trade or business” is not de-

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<sup>84</sup> MPC and its members have quite a history vis-à-vis the IRS and cooperative tax issues as discussed further below.

<sup>85</sup> Legislative history indicates the principal factor in Congress’ decision to include self-employed persons in the Social Security system was the development of a workable mechanism for determining earnings. Self-employed persons were not covered by social security prior to 1950 since “there was no agreement on a feasible method of obtaining . . . reports of their income.” Proposed Amendments to the Social Security Act: Hearings on H.R. 2892 Before the House Committee on Ways and Means, 81st Cong., 1st Sess. 1084 (1949) (statement of Dr. Arthur Altmeyer). Discussed in SSR 82-20c, available at: [http://www.socialsecurity.gov/OP\\_Home/rulings/oasi/33/SSR82-20-oasi-33.html](http://www.socialsecurity.gov/OP_Home/rulings/oasi/33/SSR82-20-oasi-33.html).

<sup>86</sup> “1402. Definitions. (a) Net earnings from self-employment. The term ‘net earnings from self-employment’ means the gross income *derived* by an individual *from any trade or business* carried on by such individual, less the deductions allowed by this subtitle which are attributable to such trade or business [. . .]. 26 U.S.C.S § 1402(a) (2013) (emphasis added).

fined in the Code, the level of activities must be examined to see if they are sufficient.<sup>87</sup>

In 1998 the SET issue was first litigated for an MCP member in the tax case of *Hansen v. Commissioner*.<sup>88</sup> There the petitioner had retired but remained a member of MCP with the obligation to supply corn to MCP based on his equity shares owned in MCP.<sup>89</sup> The petitioner did not grow corn but elected to buy corn from MCP's pool to satisfy his obligation.<sup>90</sup> MCP processed the corn, and the member received a value added payment because of the processing.<sup>91</sup>

The Tax Court found that because he did not grow the corn, he was not carrying on a trade or business directly or through an agent and therefore was not subject to the SET, a loss for the Service.<sup>92</sup> However, in the soon-to-be-heard docketed Tax Court case of *Bot*<sup>93</sup> (another case involving MCP, a member, and the SET) the IRS felt it could achieve a better outcome.<sup>94</sup>

### B. *Bot v. Commissioner*

In *Bot* the Tax Court had another case where the retired petitioner and spouse also satisfied their obligation by buying pool corn for delivery.<sup>95</sup> The Tax Court noted the SET issue was raised both by a crop share lease<sup>96</sup> with the petitioner's two sons and the rent thereunder, as well as the value-added payment.<sup>97</sup> Because of the failure by the Service to plead the crop share issue the court focused on the Bot's activities with respect to MCP to determine if the SET applied.<sup>98</sup>

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<sup>87</sup> The court stated that in order to be engaged in a trade or business the taxpayer must be involved in the activity with continuity and regularity, and the taxpayer's primary purpose for engaging in the activity must be for income or profit. *Comm'r v. Groetzinger*, 480 U.S. 23 (1987).

<sup>88</sup> *Hansen v. Comm'r*, T.C. Summary Opinion 1998-91 (May 7, 1998).

<sup>89</sup> *Id.*

<sup>90</sup> *Id.*

<sup>91</sup> *Id.*

<sup>92</sup> *Id.*

<sup>93</sup> *Bot v. C.I.R.*, 118 T.C. 138 (2002) *aff'd*, 353 F.3d 595 (8th Cir. 2003).

<sup>94</sup> See I.R.S. Notice (36)000-3 (April 21, 1999).

<sup>95</sup> *Bot*, 118 T.C. at 146.

<sup>96</sup> *Id.* (explaining that since neither party addressed the crop share issue, their consensus was the IRS had conceded the issue and that the crop share rent was not subject to SET. Since a share crop landlord does not owe SE tax unless he "materially participate[d]" in the day-to-day operation of the business (§1402(a)(1)(A)) it seems surprising that the sons' activities, as their agent, were not sufficient to find the SET as a matter of law).

<sup>97</sup> *Bot*, 118 T.C. at 153.

<sup>98</sup> *Id.*

Mr. Bot was trying to argue that the value added payments were really corporate dividends, and therefore investment income, derived from the shares owned in MPC.<sup>99</sup> This apparently led the IRS and courts to feel that Bot would escape SET because of the crop sharing arrangement. It seems likely that the IRS could have argued for an active trade of business by Bot by focusing on the agency relationship with his sons who were delivering his share of the crops to the cooperative. The owner of the land, even one subject to a crop share lease, is still the only person entitled to the patronage dividend as the member and the only one entitled to do business with the cooperative (as opposed to the crop share lessee).<sup>100</sup> This is just the nature of doing business on a cooperative basis.

The court focused on the petitioners' membership in MCP, in which they either directly or indirectly through their sons, as their agents, regularly and continuously: (1) remained as producers under the Uniform Marketing Agreement ("UMA") each year; (2) made the decisions regarding how to satisfy their production and delivery obligations to MCP under the UMA; (3) acquired option pool corn which they used to satisfy their production and delivery obligations to MCP; and (4) sold corn and corn products for profit through MCP.<sup>101</sup>

The Tax Court found it did not need to decide the agency issue with MCP and stated that even though petitioner retired as a farmer he still functioned as a dealer—selling corn for profit.<sup>102</sup> Being a dealer is a sufficient trade or business<sup>103</sup> for purposes of the SET. The court was satisfied that the value-added payments were derived from petitioners' trade or business.<sup>104</sup> Most importantly, the court had no trouble finding MCP "doing business as their agent" was unnecessary for the decision to apply

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<sup>99</sup> *Id.* at 151.

<sup>100</sup> *Fultz v. C.I.R., T.C.M. (RIA) 2005-045 (T.C. 2005); Fultz v. C.I.R. T.C.M. (RIA) 2005-046 (T.C. 2005)* (companion cases of two brothers regarding MCP, the SET, and a crop share lease with their wholly owned corporation, Fultz Farm, citing the Bot case. To purchase units in MCP, the purchaser was required to own stock in MCP. Mr. Fultz owned the MCP stock; Fultz Farms did not. Mr. Fultz entered into the UMAs with MCP, which appointed MCP as his agent, and he agreed to deliver the requisite quantities of corn to MCP each year. Fultz Farms was not a party to any agreement with MCP. See pages 12 and 13, respectively).

<sup>101</sup> Bot, 118 T.C. at 154.

<sup>102</sup> *Id.* at 156 ("Although petitioners may have retired from daily farming in 1987, they did not cease to function as dealers in corn following their retirement").

<sup>103</sup> *C.I.R. v. Groetzinger*, 480 U.S. 23 (1987).

<sup>104</sup> Bot, 118 T.C. at 161 ("We are satisfied that the value-added payments were derived from petitioners' trade or business. Petitioners, either directly or through the sons as their agents, regularly acquired and delivered option pool corn to MCP which MCP processed and then marketed and sold for petitioners").

the SET to petitioner.<sup>105</sup> In fact, the agency discussion was not used by the court to find the necessary trade or business, but to refute an assertion about the petitioners' ability to influence MCP's operation.<sup>106</sup>

On appeal, the Eight Circuit focused on the discussion of the Tax Court regarding agency, asserting that the Tax Court found that MCP acted as their agent.<sup>107</sup> The Tax Court did not find MCP to be the agent of the petitioners for all purposes, but only in the context that the business *with* the cooperative was sufficient to find the necessary trade or business.<sup>108</sup> However, the Appeals Court's focus on the agency discussion, in order to apply the SET, has directly led to the agency result being applied to incomes taxes by the courts in *Scherbart*.<sup>109</sup>

Finding that a separate taxpayer is the tax agent of another taxpayer so that the receipt of income by the agent is deemed received by the principal is a different task from attributing the activities of another to a separate taxpayer to find a trade or business for SET purposes.

### C. *Scherbart v. Commissioner*

After *Bot*, comes *Scherbart v. Commissioner*, 87 T.C.C. (CCH) 1418 (2004). *Scherbart* was initially reviewed by the Tax Court<sup>110</sup> and then, on appeal, by the Eighth Circuit.<sup>111</sup> Keith Scherbart was another member of MCP. In his Uniform Marketing Agreement<sup>112</sup> ("UMA") with MCP,

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<sup>105</sup> *Id.* at 149 ("[W]e disagree with petitioners for several reasons. First, whether MCP qualified as petitioners' agent in processing, marketing, and selling the corn petitioners acquired and delivered to MCP in 1994 and 1995 is not essential to our holding. Regardless of whether MCP acted as petitioners' agent, the record establishes that petitioners, by satisfying their production obligations [...], regularly and continuously purchased and sold corn with the intention of making a profit. Although petitioners may have retired from daily farming in 1987, they did not cease to function as dealers in corn following their retirement").

<sup>106</sup> *Id.* at 150 ("Petitioners' argument that they did not have a sufficient level of control under Minnesota law to support the explicit contractual designation of MCP as petitioners' agent, even if relevant to our analysis, is unsupported by any convincing proof in the record").

<sup>107</sup> *Bot v. C.I.R.*, 353 F.3d 595, 601 (8th Cir. 2003).

<sup>108</sup> See Subchapter T of the Internal Revenue Code *supra* note 11.

<sup>109</sup> See discussion *infra* Part C.

<sup>110</sup> *Scherbart v. Comm'r*, 87 T.C.M. (CCH) 1418 (2004).

<sup>111</sup> *Scherbart v. Comm'r*, 98 A.F.T.R2d (RIA) 5076 (2006).

<sup>112</sup> As in any contractual relationship, the uniform marketing agreement creates certain duties and rights between the parties. However, unlike the traditional two-party contract that only creates rights between the contracting parties; uniform marketing agreements creates further duties to the other members of the cooperative who sign the same marketing agreement. Clearly the agreements are not independent of each other since they are intended to be executed with all members that are members for the year. Given the multi-

Mr. Scherbart designated MCP as his “sole agent” for marketing and selling his corn.”<sup>113</sup>

MCP’s processing added value to the corn delivered by its members, and as a result, it would issue “value-added”<sup>114</sup> payments to its members.<sup>115</sup> On August 30, 1995, Mr. Scherbart received a letter from MCP stating that the year-end value-added payment for 1995 would be determined after the annual audit<sup>116</sup> and paid out in November, and offered Mr. Scherbart the opportunity to defer his year-end value-added payment until the next tax year. As done in the previous year, Mr. Scherbart exercised his option to defer payment until January of 1996<sup>117</sup> resulting in the

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tude of tax cases involving the MCP’s UMA is pretty clear all other members would have signed a similar marketing agreement appointing MPC their “sole agent.” It is quite clear that Bot’s UMA was the same as Scherbart v. Comm’r.

<sup>113</sup> In fact, it was necessary for all members to sign essentially the same agreement or there would have been no cooperative arrangement. Given the multitude of tax cases involving the MCP’s UMA it is all members would have signed a similar marketing agreement appointing MPC their “sole agent.”

<sup>114</sup> 7 C.F.R. §4284.902 (2011). (Value-added products are defined as follows: A change in the physical state or form of the product. The production of a product in a manner that enhances its value, as demonstrated through a business plan. The physical segregation of an agricultural commodity or product in a manner that results in the enhancement of the value of that commodity or product. As a result of the change in physical state or the manner in which the agricultural commodity or product is produced and segregated, the customer base for the commodity or product is expanded and a greater portion of revenue derived from the marketing, processing or physical segregation is made available to the producer of the commodity or product).

<sup>115</sup> See *Scherbart*, 87 T.C.M. (2004). (The advanced payments were not at issue in the case, only the discretionary year-end value-added payments).

<sup>116</sup> Note that there is no way to determine what the year-end payment would be until the audit for the year was done.

<sup>117</sup> See IRS, *Farmers ATG- Chapter Two- Income Feb. 2009*) available at <http://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Farmers-ATG---Chapter-Two---Income>. (The Service acknowledges that deferral agreements entered into before the proceeds are due and payable are permissible). “Under the constructive-receipt doctrine, a taxpayer recognizes income when the taxpayer has an unqualified, vested right to receive immediate payment . . . [Where a taxpayer] acquires an unconditioned vested right to receive the proceeds of the sale, and the buyer is ready, willing, and able to make payment, the taxpayer cannot avoid treating the proceeds as income for that year by voluntarily declining to accept payment during that year, or by requesting the purchaser not to pay him until a later year, or even by voluntarily putting himself under some legal disability or restriction with respect to payment. In such circumstances, he will be deemed in constructive receipt of the income notwithstanding his refusal to accept payment or his self-imposed restraints on payment.

On the other hand, where such a stipulation [deferring the receipt of income] is entered into between buyer and seller prior to the time when the seller has acquired an absolute and unconditional right to receive payment, and where the stipulation amounts to a binding contract between the parties so that the buyer has a legal right to refuse pay-

Service disallowing the deferrals. Mr. Scherbart challenged the Service's determination, arguing that he was entitled to defer the income into the later years.<sup>118</sup>

### 1. Tax Court

The Tax Court summarily found Scherbart liable for SET based on *Bot*.<sup>119</sup> It is clear that patronage income of Scherbart is self-employment income, but the determination of the year in which it is included is made under IRC §451(a).<sup>120</sup> The sole question for the Tax Court was whether Scherbart could defer the receipt of the value-added payment under MCP's deferred crop payment program.<sup>121</sup> The Tax Court found that the deferral was not effective:

Because MCP served as [Scherbart's] agent for making the sales and receiving the sales income, the only limitations placed on petitioner's receipt of that income were self-imposed and therefore ineffective to achieve a deferral for tax purposes. On this record, we conclude that petitioner constructively re-

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ment except in accordance with the terms of the agreement, then the doctrine of constructive receipt does not apply, and the taxpayer is not required to report the income until actually received by him."

The *Scherbart* court avoided any determination of whether the taxpayer had "an unqualified, vested right to immediate payment" at the time of the deferral election by finding an agency relationship.

<sup>118</sup> It appears that the midyear deliveries of corn occurred *before* Scherbart's election, which may have been sufficient independent grounds to find constructive receipt avoiding the detour into agency. The key issue would then have been whether the fact the value-added amounts could not be calculated until the year-end audit, after the election, was sufficient to prevent a vested right and therefore avoid constructive receipt.

<sup>119</sup> See *supra* Part IV, Subsection B.

<sup>120</sup> See SOCIAL SECURITY ADMINISTRATION, SSR 67-42: Section 211. –Net Earnings From Self-Employment- Payments-Under the Food and Agriculture Act of 1965 – Crop-land and Adjustment Program, available at [http://www.socialsecurity.gov/OP\\_Home/rulings/oasi/47/SSR67-42-oasi-47.html](http://www.socialsecurity.gov/OP_Home/rulings/oasi/47/SSR67-42-oasi-47.html) (last visited Jan. 28, 2013). ("Section 404.1051 of Regulations No. 4 (20 CFR 404.1051) provides that the gross income and deductions of an individual attributable to a trade or business for the purpose of ascertaining his net earnings from self-employment are to be determined by reference to the income tax provisions of the Internal Revenue code and regulations thereunder. Thus, the method of accounting applicable to the individual's computation of gross and net income for income tax purposes is equally applicable to the computation of his net earnings from self-employment for social security purposes. Section 451(a) of the Internal Revenue Code provides that any item of income is to be included in gross income for the taxable year in which it is received unless includible in a different taxable year under the taxpayer's method of accounting").

<sup>121</sup> *Scherbart v. Comm'r*, 87 T.C.M. (CCH) 1418, 1 (2004). ("After resolution of other issues as a result of *Bot v. Commissioner*, [...], the sole issue remaining for decision is whether petitioners are entitled to defer income.").

ceived the year end value-added payments during the respective taxable years in issue.<sup>122</sup>

The Tax Court simply followed the holding of the appeal court in the prior case of *Bot v. Commissioner*<sup>123</sup> to find agency: since *Bot* had examined the terms of the UMA and found agency, the Tax Court in *Scherbart v. Commissioner*, 87 T.C.M. (CCH) 1418 (2004) found MCP was the agent of the petitioner for income tax purposes.

This was argued by the taxpayer as an effective deferral election in accord with Revenue Ruling 73-210,<sup>124</sup> which allows the deferral of patronage dividends under the usual rules of a binding deferral agreement entered into prior to the right to receive the proceeds.<sup>125</sup> The Tax Court's failure to distinguish between constructive receipt and deemed actual receipt by a principal<sup>126</sup> rendered the Revenue Ruling moot because of the "agency" finding by the court. It cites *Warren v. United States*, 613 F.2d 591 (5th Cir. 1980),<sup>127</sup> for the general rule that "receipt by the agent is receipt by the principal."<sup>128</sup> However, that is inconsistent with the reference to the "self-imposed" limitation it found. A principal cannot impose a limitation on its receipt *after* it is deemed<sup>129</sup> to have actual receipt. "Actual receipt" by definition means no such limitations exist.

*Arnwine v. Commissioner*, 696 F.2d 1102 (5th Cir. 1983)<sup>130</sup> involved a contract between a cotton grower and one cotton gin where a deferred payment contract was found not to work. No cooperative arrangement was involved, but the Fifth Circuit clearly stated the difference between agency and constructive receipt. Stating that under the constructive re-

<sup>122</sup> *Id.*

<sup>123</sup> *Id.* at 5-6. ("Here, in accordance with *Bot v. Commissioner*, *supra*, and with the terms of the Uniform Marketing Agreement, we find MCP was the agent of petitioner").

<sup>124</sup> Rev. Rul. 1973-1 C.B. 211.

<sup>125</sup> See *Sedo and Brenden*, Comment, *Fairness and Taxation: The Law of Deferred Income Recognition for the Members of Agricultural Cooperatives*, 23 Akron Tax J. 81, 93. ("The Ruling established a standard that deferral will be allowed for agricultural cooperatives where (1) there is a bona fide, arm's length deferred payment agreement (2) entered into before the cooperative member had an unqualified right to receive payment.")

<sup>126</sup> In fact, on review the Appeals Court makes no mention of constructive receipt. The Appeals Court, somewhat in artfully, found that there was actual receipt by the agent therefore deemed actual receipt by the principal. The "self-imposed limitation" discussion is irrelevant, unnecessary, and misleading since that only makes sense if there is no agency relationship.

<sup>127</sup> *Warren v. U.S.* 613 F.2d 591, 593 (5th Cir. 1980).

<sup>128</sup> *Id.* at 593.

<sup>129</sup> BLACK'S LAW DICTIONARY 425 (Bryan A. Garner ed., 7th ed. 1999) (Defined deemed as: "To treat something as if it were something else").

<sup>130</sup> *Arnwine v. Comm'r*, 696 F.2d 1102 (5th Cir. 1983).

cept doctrine, “the issue is whether proceeds not actually possessed by a taxpayer are nonetheless available to him in such a manner that his control over them is not subject to any substantial limitations or restrictions,” but the agency theory is “where proceeds are deemed possessed by a taxpayer by reason of possession of the proceeds by his agent.” In a decision, logical from the court’s perspective, the court followed that when a taxpayer’s agent receives proceeds, any agreement between them which purports to place the proceeds beyond the taxpayer’s reach is a nullity.

## 2. *Eight Circuit Review*

The Eighth Circuit Court of Appeal upheld the Tax Court, finding that there was a “direct parallel” between *Scherbart* and *Warren*.<sup>131</sup> In *Warren*, the Fifth Circuit held that cotton gins were the sellers’ agents for the sale of cotton where the sellers could authorize the gins to defer sale proceeds to the next year.<sup>132</sup> The Fifth Circuit also held that “[t]he sellers decision ‘to have the gins hold the sales proceeds until the following year was a self-imposed limitation . . . . Such a . . . limitation does not serve to change the general rule that receipt by an agent is receipt by the principal.’”<sup>133</sup>

However, the “direct parallel” conclusion is incorrect. *Warren* dealt with a relationship between a cotton gin and a cotton producer outside of any cooperative arrangement.<sup>134</sup> Clearly, the gin had an agency relationship that flowed directly between it and the producer so that it could be said that the funds received by the gins for the sale of the producer’s cotton were held in trust by an agent/fiduciary for the producer – a true tax agent. Once again, the self-imposed limitation label seems too illogical after one already has receipt.<sup>135</sup>

In a cooperative setting, the cooperative receives *all* funds on behalf of *all* similarly situated members, creating a collective fiduciary duty, and

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<sup>131</sup> *Warren*, 613 F.2d at 593.

<sup>132</sup> *Id.*

<sup>133</sup> *Id.*

<sup>134</sup> *Id.* at 592. (“[Plaintiffs] are Texas cotton growers using the cash receipts and disbursements method of accounting for tax purposes. In 1969 and 1970 they took their cotton to the Cotton King Gin and the Sand Gin Company. These gins, in addition to ginning and baling, also arranged sales of the cotton for producers interested in selling. The gin obtained prices from a number of prospective buyers and relayed the information to the producer. When a producer was satisfied with a price, he could authorize the gin to sell the cotton and obtain the proceeds of the transaction”).

<sup>135</sup> Similar to refusing to take money out of ones own pocket and claiming there is a limitation.

there is no direct relationship between the dollars received and the amount that will be paid to each and every member.<sup>136</sup> This is controlled by the amount of patronage done by each member.<sup>137</sup> Only after all income and expenses are pooled and any retains calculated can the cooperative decide on the amount that will be paid to each member.<sup>138</sup>

This was the beginning of the faulty analysis of the agency issue. As discussed, finding a tax agency so that the receipt of income by the agent is disregarded and deemed received by the principal is a different task from finding sufficient activities so that a taxpayer has engaged in a trade or business for SET purposes.<sup>139</sup>

### 3. Epilogue Regarding Minnesota Corn Processors

An interesting footnote to the entire MCP story is the fact that MCP realized that it had so many retired farmers buying corn from the pool, as opposed to delivering their own corn, that they were risking their status as a cooperative and decided to convert to an LLC to insure the one level of taxation.<sup>140</sup> Actually, that was an unstated issue of the MCP related cases never addressed by anyone in the cases or decisions. Attacking each individual patron under an agency theory but not the cooperative relationship (or lack thereof) under federal tax law was a shortsighted approach. Unfortunately, the *Scherbart* case has left an incorrect or inappropriate legal holding to be applied in cases where a true cooperative relationship exists under Subchapter T.

For if the cooperative were the true tax agent for its members, it would mean that no income would be reflected on the cooperative's tax return.<sup>141</sup> It would leave the issue of how the expenses are dealt with irresolvable because of the inability to allocate expenses as they are incurred. The Tax Court and the Eighth Circuit holdings implies that there is no tax agency until the year-end calculations are done pragmatically because it avoided dealing with how to calculate the net income available at earlier times. This requires a magical transformation in status; for if

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<sup>136</sup> See *infra* note 65 discussing *Md. & Va. Milk Producers' Ass'n v. D.C.*, 119 F.2d 787 (1941).

<sup>137</sup> *Id.*

<sup>138</sup> *Id.*

<sup>139</sup> I.R.C. § 1402 (Lexis 2013) (SET applies only to individuals who derive income from a trade or business, the tax agency rule applies to any type of income including passive income).

<sup>140</sup> Minnesota Corn Processors, *LLC Information Statement – Prospectus Relating to the Conversion of Minnesota Corn Processors, Inc. to a Colorado LLC*, (Jan. 6, 2009), <http://www.sec.gov/Archives/edgar/data/1392380/000119312510187275/ds1.htm>.

<sup>141</sup> See *Nat'l Carbide Corp. v. Comm'r of Internal Revenue*, 336 U.S. 422, 424 (1949).

they were agents from the moment the Marketing Agreement was signed then there should be no need to wait until the year-end calculations. The receipt of the payments from customers by the cooperative/agent is gross income to each member/principal.<sup>142</sup> To hold that there is no agency until the year-end determination and then it somehow arises is problematical to say the least. This sort of transformation from non-agency to agency solely because the allocation amounts are calculable would not be based on any statutory reasoning.

#### 4. *Ownership Issue*

If the ownership of product remains with each member then there is no cooperative relationship, only a tax agency or an assignment of income issue.<sup>143</sup> There is a telling statement in the Eighth Circuit Court's opinion discussing the sales characterization and transfer of ownership:

We noted in *Bot*, 353 F.3d at 601-02, that MCP's "program operated on the basis that [the members] were producers or owners of the corn delivered under the program and that MCP acted as their agent in further processing and marketing the corn." *Bot's holding would collapse into nonsensicality if MCP owned the corn in question; MCP's agency with regard to processing and marketing is meaningful only if the corn is owned by the member after delivery.* Since *Bot* dealt with the same type of relationship and transaction as this case does, we hold that the transactions at issue here were not sales."<sup>144</sup> [Emphasis added]

The court again fails to look at the tax context of Subchapter T. This is not how taxation of cooperatives operates under Subchapter T and the court fell short in its analysis. Just one additional step and the court could have found there was no cooperative relationship under Subchapter T with respect to the product in question.

Put another way, if a cooperative is operating on a "cooperative basis," ownership to the product, at least for tax purposes,<sup>145</sup> necessarily passes to the cooperative otherwise it would not have any income to retain or pass out to the members. To hold otherwise is to ignore the entire cooperative nature and treat the cooperative as merely a separate broker for each member's product for tax purposes.

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<sup>142</sup> Assuming there is any feasible way to trace the dollars paid to the cooperative to a particular member and its product.

<sup>143</sup> See Alex Raskolnikov, Article, *Contextual Analysis of Tax Ownership*, 85 B.U.L. Rev. 431 (2005).

<sup>144</sup> *Scherbart*, 453 F.3d 987 at 989.

<sup>145</sup> See *supra* note 65.

## VII. CONCLUSION

If the IRS believes there is a true tax agency between a cooperative and its members, then there is likely no Subchapter T cooperative relationship and the tax results should flow from that finding.<sup>146</sup> The *Scherbart* case shows the Tax Court and Appeals Court are also confused about agency and constructive receipt doctrines, and these cases should not be the final word about these very important cooperative taxation issues.

RONALD A. HENDERSON<sup>147</sup>

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<sup>146</sup> See *supra* note 138 and accompanying text (consistent with the MCP's directors deciding to convert to an LLC).

<sup>147</sup> Ronald A Henderson, Principal at Dowling Aaron Incorporated, a Professional Law Corporation.