Volume 21 | Number 1 Article 1

1-8-2010

Change of "Taxpayer" After Crop Insurance (and Disaster Payment) Deferral

Neil E. Harl
Iowa State University

Agricultural Law Press
Publisher/Editor
Robert P. Achenbach, Jr.
Contributing Editor
Dr. Neil E. Harl, Esq.
* * * *

Issue Contents

Agricultural
Law Digest

Volume 21, No. 1 January 8, 2010 ISSN 1051-2780

Change of "Taxpayer" After Crop Insurance (and Disaster Payment) Deferral

-by Neil E. Harl*

Recently, the question was asked, "what are the consequences of incorporating or forming an LLC after electing to defer crop insurance and disaster payments?"[1] It is tempting to change entities (for the business entity involved), particularly if income shifting to a lower tax bracket taxpayer is possible. However, that outcome seems to be blocked by assignment-of-income rules of long standing.

Provisions of the deferral statute and regulations

The statute governing deferrals of crop insurance and disaster assistance proceeds[2] is silent on the issue of whether the income tax on deferrals must be paid by the electing taxpayer. The regulations state that an election is ". . . deemed to cover all such proceeds which are attributable to crops representing a single trade or business under section 446(d)."[3] A separate election must be made with respect to insurance proceeds attributable to each crop which represents a separate trade or business under section 446(d)."[4] Section 446(d) states that a taxpayer engaged in more than one trade or business may, in computing taxable income, use a different method of accounting for each trade or business.[5] Thus, it would appear from that authority that an election by a sole proprietorship could be effective for a successor entity so long as the new entity is the same trade or business with no change of ownership or change in the scope of operation.[6]

However, nowhere is the issue addressed directly in either the Internal Revenue Code, regulations or rulings. Nonetheless, it seems questionable whether the "trade or business" requirement could be stretched to allow assignment of the obligation to pay income tax on the deferred proceeds to a successor entity.

Midstream incorporation rules

The "midstream incorporation" rules applicable to tax-free exchanges to a corporation[7] cast some light on what types of conveyances to a newly-formed corporation are likely to be challenged by the Internal Revenue Service. Those rules include application of the "assignment of income" doctrine which can override an otherwise tax-free exchange and result in the taxing of proceeds from the subsequent recognition of gain back to the transferor.[8] The midstream incorporation rules also include the reallocation of income,

* Charles F. Curtiss Distinguished Professor in Agriculture and Emeritus Professor of Economics, Iowa State University; member of the Iowa Bar.

deductions, credits or allowances by the Commissioner as necessary "... in order to prevent the evasion of taxes or clearly to reflect. . . income. . . ."[9] In *Rooney v. Commissioner,*[10] the Commissioner was upheld in reallocating to a newly-formed corporation production expenses incurred by the individual taxpayer. The case involved a July 31 transfer of a growing hop crop (which had been sold under contract the prior January 22) to the new corporation with the crop harvested in late August and early September. Before the Commissioner's reallocation, the individual taxpayer had incurred a substantial net operating loss which the taxpayer sought to carry back to the three prior years.[11] In two subsequent cases,[12] the courts rejected the Commissioner's reallocation where no operating loss had been incurred by the transferor.

Tax-free incorporations can also be challenged under the "tax benefit" theory and lack of business purpose doctrine.

In several private letter rulings, the Internal Revenue Service has ruled that, in general, formation of a farm or ranch corporation in the regular course of business in a tax-free exchange that does not involve substantial tax avoidance motives or a manifest desire to shift income tax liability artificially should not result in recognition of income because of conveyance of stored grain, growing crops or livestock being fed out.[13] Similarly, IRS has ruled that the transfer of cash, prepaid expenses, feed on hand and supplies did not trigger recognition of gain;[14] the transfer of a Commodity Credit Corporation loan and the right to receive payment-in-kind program benefits to a corporation did not result in a reallocation;[15] nor did the deductibility of prepaid feed expense.[16] Note, however, that none of those rulings involved the handling of deferred income amounts, which is easily distinguished from the transfer of an asset.

Assignment of income

As noted above,[17] the assignment-of-income doctrine is the most likely barrier to shifting deferred income from crop insurance and disaster payments to a successor entity. That doctrine has a long and storied history. In 1930 the United States Supreme Court in *Lucas v. Earl*[18] held that an individual who gave his wife the right to receive a portion of the future income generated by his law practice in what amounted to joint tenancy (one-half) remained taxable to the husband who was responsible for creating the income. In *Helvering v. Horst*[19] the court held that an individual who gave his son interest coupons which were detached from bonds owned by the transferor was liable for the interest accrued before the gift and later paid to the son. The well-established rule has been that the assignment of income is ineffective; the conveyance must be of the income-producing property to be beyond challenge. As is often stated, one cannot give away the fruit without giving away the tree.

Thus, it would seem that it is not possible to shift the responsibility for paying income tax on deferred crop insurance proceeds and disaster payments to a successor entity. As a practical matter, it only makes a difference if the successor corporation is a C corporation or any other entity with income sharing among taxpayers different from the electing entity or income sharing in different proportions.

ENDNOTES

[1] I.R.C. § 451(d). See Harl, "Deferring Crop Insurance and Disaster Payments: How Not to Do It," 19 *Agric. L. Dig.* 33 (2008). See generally 4 Harl, *Agricultural Law* § 27.03[7][a] (2009); Harl, *Agricultural Law Manual* § 4.02[4] (2009); 1 Harl, *Farm Income Tax Manual* § 2.13[1] (2010 ed.).

[2] I.R.C. § 451(d).

[3] Treas. Reg. § 1.451-6(a)(2).

[4] *Id.*

[5] I.R.C. § 446(d).

[6] Treas. Reg. § 1.451-6(a)(2). See I.R.C. § 446(d).

[7] I.R.C. § 351. See generally 7 Harl, *Agricultural Law* § 53.07 (2009); Harl, *Agricultural Law Manual* § 7.02[2][c] (2009); 2 Harl, *Farm Income Tax Manual* § 7.02[2] (2010 ed.).

[8] See, e.g., Weinberg v. Comm'r, 44 T.C. 233 (1965), *aff'd per curiam sub nom.* Comm'r v. Sugar Daddy, Inc., 386 F.2d 836 (9th Cir. 1967), *cert. denied*, 392 U.S. 929 (1968) (14 separate corporations formed to receive crop sale proceeds).

[9] I.R.C. § 482.

[10] 305 F.2d 681 (9th Cir. 1962).

[11] *Id.* See also Central Cuba Sugar Co. v. Comm'r, 198 F.2d 214 (2d Cir.), *cert. denied*, 344 U.S. 874 (1952).

[12] Fanning v. United States, 568 F. Supp. 823 (E.D. Wash. 1983); Heaton v. United States, 573 F. Supp. 12 (E.D. Wash. 1983).

[13] Ltr. Rul. 7924003, February 26, 1979; Ltr. Rul. 7942094, May 14, 1979; Ltr. Rul. 7935005, May 18, 1979.

[14] Ltr. Rul. 8303025, October 15, 1982).

[15] Ltr. Rul. 8431032, May 1, 1984.

[16] Ltr. Rul. 8412033, December 19, 1983.

[17] See note 8 and accompanying text.

[18] 281 U.S. 111 (1930).

[19] 311 U.S. 112 (1940).