Florida State University Law Review

Volume 8 | Issue 2 Article 4

Spring 1980

The Continuing Saga of Prepaid Feed Expense: The Fat Lady Has Not Sung

James D. Wright

Nancy E. Wright

COMMENTS

THE CONTINUING SAGA OF PREPAID FEED EXPENSE: THE FAT LADY HAS NOT SUNG*

JAMES D. WRIGHT AND NANCY E. WRIGHT

I. INTRODUCTION

How can a farmer's accounting treatment of a simple item of expense, prepaid feed, cause so much confusion and conflict among the courts, the Internal Revenue Service (the Service), and the taxpayers? This problem has been the subject of numerous articles[1] and several revenue rulings,[2] yet, as recent cases illustrate, the conflict remains unresolved.[3]

The disagreement stems from a seemingly inconsequential treasury regulation which has been in existence for twenty-two years. Under Treasury Regulation section 1.471-6(a),[4] a farmer is given the option of using the cash receipts and disbursements method of accounting instead of an inventory system. Farmers were singled out for this preferential treatment primarily because the nature of their business makes a simplified method of accounting more practical.[5] This unique benefit granted farmers did not go unnoticed,

* Properly stated: "The opera's not over until the fat lady sings." This phrase was made popular by Dick Motta, coach of the Washington Bullets professional basketball team, while his team was playing the 1978 National Basketball Association championship series. As used by Coach Motta, the phrase indicated that the series was not over until the final buzzer sounded. As used here, the phrase is meant to imply that a legal conflict among courts is never finally resolved until the Supreme Court or Congress decides the issue. No disrespect of the Supreme Court or Congress is intended.

1. *See generally* Branscomb, *The Cash Method as Applied in Agriculture—A Reexamination*, 25 TAX LAW. 125 (1971); Hjorth, *Cattle, Congress and the Code—The Dangers of Tax Incentives*, 1968 WIS. L. REV. 641, 665-66; Klien, *Treasury's Prepaid Feed Ruling: Tough New Tests and Retroactivity Raise Questions*, 40 J. TAX. 96 (1974); Pinney & Olsen, *Farmer's Prepaid Feed Expenses*, 25 TAX LAW. 537 (1972); Ward, *Tax Postponement and the Cash Method Farmer: An Analysis of Revenue Ruling 75-152*, 53 TEX. L. REV. 1119 (1975); Willingham & Kasmir, *Prepaid Feed Deduction: How to Cope with IRS' Restrictive New Ruling*, 43 J. TAX. 230 (1975).

2. Rev. Rul. 79-229, 1979-31 I.R.B. 6; Rev. Rul. 75-152, 1975-1 C.B. 144.

3. *See, e.g.*, Clement v. United States, 580 F.2d 422, 78-2 USTC ¶ 9566 (Ct. Cl. 1978); Owens v. Commissioner, 568 F.2d 1233, 78-1 USTC ¶ 9144 (6th Cir. 1977), *aff'g and rev'g* 64 T.C. 1 (1975); Haynes v. Commissioner, 38 T.C.M. (CCH) 950 (1979); Heinold v. Commissioner, 39 T.C.M. (CCH) 685 (1979); Van Raden v. Commissioner, 71 T.C. 1083 (1979); De La Cruz v. Commissioner, 37 T.C.M. (CCH) 24 (1978).

4. (1980). The regulation provides: "A farmer may make his return upon an inventory method instead of the cash receipts and disbursements method. It is optional with the taxpayer which of these methods of accounting is used . . . ."

5. *See, e.g.*, United States v. Catto, 384 U.S. 102, 116 (1966); Heinold v. Commissioner,

however, as taxpayers became increasingly aware of the possible tax benefits of such a regulation, apart from the business benefits. Assisted by the Department of the Treasury's (the Treasury) liberal definition of "farmer,"[6] a tax shelter scheme was developed around a limited partnership organized near the end of the year to do business as a cattle feeding operation.[7] In November or December the partnership "farmer" would purchase large amounts of grain, sufficient to feed its cattle well into the next year. Using the cash method of accounting, the partnership would deduct the full amount of feed expense on its return, and since no cattle could be sold in the partnership's short tax year there would be no offsetting income. The resulting net loss would be divided among the limited partners, sheltering their other income.[8]

No doubt feeling insulted that their regulation was being used against them, the Service sought to require deduction of feed expense when the feed was consumed rather than in the year of payment. Their first argument in support of this position was that the taxpayer had only placed a deposit for the delivery of feed in the future; the final payment was uncertain so it could not be currently deducted.[9] This argument (still in the Service's arsenal) was of limited usefulness, however, since a binding contract with a nonrefundability clause could easily be arranged between wary taxpayers.[10]

A more serious attack on the cash method for farmers' prepayment and deduction of feed expense came in the form of Revenue Ruling 75-152.[11] In that 1975 ruling, the Service loaded a triple-

---

39 T.C.M. (CCH) 685 (1979). *See also* Hawkinson, *Farm Expenses and General Accounting Principles*, 22 TAX L. REV. 237, 224-46 (1967); Ward, *supra* note 1, at 1148-51.

6. "All individuals, partnerships, or corporations that cultivate, operate, or manage farms for gain or profit, either as owners or tenants, are designated as farmers." Treas. Reg. 1.61-4(d) (1980).

7. Investment in cattle feeding partnerships increased at a rapid rate during the early 1970's. Haynes v. Commissioner, 38 T.C.M. (CCH) 950, 952 (1979). According to one news periodical, these partnerships were attracting almost $100 million a year of new money. *See* Ward, *supra* note 1, at 1121 (citing NEWSWEEK, July 22, 1974, at 64).

8. I.R.C. § 702(a).

9. *See* Shippy v. United States, 199 F. Supp. 842 (D.S.D. 1961), *aff'd*, 308 F.2d 743, 62-2 USTC ¶ 9780 (8th Cir. 1962); Lillie v. Commissioner, 45 T.C. 54 (1965), *aff'd per curiam*, 370 F.2d 562, 67-1 USTC ¶ 9146 (9th Cir. 1966); Ernst v. Commissioner, 32 T.C. 181 (1959). For a thorough discussion of the payment versus deposit test, see Ward, *supra* note 1, at 1123-45.

10. *See, e.g.*, Mann v. Commissioner, 483 F.2d 673, 73-2 USTC ¶ 9618 (8th Cir. 1973); Gaddis v. United States, 330 F. Supp. 741, 71-2 USTC ¶ 9527 (S.D. Miss. 1971); Estate of Cohen, 29 T.C.M. (CCH) 1221 (1970).

11. 1975-1 C.B. 144.

barrel shotgun to be used against the prepayment scheme. Under the ruling, prepaid feed expenses could not be deducted in the year of payment unless three conditions were met:

> First, the expenditure must be a payment for the purchase of feed rather than a deposit; second, the prepayment must be made for a business purpose and not merely for tax avoidance; and third, the deduction of such costs in the taxable year of prepayment must not result in a material distortion of income.[12]

This provided the Service with two additional weapons: the requirements that the timing of the payment have a business purpose and that the deduction not result in a material distortion of income.

Watching the increasing popularity of cattle feeding tax shelters,[13] Congress did not remain silent. The 1976 Tax Reform Act added two new sections to the Internal Revenue Code (the Code) which effectively eliminated a farmer's option to use the cash method for most farming corporations and limited partnerships.[14] With these new pieces of legislation Congress pulled the rug out from under the cattle feed tax shelter schemes. Unfortunately, the Service's concurrent attacks upon these tax shelters resulted in court decisions and revenue rulings which failed to differentiate between "tax shelter" farming operations and legitimate farmers. Thus, this indiscriminating adjudication means the issues surrounding Treasury Regulation section 1.471-6(a) are alive and well with respect to individual farmers and farming operations not within the reach of the 1976 legislation. With respect to these farmers, the right to immediate deduction of prepaid feed expenses under the cash method of accounting depends upon recent court decisions rather than Congress. This comment focuses on the recent cases in the area which deal primarily with the business purpose and distortion of income tests.

---

12. *Id.* In 1973, the Service announced Rev. Rul. 73-530, [1973] 7 STAND. FED. TAX REP. (CCH) ¶ 6951 (discussed in Ward, *supra* note 1, at 1122), to address the prepaid expense issue. This ruling was temporarily enjoined by an Oklahoma district court which held the ruling to be an unconstitutional invasion of legislative authority. On appeal, the Tenth Circuit reversed. Cattle Feeders Tax Comm. v. Shultz, 504 F.2d 462, 74-2 USTC ¶ 9732, *rev'g* 74-1 USTC ¶ 9121 (D. Okla. 1973). The ruling was finally issued as Rev. Rul. 75-152.

13. *See* note 7 *supra.*

14. I.R.C. §§ 447, 464. *See* discussion in Part II of text *infra.*

II. Laying the Foundation

A general understanding of the Code definitions of accounting methods and the various limitations on their uses is essential when considering the prepayment problem. One of the taxpayers' principal arguments turns upon interpretation of "inventorying," while the Commissioner of Internal Revenue's (the Commissioner) definition of "clear reflection of income" serves as a primary weapon against deduction of the prepayment. Both of these terms imply arguments, as well as several parallel assertions, grounded in Code sections listing the circumstances under which a particular type of accounting treatment may be used.

A. *General Rules*

1. *Method of Accounting: I.R.C. § 446*

The starting point for any discussion of the Code's treatment of accounting methods must be section 446.[15] Under section 446(a), a taxpayer may, subject to limitations not presently discussed, compute taxable income based upon the method of accounting which the taxpayer regularly uses to keep personal or business books. The general rule under section 446(a) is self-explanatory except for the term "method of accounting." A literal interpretation of the phrase might indicate that the Code is referring only to the general accounting treatment of all items of income and expense. The regulations under section 446, however, state that "method of accounting" includes both the overall method and the accounting treatment of any item.[16] As will be explained later, this regulation

---

15. I.R.C. § 446 provides, in part:

(a) **General Rule.**—Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

(b) **Exceptions.**—If no method of accounting has been regularly used by the taxpayer, or if the method does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.

(c) **Permissible Methods.**—Subject to the provision of subsections (a) and (b), a taxpayer may compute taxable income under any of the following methods of accounting—

(1) the cash receipts and disbursements method;

(2) an accrual method;

(3) any other method permitted by this chapter; or

(4) any combination of the foregoing methods permitted under the regulations prescribed by the Secretary.

16. Treas. Reg. § 1.446-1(a)(1) (1980).

plays a role in the Service's argument that prepaid feed expense should be deducted only when feed is consumed.

Section 446(c) lists permissible methods of accounting, including the cash receipts and disbursements method, the accrual method, any other method permitted by chapter 1 of the Code, or any approved combination of the previously listed methods.[17] The cash method of accounting provides for deduction of expenditures in the year paid and inclusion of income in the year received.[18] The accrual method, on the other hand, has a slightly more complex formula for the year of inclusion or deduction: an expense is deducted when "all events have occurred which establish the fact of the liability giving rise to such deduction";[19] income is included when "all events have occurred which fix the right to receive such income."[20] For both items of income and expense, the accrual method requires an additional condition, that the amount of the item be ascertainable "with reasonable accuracy."[21]

2. *Year of Deduction: I.R.C. § 461*

Section 461 coincides very nicely with section 446(a) by providing that any allowable deduction or credit is to be taken in the taxable year which is proper under the method of accounting used.[22] Therefore, under the cash method expenditures are generally deductible in the taxable year paid, while under the accrual method taxpayers normally deduct expenses in the taxable year when the liability is certain and the amount is ascertainable.

B. *Limitations*

Treasury Regulation section 1.461-1(a)(1) includes a caveat ap-

17. Methods permitted under chapter 1 of the Code include the crop method of accounting, Treas. Reg. §§ 1.61-4, 1.62-12 (1980); the installment method, I.R.C. § 453; long-term contract methods, Treas. Reg. § 1.451-3 (1980); special treatment of research and conservation expenditures, I.R.C. §§ 174-75, respectively.

The regulations recognize that uniformity among taxpayers is not advisable because of circumstances unique to an individual or business; "Each taxpayer shall adopt such forms and systems as are, in his judgment, best suited to his needs." Treas. Reg. § 1.446-1(a)(2) (1980).

18. Treas. Reg. § 1.446-(c)(i) (1980). For a good discussion of all basic accounting methods see Diamond & Holman, 46-4th T.M., *Accounting Methods—Definitions, Permissibility.* A detailed discussion of the cash and accrual methods is provided by Bebee & Misiewicz, 407 T.M., *Cash and Accrual Methods of Accounting.*

19. Treas. Reg. § 1.446-1(c)(ii) (1980).

20. *Id.*

21. *Id.*

22. I.R.C. § 461(a).

plicable to both the cash and accrual methods: "If an expenditure results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year, such an expenditure may not be deductible, or may be deductible only in part, for the taxable year in which made."[23] The only specific example mentioned in the regulations of a situation where this caveat would apply is an expenditure for capital improvements on leased property by the lessee, provided the useful life of the improvements exceeds the period left on the lease.[24] The regulation then refers the reader to section 263 of the Code, which requires that certain expenditures relating to real property be capitalized rather than currently deducted.[25]

Despite the differences between feed expenses and expenditures for improvements of leaseholds or real property, the Service has successfully argued that prepayment of feed creates an asset with a useful life extending beyond the close of the taxable year.[26]

Section 446(b) is the principal limitation on the method of accounting available to a taxpayer. That section provides, "If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income."[27] Thus, the Commissioner is given considerable discretion to require a taxpayer to change his or her method of accounting when, in his opinion, the taxpayer's method does not "clearly reflect income." When the Commissioner has determined a deficiency on this basis, the taxpayer must bear the burden of proving that the challenged accounting method clearly reflects income and this burden is by no means light.[28]

---

23. Treas. Reg. § 1.461-1(a)(1) (1980). This regulation is included in the Treasury's discussion of proper timing of deductions under the cash method. *See also* Treas. Reg. § 1.461-1(a)(2) (1980) where identical language is used in reference to the accrual method. In addition, Treas. Reg. § 1.446-1(a)(4)(ii) (1980) states: "Expenditures made during the year shall be properly classified as between capital and expense. For example, expenditures for such items as plant and equipment, which have a useful life extending substantially beyond the taxable year, shall be charged to a capital account and not to an expense account."

24. Treas. Reg. § 1.461-1(a)(1) (1980).

25. For example, I.R.C. § 263(a)(1) provides: "No deduction shall be allowed for—(1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate."

26. *See, e.g.*, Clement v. United States, 580 F.2d 422, 78-2 USTC ¶ 9566 (Ct. Cl. 1978); Van Raden v. Commissioner, 71 T.C. 1083, 1114 (1979) (Wilbur, J., dissenting).

27. I.R.C. § 446(b).

28. Clement v. United States, 580 F.2d 422, 430, 78-2 USTC ¶ 9566 at 84,778 (Ct. Cl.

As might be expected, neither the Code nor the regulations give much assistance in construing what is meant by "clearly reflecting income." Treasury Regulation section 1.446-1(a)(2), however, does offer some guidance. It provides that consistent, year-to-year accounting in compliance with generally accepted accounting principles in a particular trade or business, and in accordance with accepted conditions or practices of the trade or business, will *ordinarily* be regarded as clearly reflecting income. The regulations do not hint at the extraordinary circumstances that might trigger the application of section 446(b).

Because "method of accounting" includes the accounting treatment of any item, and because of the regulation's presumptions in favor of the Commissioner, the Service's primary argument against prepaid feed expense is made under section 446(b). According to the Service, the deduction of prepaid feed expense in the year of payment does not clearly reflect income (or, as stated by Revenue Ruling 75-152, the deduction results in a "material distortion of income"). To correct the distortion, the Service seeks to require that the farmer-taxpayer deduct the feed expense when the feed is consumed.

Although inventorying is not specifically described as a "method of accounting" under section 446(c), section 471 gives the Commissioner the authority to require a taxpayer to use inventories when necessary "in order clearly to determine the income."[29] Thus, the ambiguous "clear reflection of income" test found in section 446(b) has also been incorporated into section 471. The ambiguity is somewhat clarified by section 471, because of the detailed examples given in the regulations.[30] The most significant instance where inventories are required is a business in which "the production, purchase or sale of merchandise is an income-producing factor."[31] Where the sale of a product is involved, the use of inventories will result in a more perfect matching of income and expenses. Both the matching phenomenon and the inventory process are illustrated by the following example.

1978); Fort Howard Paper Co. v. Commissioner, 49 T.C. 275, 284 (1967).

29. I.R.C. § 471 states:

> Whenever in the opinion of the Secretary the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer on such basis as the Secretary may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

30. Treas. Reg. § 1.471 (1980).

31. Treas. Reg. § 1.471-1 (1980).

Save Humanity From Itself, Inc. produces solar-powered monorail cars to be used in progressive cities throughout the world. Such items as tinted plexiglass windows, orthopedically designed seats, hydraulic platform lifts for handicapped passengers, and educational television monitors are mass-purchased during the course of the year for installation in each car. If the company were not required to inventory, these expenses would be deductible either at the time of payment or on the date the liability for payment becomes fixed.[32] Under the inventory method, however, the cost of component parts of a product is not deductible until the product is sold. A physical inventory of items such as windows and seats is taken at the beginning and at the end of the year, and the total cost of the items inventoried is calculated.[33] To determine the cost of the cars sold during the year (the "cost of goods sold") the amount of the beginning inventory is added to the total cost of all parts purchased during the year and then is reduced by the amount of ending inventory. This technique allows the sales price of each car to be offset by the cost of producing the car, the result being net profit.[34]

The main benefit derived from this accounting process is its theoretically desirable matching of income with the expense incurred to produce that income. Unfortunately, this laudable goal does not bring joy to the hearts of taxpayers for two reasons: (1) a deferred deduction is not worth as much as an immediate one; and (2) with-

32. Treas. Reg. § 1.446-1(c)(1)-(2) (1980).

33. Treas. Reg. § 1.471-1 (1980) provides that "[t]he inventory should include all finished or partly finished goods . . . ." In addition, only those raw materials and supplies "which have been acquired for sale or which will physically become a part of merchandise intended for sale" shall be included in inventory. The most difficult element of the inventorying procedure is assigning a cost to the inventory. This costing process involved such concepts as LIFO inventories (I.R.C. § 472) and the lower of cost or market, which are outside the scope of this paper.

34. The inventory regulations under I.R.C. § 471 do not define "inventory," an unfortunate deficiency which has allowed the Service to argue that requiring deduction of feed expense when feed is consumed is not the same as requiring the taxpayer to inventory. Section 471 regulations are clearly intended to provide the rules for deducting "product costs" (costs incurred in producing a product) as the product is sold. This is most apparent from an example in Treas. Reg. § 1.471-6(e) (1980) where the unit-livestock price method of valuing a farmer's inventory is explained. In that example, a cattle raiser determines that it costs $15.00 to produce a calf and *$7.50 per year to raise it.* The example then provides that the $7.50 per year to raise a calf is allocated to the cost of calves each year (rather than deducted as consumed). One could infer from this example (and other examples throughout this regulation) that I.R.C. § 471 "inventorying" means allocating product costs to an account which accumulates the cost elements of the final product and then deducting these costs as the product is sold. Thus the regulations, read as a whole, are beneficial to the Commissioner's argument that requiring deduction when consumed is not "inventorying."

out an immediate deduction for the cash expenditure, taxpayers may be short of cash when April rolls around.

C. *The Farmer's Historical Preference*

Although a farmer is as much in the business of selling a product as is a manufacturer of monorail cars, Treasury Regulation section 1.471-6(a) gives the farmer the option not to use inventories and to choose, instead, to use the cash method.[35] The justification for this concession, granted to farmers years ago, has been stated in a number of different ways, most of which stem from the nature of the farming business. The explanation most often cited, but hardly enlightening, is that given by the Supreme Court in *Catto v. United States*: "The sacrifice in accounting accuracy under the cash method represents an historical concession by the Secretary and the Commissioner to provide a unitary and expedient bookkeeping system for farmers and ranchers in need of a more simplified accounting procedure."[36]

So why do farmers need a more simplified method of accounting? One reason given is that the costs of "producing" one cow or a bushel of wheat are not as easily ascertainable as the costs of producing manufactured goods.[37] The cost of a farmer's product depends upon the season, the weather and a whole list of other intangibles.[38] These practical difficulties in determining the cost of goods sold are recognized by other regulations which provide farmers who opt to use the inventory system with special methods for allocating cost.[39]

Other possible justifications for the farmers' historical preference are not as persuasive. One author suggested that the special treat-

---

35. *See* note 4 *supra*.

36. United States v. Catto, 384 U.S. 102, 116, 66-1 USTC ¶ 9376 (1966).

37. *See* Davenport, *A Bountiful Tax Harvest*, 48 TEX. L. REV. 1, 2 (1969); Emory, *The Corman and Mills-Mansfield Bills: A Look at Some Major Tax Reform Issues*, 29 TAX L. REV. 1, 76 (1973); Ward, *supra* note 1, at 1148-51. Another practical problem faced by farmers is that under an inventory system the amount of an item that has been consumed in producing unsold products must be determined in order to arrive at a final cost of goods sold. If a cattle feeder starts the year with ten bushels of corn and ends the year with five bushels (with no intervening purchases), and if he sold two of his five cows during the year, theoretically he would determine the cost (in terms of corn) of the cows sold by subtracting ending inventory (five bushels) and the amount of corn consumed by the three remaining cows from beginning inventory. It is very burdensome, however, for the farmer to maintain records of the feed consumed by each cow. *See* Gaddis v. United States, 330 F. Supp. 741, 758, 71-2 USTC ¶ 9527 at 87,134-35 (S.D. Miss. 1971).

38. Heinold v. Commissioner, 39 T.C.M. (CCH) 685, 691 (1979).

39. *See* Treas. Reg. § 1.471-6(d), (e) (1980).

ment may be a disguised tax subsidy due to the average farmer's low income status.[40] Another author noted the average farmer's relative lack of bookkeeping experience.[41]

Whatever the reason for the preference, the fact remains that under Treasury Regulation section 1.471-6(a), most farmers may not be required to inventory. The taxpayer, therefore, has argued that the Commissioner will violate that regulation if he forces the taxpayer-farmer to deduct feed expense at the time feed is consumed, a requirement that will at least entail taking a physical inventory.

D. *Recent Congressional Response*

The foundation of this comment will not be complete unless it is recalled that some types of farmers have been legislatively excluded from the scope of Treasury Regulation section 1.471-6(a). Code section 447, passed by Congress as part of the 1976 Tax Reform Act, no longer allows farming corporations or farming partnerships with a corporate partner the option to use the cash method.[42] Except for certain small corporations, subchapter S corporations, and family corporations, corporate farmers must use the accrual method "with the capitalization of preproductive period expenses."[43] This latter clause, in essence, requires the deduction of costs related to the production of crops or livestock in the year when the crops or livestock are sold.[44]

Section 464, also part of the 1976 Tax Reform Act, is aimed at limited partnerships typically used in the present tax shelter scheme. This section provides that "farming syndicates," defined to include most tax shelter vehicles, must deduct amounts paid for such items as feed, seed and fertilizer when the items are

---

40. *See* Davenport, *supra* note 37, at 44-49.

41. J. O'Byrne, Farm Income Tax Manual § 104(a) (5th ed. 1977).

42. I.R.C. § 447(a) provides:

(a) **General rule.**—Except as otherwise provided by law, the taxable income from farming of—

(1) a corporation engaged in the trade or business of farming, or

(2) a partnership engaged in the trade or business of farming, if a corporation is a partner in such partnership,

shall be computed on an accrual method of accounting and with the capitalization of preproductive period expenses . . . .

43. *Id.*

44. I.R.C. § 447(b)(1) states that in general: "For purposes of this section, the term 'preproductive period expenses' means any amount which is attributable to crops, animals, or any other property having a crop or yield during the preproductive period of such property."

consumed.[45]

Although deduction of prepaid farming expenses in the year purchased is no longer available to large farming corporations or "farming syndicates," there remains a sizeable group of farmers not covered by the recent legislation. For the individual farmer or family-owned farming operation, the cash method of accounting may be preferable both because the taxes due more closely coincide with the cash available and because bookkeeping is simplified. If for business reasons these cash basis farmers must purchase more feed or fertilizer than can be used in the tax year, disallowing a deduction of that expense may result in tax liabilities which the small farmer cannot realistically meet. Thus, the question of the proper timing of prepaid farming expenses remains of great concern to those farmers not within the scope of sections 447 and 464. For any resolution of the issue, the farmer must wade through the muddy waters of recent cases.

III. Recent Case Law

Recent decisions subsequent to the Service's statement of its position in Revenue Ruling 75-152 indicate that the situation is not any clearer; in fact, the waters are murkier than ever. The Court of Claims has taken the side of the Service, requiring prepaid feed

---

45. I.R.C. § 464(a) provides:

(a) **General rule.**—In the case of any farming syndicate (as defined in subsection (c)), a deduction (otherwise allowable under this chapter) for amounts paid for feed, seed, fertilizer, or other similar farm supplies shall only be allowed for the taxable year in which such feed, seed, fertilizer, or other supplies are actually used or consumed, or, if later, in the taxable year for which allowable as a deduction (determined without regard to this section).

. . . .

(c) **Farming syndicate defined.**—

(1) **In general.**—For purposes of this section, the term "farming syndicate" means—

(A) a partnership or any other enterprise other than a corporation which is not an electing small business corporation (as defined in section 1371 (b)) engaged in the trade or business of farming, if at any time interests in such partnership or enterprise have been offered for sale in any offering required to be registered with any Federal or State agency having authority to regulate the offering of securities for sale, or

(B) a partnership or any other enterprise other than a corporation which is not an electing small business corporation (as defined in section 1371 (b)) engaged in the trade or business of farming, if more than 35 percent of the losses during any period are allocable to limited partners or limited entrepreneurs.

expenses to be deducted when consumed.[46] The Tax Court, however, has consistently held for the taxpayer, basing its decisions both upon the historical preference given to farmers and upon a mystical union of the "business purpose" and the "clear reflection of income" tests.[47] The Sixth Circuit has also held for the taxpayer, but its analysis of the problem derives primarily from an implied limitation of the Service's authority under section 446.[48]

The most recent prepaid feed expense cases generally deal with a limited partnership organized at the end of the tax year for the purpose of operating a cattle feeding business. The partnership immediately purchases large quantities of feed, most of which will be consumed in the following year; thus, the partnership has no income for its short tax year, but reports the entire amount of feed purchased as a deduction. The cash basis taxpayer, a limited partner, claims a share of the ordinary loss generated by the feed expense to offset against personal income.[49]

A. *Owens v. Commissioner*

Owens v. Commissioner[50] involves only a slight deviation from the normal fact pattern because the business entity was a corporation rather than a limited partnership. The taxpayer, as transferee of the corporation's assets, was potentially liable for any deficiency due to the corporation's deduction of prepaid feed expenses.[51]

The Tax Court disallowed the deduction, finding that the purchases of feed were made by a refundable deposit rather than an actual payment.[52] Re-examining the purchase contracts, the Sixth Circuit disagreed with the Tax Court. It held that because the parties contracted for and adhered to a fixed price, the purchases were not made on the basis of a refundable deposit.[53]

---

46. Clement v. United States, 580 F.2d 422, 78-2 USTC ¶ 9566 (Ct. Cl. 1978).

47. Van Raden v. Commissioner, 71 T.C. 1083 (1979); Rocco, Inc. v. Commissioner, 72 T.C. 140 (1979); De La Cruz v. Commissioner, 37 T.C.M. (CCH) 24 (1978); Haynes v. Commissioner, 38 T.C.M. (CCH) 950 (1979); Heinold v. Commissioner, 39 T.C.M. (CCH) 685 (1979).

48. Owens v. Commissioner, 568 F.2d 1233, 78-1 USTC ¶ 9144 (6th Cir. 1977), *aff'g and rev'g* 64 T.C. 1 (1975).

49. Although the majority of the cases revolve around a limited partnership, the courts have made no distinction between partnership or corporate farming operations and individual farmers for purposes of analysis.

50. 568 F.2d 1233, 78-1 USTC ¶ 9144 (6th Cir. 1977), *aff'g and rev'g* 64 T.C. 1 (1975).

51. *Id.* at 1236, 78-1 USTC at 83,148.

52. 64 T.C. at 19.

53. 568 F.2d at 1244, 78-1 USTC at 83,154.

The Sixth Circuit, therefore, was forced to reach the Commissioner's second contention that the deduction in the year of purchase did not clearly reflect income. Under section 446(b), the Commissioner sought to reallocate a portion of the feed expense to the year when it was actually consumed.[54] The court was not impressed, and the Commissioner's argument was disposed of in a single paragraph without any mention of the farmer's historical option to use the cash method of accounting.

The court noted that the Commissioner had the authority under section 446 to change the accounting treatment of any item of income or deduction in order to clearly reflect income;[55] however, according to the court, a limitation on this power was implied in the regulations:

> The problem with the Commissioner's argument is that under Regulation section 1.446(a)(1), the Commissioner is required to choose some other method of accounting that would more accurately reflect income, and in the present case it is not apparent that any other method of accounting would lead to a different result than the cash receipts and disbursements method of handling the feed expense deduction. It would not be different with the accrual method.[56]

Under the accrual method, liabilities may be deducted in the taxable year when all events have occurred which establish the liability, if the dollar amount of the expense is reasonably certain.[57] A cash prepayment of a fixed amount under a contract meets the above stated test; therefore, the cash and accrual methods would treat prepaid feed expense the same.[58] There was no discussion of the appropriateness of capitalizing the expense (deducting when consumed) or of requiring the taxpayer to inventory under section 471 (treating the expense as part of the cost of cattle and deducting it when the cattle are sold).

B. *Clement v. United States*

Shortly after the Sixth Circuit wrestled with farmers' prepaid feed expense in *Owens*, the Court of Claims was faced with the

54. *Id.* at 1243 n.8, 78-1 USTC at 83,153 n.8.
55. *Id.* at 1245, 78-1 USTC at 83,155.
56. *Id.* at 1246, 78-1 USTC at 83,155.
57. *Id. See* Treas. Reg. § 1.446-1(c)(1)(ii) (1980).
58. 568 F.2d at 1246, 78-1 USTC at 83,155-56.

same issue in *Clement v. United States*.[59] The *Clement* taxpayer, a limited partner of a cattle feeding business, was not as fortunate as the taxpayer in *Owens*. In a lengthy per curiam opinion, the trial judge's decision in favor of the taxpayer was reversed, and the taxpayer was required to deduct the prepaid expenses in the year or years when the feed was consumed.

The issues in *Clement* were framed by the conditions for deduction found in Revenue Ruling 75-152: (1) the prepayment is not merely a deposit; (2) the expenditure is made for a business purpose rather than a tax avoidance purpose; and (3) deduction of the expense does not result in a material distortion of income. Since the Government did not argue that the expenditure was a deposit,[60] only the latter two conditions were at issue. Additionally, the taxpayer argued that even if a material distortion of income existed, the regulation giving a farmer the option not to inventory precluded the Commissioner from requiring the taxpayer to deduct feed expense when consumed.[61] The trial judge's opinion and the court's opinion differed only as to this last issue.[62]

1. *Business Purpose versus Tax Avoidance Purpose*

Initially, the *Clement* taxpayer protested the requirement that he justify the timing of his feed expense because the purchase of feed was obviously "ordinary and necessary" under section 162 of the Code.[63] The taxpayer relied on *Mann v. Commissioner*,[64] where the Eighth Circuit searched in vain for cases supporting the Government's argument that the taxpayer must prove some nontax benefit resulting from the timing of the prepayment.[65] The *Clem-*

---

59. 580 F.2d 422, 78-2 USTC ¶ 9566 (Ct. Cl. 1978).

60. *Id.* at 424 n.1, 78-2 USTC at 84,773 n.1.

61. *Id.* at 432, 78-2 USTC at 84,779.

62. In fact, the court adopted verbatim the opinion of the trial judge as to the first two issues (whether a business purpose existed and whether the deduction materially distorted income). *Id.* at 424, 78-2 USTC at 84,773.

63. *Id.* at 427, 78-2 USTC at 84,775. Section 162(a) provides: "There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . . ."

64. 483 F.2d 673, 73-2 USTC ¶ 9618 (8th Cir. 1973). The taxpayer also cited Cravens v. Commissioner, 272 F.2d 895, 60-1 USTC ¶ 9139 (10th Cir. 1959); Gaddis v. United States, 330 F. Supp. 741, 71-2 USTC ¶ 9527 (S.D. Miss. 1971); Ernst v. Commissioner, 32 T.C. 181, 185-86 (1959).

65. The *Mann* court stated that it found "no substantial support . . . to support the Government's contention that a benefit to the taxpayer is necessary to support the timing of a business expense deduction which meets the terms of § 162(a) . . . ." 483 F.2d at 680, 73-2 USTC at 82,002.

ent court noted that several of the cases cited by the taxpayer as questioning the necessity of the business purpose test nevertheless went on to discover a business purpose for the timing of the prepayment.[66] Even the strong language of the *Mann* court was mere dicta, because that court had already acknowledged the existence of a business purpose.[67] Faced with a balanced lack of support for either position, the court in *Clement* was reluctant to disregard the motives of the taxpayer; "Acceptance of the [taxpayer's] proposition would confront the policy that tax consequences should be based on business reality and not on mere events created to avoid taxes."[68] No such confrontation occurred, however, since the court went on to find a business motive for buying substantial quantities of feed in December—an assured supply of feed at a fixed (and historically lower) price.[69]

2. *Material Distortion of Income*

Citing Treasury Regulation section 1.471-6(a), the taxpayer argued that the Commissioner could not use his powers under section 446(b) of the Code against a farmer using the cash method of accounting.[70] This argument, however, was quickly rejected by the court in light of the Commissioner's broad discretion under section 446(b) and his ability to change the accounting treatment of any one item in order to clearly reflect income.[71] In addition, the court cited several cases (none involving farmers) holding that the Commissioner was authorized to alter the accounting treatment of an item on the ground that improper timing of a deduction materially distorted income.[72] The court also briefly mentioned Treasury Regulation section 1.461-1(a)(1), a section that would be invoked later to the benefit of the Commissioner.

---

66. 580 F.2d at 427, 78-2 USTC at 84,775. The Court of Claims cited Ernst v. Commissioner, 32 T.C. 181 (1959), as the only case where the court actually failed to find a business purpose. Since the principle issue in *Ernst* was whether a payment or a deposit was made, the *Clement* court found *Ernst* to be distinguishable. 580 F.2d at 427, 78-2 USTC at 84,775.

67. 580 F.2d at 427, 78-2 USTC at 84,775.

68. *Id.*, 78-2 USTC at 84,775-76.

69. *Id.* at 427-28, 78-2 USTC at 84,776.

70. *Id.* at 430, 78-2 USTC at 84,778. *See* note 15 *supra*.

71. 580 F.2d at 430, 78-2 USTC at 84,778.

72. *Id.* at 430-32, 78-2 USTC at 84,777-79. The court cited Burck v. Commissioner, 533 F.2d 768, 76-1 USTC ¶ 9283 (2d Cir. 1976) (prepaid interest); Commissioner v. Boylston Mkt. Ass'n, 131 F.2d 966, 42-2 USTC ¶ 9820 (1st Cir. 1942) (prepaid insurance premiums); Sandor v. Commissioner, 62 T.C. 469 (1974), *aff'd*, 536 F.2d 874, 76-2 USTC ¶ 9488 (9th Cir. 1976) (prepaid interest); Lovejoy v. Commissioner, 18 B.T.A. 1179 (1930) (prepaid loan fees).

Satisfied that section 446(b) was applicable to the situation, the court had little difficulty finding a material distortion of income. Though the factors cited in Revenue Ruling 75-152 were to be used "as a guide,"[73] the court ignored all but the monetary differences between income as computed by the taxpayer and as computed by deducting the expense in a subsequent year. Because the choice of year for deduction would result in very different income figures, deduction in the year of payment was found to cause a material distortion.[74]

3. *Historical Preference*

Having agreed on the presence of a business purpose and a material distortion of income, the trial judge and the court parted company. The trial judge found that even though income was not clearly reflected, the Commissioner could not force a cash basis farmer to deduct feed expense when the feed is consumed, rather than when payment is made. Such a requirement, the trial judge reasoned, would "indirectly" force the taxpayer to use an inventory method, a result prohibited by Treasury Regulation section 1.471-6(a) (which gives farmers the option not to use an inventory method of accounting).[75]

The court interpreted Treasury Regulation section 1.471-6(a) much differently. For a number of reasons, the court concluded that the Commissioner's required deduction of feed when consumed was a perfectly appropriate adjustment under the cash method; it therefore did not impose an inventory method of accounting. The court's position was supported primarily by Treasury Regulation section 1.461-1(a)(1), which is part of the Treas-

---

73. 580 F.2d at 431, 78-2 USTC at 84,779. Rev. Rul. 75-152, 1975-1 C.B. 144, lists factors to be considered in determining whether a material distortion of income exists: "[T]he customary business practice of the taxpayer in conducting his livestock operations, the amount of the expenditure in relation to past purchases, the time of the year the expenditure was made, and the materiality of the expenditure in relation to the taxpayer's income for the year." 75-1 C.B. at 145.

74. 580 F.2d at 431, 78-2 USTC at 84,779. As in *Clement*, a finding of "material distortion of income" often turns upon a comparison of dollar amounts of taxable income under both the accrual method and cash method accounting. *See, e.g.*, Sandor v. Commissioner, 536 F.2d 874, 76-2 USTC ¶ 9488 (9th Cir. 1976); Baird v. Commissioner, 68 T.C. 115 (1977); Cole v. Commissioner, 64 T.C. 1091 (1975). The disparity in amount may be a sure indication of materiality, but the courts often fail to explain why the method chosen by the taxpayer, rather than by the Commissioner, "distorts" income. See Judge Hall's criticism of the practice of comparing results under accrual and cash methods. *Cole*, 64 T.C. at 1107 (Hall, J., concurring).

75. 580 F.2d at 432, 78-2 USTC at 84,779.

ury's discussion of when expenses may be deducted under the cash method. This regulation provides either for partial deduction or no deduction of an expenditure in the year made if the payment "results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year . . . ."[76] According to the court, feed was a "separate and distinct asset" with a useful life exceeding the taxable year.[77]

The court stated that application of section 1.461-1(a)(1) to prepaid feed expenses of a cash basis farmer did not operate to force the taxpayer to use the inventory system; rather "what the Service did was to treat plaintiffs like other cash-method taxpayers."[78] This result was supported by a rather loosely woven discussion of "period costs" and "product costs," terms generally used to delineate the proper accounting procedure for expenses under the inventory method. The court explained that " '[p]roduct costs' are incurred in producing a product and are accounted for, under the inventory method, only on the sale of the products to which they relate . . . ."[79] Period costs, however, "arise with respect to time intervals rather than with particular products or services . . . ."[80]

The inventory system of accounting, which requires certain items to be inventoried at year's end and deducted when the related product is sold, applies only to product costs.[81] Since the Commissioner was not requiring the taxpayer to deduct feed expense when the cattle were sold, the court reasoned that section 1.471-6(a) was not violated.[82] Feed, normally a product cost, was being treated instead as a period cost, deductible when the feed was consumed.[83] The court stated that "[f]or all cash-method taxpayers, comparable 'period costs' (where there would otherwise be income distortion) would be spread over a time span . . . ."[84] Finding no evidence that cash basis farmers were to be treated any

---

76. Treas. Reg. § 1.461-1(a)(1) (1980). *See also* Treas. Reg. § 1.461-1(a)(2) (1980) where the same language is also applied to accrual method taxpayers.

77. 580 F.2d at 432 n.9, 78-2 USTC at 84,780 n.9.

78. *Id.* at 433, 78-2 USTC at 84,780. *Cf.* Gold-Pak Meat Co. v. Commissioner, 522 F.2d 1055, 1057, 75-2 USTC ¶ 9693 at 88,106 (9th Cir. 1975) ("Treas. Reg. § 1.471-6 gives a farmer a favor which comports with the general beneficence given farmers by Congress and it is not lightly to be taken away by another regulation. Maybe it should be taken away, but that is not our function.").

79. 580 F.2d at 432 n.7, 78-2 USTC at 84,780 n.7.

80. *Id.* at n.8, 78-2 USTC at 84,780 n.8.

81. *Id.* at 432, 78-2 USTC at 84,780.

82. *Id.* at 432 n.7, 78-2 USTC at 84,780 n.7.

83. *Id.* at 433, 78-2 USTC at 84,780.

84. *Id.*

differently than other cash method taxpayers, and assuming that an inventory system was not being imposed, the court required that the taxpayer's feed expense be spread over the period consumed.[85]

C. *Van Raden v. Commissioner*

The facts of *Van Raden v. Commissioner*[86] are substantially similar to those in *Clement* with one additional aspect—the *Van Raden* taxpayer purchased his interests in the limited partnership shortly after receiving an extraordinary capital gain of $2 million in the same tax year. As will be seen, this indication of tax motivation had little influence on the Tax Court.

Reviewed by the full court, the *Van Raden* case is indicative of the confusion in the area of prepaid feed expense. The majority opinion by Judge Goffe drew a concurring opinion by Judge Tannenwald (joined by four other judges), a dissent by Judge Wilbur (joined by two other judges) and a dissent by Judge Chabot. Rather than explaining each opinion separately, this comment will analyze the case issue by issue, with a discussion of how the judges differed.

1. *Business Purpose*

Unlike the taxpayer in *Clement*, the *Van Raden* taxpayer did not challenge the applicability of the business purpose test to the timing of the deduction.[87] Instead, the taxpayer relied upon testimony of the manager of the limited partnership and upon statistics of corn prices over the previous seven years to prove that corn prices are generally lower near the end of the year. The court found that the evidence was sufficient to establish a business purpose, particularly since the Service did not offer any evidence to rebut either the manager's testimony or the statistics.[88]

The court was not concerned that the taxpayer's need to offset a massive capital gain may have motivated the transaction.[89] The

85. *Id.*

86. 71 T.C. 1083, 1084 (1979).

87. *Id.* at 1097. In his concurring opinion, Judge Tannenwald felt "constrained to mention" that the appropriateness of the business purpose test was suspect, but did not pursue the issue further. *Id.* at 1112.

88. *Id.* at 1099.

89. *Id.* at 1100. The *Van Raden* majority cited Frank Lyon Co. v. United States, 435 U.S. 561, 580, 78-1 USTC ¶ 9370 at 83,883 (1978), where the Supreme Court stated that "[t]he fact that favorable tax consequences were taken into account by Lyon [the taxpayer]

concurring opinion placed slightly more emphasis on tax avoidance motives, but found enough economic reality to legitimize the transaction.[90]

Judge Wilbur, in his dissent, stated that the majority's finding of business purpose was "surprising."[91] He believed that the taxpayer was acting against his business interests by purchasing feed every December, rather than earlier in the fall harvest when prices were even lower.[92] According to Judge Wilbur, the tax motivation for the timing of the purchase should preclude immediate deduction of the expense.[93]

2. *Material Distortion of Income*

The *Van Raden* taxpayer contested the use of section 446(b) on a cash-method farmer with an argument similar to that raised by the taxpayer in *Clement*. The *Van Raden* taxpayer argued that section 446(b) conflicted with the option given farmers to use the cash method and section 461, which provides generally for deduction of expenses in the taxable year which would be proper under the taxpayer's chosen method of accounting.[94] The majority followed *Clement* on this point, stating that "nothing in the case law cited by petitioners convinces us that section 446(b) cannot be used by the Commissioner to prevent abuses by farmers who report on the cash method of accounting."[95]

After deciding that section 446(b) should be applied at the partnership level,[96] the court was next faced with the question "whether the Commissioner abused his discretion in his determination that the partnership must use an inventory method of accounting for the feed in order to clearly reflect income."[97] Unlike the *Clement* court, the majority in *Van Raden* went beyond the

---

on entering into the transaction is no reason for disallowing those consequences."

90. 71 T.C. at 1111-12.

91. *Id.* at 1115.

92. *Id.* at 1116.

93. *Id.*

94. *Id.* at 1102.

95. *Id.* at 1103. The concurring opinion of Judge Tannenwald was more favorable to the taxpayer on this point. Judge Tannenwald felt that the Treasury's concession to farmers under Treas. Reg. § 1.471-6(a) amounted to the Commissioner's "agreement that the 'clearly reflect income' requirement of section 446(b) is deemed to have been satisfied." *Id.* at 1111.

96. *Id.* at 1104.

97. *Id.* It might be noted that the court framed the issue assuming, without discussion, that the Commissioner's requirement of deducting feed expense when consumed forced the taxpayer onto the inventory method. Later in the opinion the court explained its position more fully.

dollar amounts involved in determining whether income was actually distorted. The court first pointed out that the cash method of accounting, by its nature, will not result in income perfectly matched with expenses; the benefits derived from the expenses will often spill over into more than one accounting period.[98] Consistent application of the cash method over a period of years, however, would tend to eliminate the inherent distortions.[99]

Perceiving that the taxpayer's treatment of prepaid expenses was consistent over years of business activity and was in accord with generally accepted accounting principles (GAAPs),[100] the court reasoned that the method would be regarded as clearly reflecting income unless the GAAPs conflicted with the regulations.[101] The court noted that the Commissioner's own regulations gave farmers the option to use the cash method without inventorying. The court further stated, with some sarcasm, that the Commissioner "does not contend that his own regulations prescribed an optional accounting system that does not clearly reflect income."[102]

At this point, the court embarked upon a line of reasoning which brought criticism from both dissenting opinions. Because the accounting method of a particular business is often dictated by trade conditions or practices, the court felt that distortion of income could not be properly determined without examining the business considerations surrounding the challenged transaction.[103] In other

---

98. *Id.*

99. *Id. See also* Gold-Pak Meat Co. v. Commissioner, 522 F.2d 1055, 1057, 75-2 USTC ¶ 9693 at 88,106 (9th Cir. 1975); Spitalny v. United States, 430 F.2d 195, 197, 70-2 USTC ¶ 9545 at 84,323 (9th Cir. 1970).

100. " 'Generally accepted accounting principles' are a body of rules used to 'indicate whether [a] company being audited has prepared its financial statements in an acceptable manner, so that they may fairly be compared with the prior year's statements and with the financial statements of other companies.' " W. MEIGS, A. MOSICH, C. JOHNSON & C. KELLER, INTERMEDIATE ACCOUNTING 12 (3d ed. 1974). These accounting principles, although not contained in one specific source, represent the theoretically proper accounting techniques to be used in analyzing and compiling financial data. *Id. See also,* Note, *Generally Accepted Accounting Principles: Instruction H(f) and the Preferability Issue,* 11 VAL. U.L. REV. 229, 230 (1977).

101. 71 T.C. at 1105. The court was dangerously close to granting a presumption in favor of the taxpayer if GAAP were met. The recent Supreme Court decision of Thor Power Tool Co. v. Commissioner, 99 S.Ct. 773, 785, 79-1 USTC ¶ 9139 at 86,134 (1979), *cited in Van Raden,* 71 T.C. at 1105, strongly denied such a presumption, stating that conformance with GAAPS and clear reflection of income were separate tests, with clear reflection of income having greater weight.

102. 71 T.C. at 1105.

103. *Id.* Some examples given by the court of accounting methods suited to a particular business included inventorying for a product manufacturing or sales business, Treas. Reg. § 1.446-1(a)(4)(i) (1980); a crop method of accounting for farmers, Treas. Reg. § 1.446-

words, a distortion which results from the method of operation of the business rather than from the method of accounting alone is not the type of distortion which may be attacked by the Commissioner. As an example, the court considered the case of a retail business which had income much greater in December than in January because of the relative success of the sales force. The court analogized this business-created distortion of income to the distortion involved when prepaid feed expenses are deducted in the year of payment: "Should the result be different if the taxpayer purchases a year's supply of its primary cost item at its lowest cost consistently from year to year? We do not think so."[104] The general rule emerging from the court's analysis, previously recognized only implicitly (and even this was debated[105]), is that "a substantial legitimate business purpose satisfies [*i.e.*, does not offend] the distortion of income test."[106] Having already found that a business purpose existed for the prepayment, the court concluded that the taxpayer's accounting method clearly reflected income.

The dissenting opinions, particularly that of Judge Chabot, opposed the union of the business purpose test with the question of whether an accounting method clearly reflects income.[107] According to Judge Chabot, the majority effectively nullified section 446(b) with respect to prepaid feed expense.[108] He relied on *Baird v. Commissioner*[109] for the proposition that the existence of a business purpose is merely a factor in determining whether there is a distortion of income.

3. *Historical Preference*

The majority in *Van Raden* refused to follow the *Clement*

1(c)(10)(iii) (1980); and not requiring formal books for a wage earner, Treas. Reg. § 1.446-1(b)(2) (1980).

104. 71 T.C. at 1106.

105. *See id.* at 1117 (Chabot, J., dissenting).

106. *Id.* at 1106. The majority cited Sandor v. Commissioner, 62 T.C. 469 (1974), *aff'd*, 536 F.2d 874, 76-2 USTC ¶ 9488 (9th Cir. 1976) as implicitly recognizing this general rule. Other cases cited by the court for this proposition were Maple Leaf Farms, Inc. v. Commissioner, 64 T.C. 438 (1975); Hi-Plains Enterprises, Inc. v. Commissioner, 60 T.C. 158 (1973), *aff'd*, 496 F.2d 520, 74-1 USTC ¶ 9431 (10th Cir. 1974); Stokes v. Commissioner, 22 T.C. 415 (1954).

107. 71 T.C. at 1117 (Chabot, J., dissenting). Judge Wilbur called the majority's position "dubious" but did not discuss the issue at length. Since he felt that no business purpose existed, in his opinion the taxpayer should have lost even under the majority's test. 71 T.C. at 1115-16 (Wilbur, J., dissenting).

108. 71 T.C. at 1117.

109. 68 T.C. 115, 133 (1977).

court's analysis of the farmers' historical option to elect not to inventory.[110] The *Clement* court, as well as Judge Wilbur's dissenting opinion,[111] concluded that the feed expense was being treated as a period cost, for purposes of Treasury Regulation section 1.461-1(a)(1). The *Van Raden* majority, however, could not so easily reclassify feed as a period cost.

The court believed that one of the major differences between period and product costs was that period costs may be allocated with convenience, usually by simple division of the cost by the number of months over which its useful life extends.[112] Because product costs, such as feed, are related to the production process, variations in production will increase or decrease the rate of allocation.[113] To properly determine when cattle feed is consumed would require the farmer to maintain an inventory of feed from year to year or to keep records of consumption which is, in essence, a continual inventory.[114] The court concluded that requiring either system would conflict with the regulation allowing farmers to choose to forgo inventorying.[115]

In his concurrence, Judge Tannenwald enthusiastically agreed with the majority's analysis of this issue. In fact, Judge Tannenwald would have decided for the taxpayer solely upon the basis of the farmers' historical preference, without considering the other issues. Supported by Gertrude Stein's definition of a rose,[116] he admonished the Court of Claims for engaging in "sheer semantic legerdemain" when they characterized feed expenditures as period costs rather than an element of cost of goods sold.[117] Although he recognized that deducting feed expense when consumed is different from inventorying it as part of the cost of cattle, he insisted that the Service's position would still require farmers to maintain an inventory of their feed, a requirement in direct conflict with the farmer's right to use the cash method under Treasury Regulation section 1.471-6(a).[118]

---

110. 71 T.C. at 1107.
111. *Id.* at 1114.
112. *Id.* at 1108.
113. *Id.*
114. *Id.*
115. *Id.*
116. " 'A rose is a rose, is a rose, is a rose.' " *Id.* at 1111 (quoting G. STEIN, GEOGRAPHY AND PLAYS: SACRED EMILY 187 (1922)). To complete the analogy: a product cost is a product cost, is a product cost; calling it a "period cost" will not make it so.
117. 71 T.C. at 1111.
118. *Id.*

IV. Other Recent Decisions and Rulings

A. *Tax Court*

In two recent Tax Court memo decisions, *Haynes v. Commissioner*[119] and *Heinold v. Commissioner*,[120] the Tax Court substantially adhered to the position it adopted in *Van Raden*. The Service, however, altered its emphasis to conform more closely to the *Clement* opinion. The primary argument of the Service in both cases was that feed is a capital asset subject to the rules for capitalizing expenditures under Treasury Regulation section 1.461-1(a)(1).[121] This argument was used in conjunction with the Service's old standby: immediate deduction of the full amount did not clearly reflect income; therefore, the Commissioner had the authority under section 446(b) to require deduction as the feed was consumed.[122] In addition, the Service argued in *Heinold* that the taxpayer had no business purpose for the prepayment. The Service conceded business purpose in *Haynes*.[123]

In deciding for the taxpayer, both the *Haynes* and *Heinold* courts made a very important subtraction from and addition to the *Van Raden* opinion.[124] The subtraction, quite obvious and very puzzling, is found in their consideration of the distortion of income test. In *Van Raden* the court had stated unequivocally that "a substantial legitimate business purpose satisfies [*i.e.*, does not offend] the distortion of income test."[125] Yet in *Haynes* and *Heinold* the courts, having recognized a valid business purpose, resolved the distortion issue by relying upon the cash method's tendency to correct distortions over a period of time.[126] Neither court mentioned business purpose in conjunction with the distortion of income test.

The addition to *Van Raden* may have resulted from its analysis of whether income was clearly reflected; however, the substance of this new rationale is not apparent in previous cases. Although rec-

---

119. 38 T.C.M. (CCH) 950 (1979).

120. 39 T.C.M. (CCH) 685 (1979).

121. *Haynes*, 38 T.C.M. (CCH) at 953; *Heinold*, 39 T.C.M. at 690. The Service also mentioned "the principles of I.R.C. § 263," even though that section has no relation to prepaid feed expense. 38 T.C.M. (CCH) at 953-54.

122. *Haynes*, 38 T.C.M. (CCH) at 952; *Heinold*, 39 T.C.M. (CCH) at 688.

123. In neither case did the taxpayer challenge application of the business purpose test to the timing of feed deductions.

124. The importance of these modifications is amplified by the fact that the judges who wrote these opinions, Judge Featherston and Judge Wiles, were members of the *Van Raden* majority.

125. 71 T.C. at 1106.

126. *Haynes*, 38 T.C.M. (CCH) at 953; *Heinold*, 39 T.C.M. (CCH) at 691.

ognizing that income was distorted, the *Haynes* and *Heinold* courts rejected the Commissioner's attempt to use section 446(b) as a springboard into section 1.461-1(a)(1) of the regulations, reasoning that:

> The distortion in the partnership's 1973 income is not attributable to the failure to feed all the purchased grain in that year. It is due to the partnership's failure to sell cattle so that income would be available to match the cost of the purchases. The same distortion would have occurred if the partnership had fed all the grain in 1973 and sold none of its cattle. Distortions of this character can be prevented only by requiring farmers to employ a method of accounting which requires a matching of income with expenses. Yet the regulations . . . expressly permit farmers to use the cash method of accounting.[127]

In essence, the courts are pointing out that the Commissioner's discretion under section 446(b) is limited to changing a taxpayer's method of accounting to a method which "*does* clearly reflect income."[128] Since feed expense is a "product cost" (a part of cost of goods sold), the only way to "clearly reflect" the taxpayer's income is to require feed expense to be deducted when the cattle are sold; allowing deduction when the feed is consumed does not promote a clear reflection of income.[129] Yet, the Commissioner cannot require a farmer to treat prepaid feed as an element of cost of goods sold because of section 1.471-6(a).

Despite the logic of the foregoing analysis, both courts felt compelled to provide more support for their position. Each court distinguished cattle feed from the type of asset dealt with in section 1.461-1(a)(1); however, the *Heinold* court's analysis was more persuasive.[130] As in *Van Raden,* the *Heinold* court stated that section 1.461-1(a)(1) applies only to "period costs," expenditures which

---

127. 38 T.C.M. (CCH) at 954.

128. I.R.C. § 446(b) does indicate that "the opinion of the Secretary" is important in determining the proper accounting method.

129. Requiring deduction when feed is consumed rather than when it is paid for may help promote a clearer reflection of income; however, the Commissioner, under I.R.C. § 446(b), does not have discretion to require a change in accounting methods unless the new method "does clearly reflect income."

130. The *Haynes* court tackled the regulation with the argument that: "The term 'useful life' refers to an asset which is gradually exhausted through use or the passage of time. Cattle feed does not deteriorate with the passage of time or become exhausted through use over an extended period." 38 T.C.M. (CCH) at 954-55. Although this may be a valid distinction, it is difficult to see why cattle feed is not "exhausted through use over an extended period of time."

"arise with respect to time intervals."[131] Feed costs, which "depend upon the size of the production process," would not be reclassified as "period costs" for the convenience of the Commissioner.[132]

The *Heinold* court also rejected the Commissioner's section 461 argument because farmers would be forced to take inventories or maintain consumption records, a requirement that directly conflicts with the historical preference given to farmers in *Catto.*[133]

B. *District Court*

Without the benefit of the *Van Raden* decision, in *Dunn v. United States,*[134] the Southern District of New York relied primarily on Revenue Ruling 75-152 to resolve a prepaid cattle feed expense case in favor of the government. A major portion of the opinion was spent in deciding whether the ruling should be applied to the taxpayer retroactively. Finding for the Commissioner on that issue,[135] the court briefly considered the remaining issue of whether the prepayment resulted in a material distortion of income. The facts of *Dunn* were particularly egregious—a hurried, yearend purchase of feed with little or no evidence of business purpose. The court had little difficulty in finding a material distortion.[136] Mentioning section 1.471-6(a) in a footnote,[137] the court did not discuss the possibility of conflict between the regulation and the Commissioner's requirement that the taxpayer deduct feed expense when the feed was consumed.

C. *Revenue Ruling 79-229*

The Service responded to the *Van Raden* decision by issuing Revenue Ruling 79-229,[138] essentially a restatement of Revenue Ruling 75-152 buttressed by additional arguments and citations of authority. The three-part test established in Revenue Ruling 75-152 was left untouched, but support for both the business purpose and material distortion of income tests was fortified.

---

131. 39 T.C.M. (CCH) at 691.
132. *Id.*
133. *Id.*
134. 468 F. Supp. 991, 79-1 USTC ¶ 9295 (S.D.N.Y. 1979).
135. *Id.* at 995, 79-1 USTC at 86,670.
136. *Id.* at 996, 79-1 USTC at 86,670.
137. *Id.* at 994 n.14, 79-1 USTC at 86,668-69 n.14.
138. 1979-31 I.R.B. 6.

1. *Business Purpose*

The principle addition to the Service's position under the business purpose test was a warning to those "farmers" who did not have "a significant capital investment in agricultural assets in addition to the feed and animals involved."[139] According to the Service, these investor-farmers are usually participants in a tax shelter scheme where the investors contribute an amount sufficient to purchase the feed, which is then used as collateral for the purchase of cattle. In the future, such transactions will be more carefully scrutinized by the Service to discover the true motives of the investor.[140]

2. *Distortion of Income*

Under the distortion of income test the Service's opposition to *Van Raden* could be seen more clearly. In effect, summarily dismissing the theory that a substantial, legitimate business purpose satisfies the clear reflection of income standard under section 446(b),[141] the Service announced that "[t]he business practice of prepayment does not necessarily refute the existence of . . . a material distortion."[142] Although the Service still listed "customary, legitimate business practice" as a factor in determining distortion of income, its position on the list of factors was moved from first to fourth place.[143]

The Service also refused to accept the assertion that a prepayment, deductible under the cash method, was not a distortion of income because of the cancelling-out process over a period of years. The Service stated, "The legitimate use of the cash or accrual methods of accounting does not encompass certain tax shelter techniques . . . ."[144] In other words, the Service will continue to apply section 446(b) to cash basis farmers, despite the authority given farmers to use the cash method without inventorying.[145]

139. *Id.* at 7. Basically, the Service is aiming at farming syndicates not covered by I.R.C. § 464. *See* note 45 *supra.*

140. 1979-31 I.R.B. at 7.

141. *See Van Raden,* 71 T.C. at 1106.

142. 1979-31 I.R.B. at 7. Despite this obvious attack on *Van Raden,* the Service did not specifically mention *Van Raden* in the ruling.

143. *Id.* at 8. In light of the *Haynes* and *Heinold* courts' lack of concern with the *Van Raden* court's combination of the two tests, the Service's position weakens *Van Raden* even more.

144. *Id.* at 7.

145. The Service minimized but did not totally ignore the effect of the year to year process of "balancing out" under the cash method in that consistent deduction of prepaid feed

The Service's reliance on Treasury Regulation section 1.461-1(a)(1), prohibiting deductions which cause a material distortion of income, was made more prominent with the citation of *Clement* and several prepaid interest cases that applied section 446(b) to timing discrepancies under section 461.[146] Coincidentally, the list of factors to be considered in determining material distortion of income was enlarged to include "the useful life of resulting assets during and beyond the taxable year paid."[147]

V. ANALYSIS

As the reader may have noticed from the previous discussion of cases, the courts deciding cases in this area are not adverse to the "shotgun" method of analysis, usually with the result that it is difficult to tell where one theory ends and the next begins. For this reason, it might be helpful to briefly analyze the arguments and counter-arguments.

A. *Whether the Business Purpose Test Applies to Timing of the Prepayment.*

As stated in Revenue Rulings 75-152 and 79-229, the Service contends that a prepayment must have been made for a valid business purpose rather than for a tax avoidance purpose. The exact origin of this test is unclear, however, since the rulings cite neither Code sections nor case law to support its application. The most logical justification for the test arises from the numerous cases which have held against a taxpayer based upon a finding that the transaction was motivated solely by a tax avoidance purpose.[148] The courts in these cases, placing substance over form, traditionally have refused to recognize such schemes. In *Clement,* the court recognized this policy and proceeded to apply the business purpose test to the timing of the prepayment.[149]

---

costs was recognized as one of the factors to be considered in determining whether a material distortion of income exists. *Id.* at 8.

146. *Id.* In addition to *Clement,* the Service cited Burck v. Commissioner, 533 F.2d 768, 76-1 USTC ¶ 9283 (2d Cir. 1976); Cole v. Commissioner, 64 T.C. 1091 (1975); Sandor v. Commissioner, 62 T.C. 469 (1974), *aff'd per curiam,* 536 F.2d 874, 76-2 USTC ¶ 9488 (9th Cir. 1976).

147. 1979-31 I.R.B. at 7.

148. *See, e.g.,* Commissioner v. Court Holding Co., 324 U.S. 331, 45-1 USTC ¶ 9215 (1945); Gregory v. Helvering, 293 U.S. 465, 35-1 USTC ¶ 9043 (1935); Goldstein v. Commissioner, 364 F.2d 734, 66-2 USTC ¶ 9561 (2d Cir. 1966); Bridges v. Commissioner, 325 F.2d 180, 64-1 USTC ¶ 9103 (4th Cir. 1963).

149. 580 F.2d at 427, 78-2 USTC at 84,775-76.

The "substance over form" cases, however, are not strictly analogous to the prepaid feed cases. In *Goldstein v. Commissioner,*[150] for instance, the taxpayer arranged a loan and prepaid the interest solely to lower her tax liability in a year of unusually high income; the underlying transaction had no business or profit motive. Where a farmer purchases a year's supply of feed in advance, however, the feed itself is obviously a necessary item for the operation of the business. The timing of the purchase may have been tax motivated, but the entire transaction has a legitimate business motive which should be sufficient to meet the deductibility tests of section 162 (an ordinary and necessary business expense).[151] Nowhere does section 162 require that a taxpayer justify the timing of an expense which is necessary to the operation of the taxpayer's business. It does not necessarily follow that an entire transaction is solely tax motivated merely because one element of a legitimate business transaction is tax motivated.

Another closely related reason for discounting the *Goldstein* line of cases when considering this issue involves the policy, as strong as the "business motive" policy cited in *Clement,* that a taxpayer is allowed to minimize his taxes by any legitimate means.[152] This policy is well illustrated by a recent Supreme Court case reviewing the provisions of a business motivated sale-leaseback arranged so that the taxpayer-lessee could reap tremendous tax savings.[153] The Supreme Court did not find the taxpayer's consideration of the tax benefits to be detrimental to the transaction: "We cannot ignore the reality that the tax laws affect the shape of nearly every business transaction."[154]

Despite the apparent lack of authority for requiring a taxpayer to prove business reasons for his prepayment, the courts continue to apply the test, sometimes without any challenge from the taxpayer.[155] This failure to challenge is probably due to the fact that the business purpose test is relatively easy to satisfy. Grain costs are generally lower in the fall harvest and prepayment usually assures a supply of feed while also fixing the maximum price. These reasons should be sufficient to prove the necessary business benefit.

---

150. 364 F.2d 734, 66-2 USTC ¶ 9561 (2d Cir. 1966).
151. *See* I.R.C. § 162(a), *quoted at* note 63 *supra.*
152. *See* Gregory v. Helvering, 293 U.S. 465, 35-1 USTC ¶ 9043 (1935).
153. Frank Lyon Co. v. United States, 435 U.S. 561, 78-1 USTC ¶ 9370 (1978).
154. *Id.* at 580, 78-1 USTC at 83,883.
155. *See Van Raden,* 71 T.C. at 1083.

B. Whether the Commissioner Has the Authority To Require Deduction of Feed Expense as Feed Is Consumed.

The argument pressed most fervently by the Service in recent cases is that the deduction of feed expense in the year paid does not clearly reflect income; therefore, section 446(b) authorizes the Commissioner to change the taxpayer's method of accounting for that item of expense. The Commissioner then relies upon Treasury Regulation section 1.461-1(a)(1) to require deduction of the expense as feed is consumed. Unfortunately for the Service, there are many flaws in this argument, each of which has been recognized by at least one court.

Perhaps the most persuasive counter-argument, and certainly the most recently recognized, is that section 446(b) does not give the Service the power to alter an accounting method in order to *more* clearly reflect income; rather, the Commissioner must require a method which "*does* clearly reflect income."[156] Since prepaid feed expense is universally recognized as a "product cost,"[157] the only accounting method which will clearly reflect income and allow deduction of that expense is an inventory method which requires deduction when the cattle are sold. The Commissioner's method of deferring the deduction until after consumption of the feed may reflect income more clearly than the immediate deduction method. Imposition of such a change, however, is not within the Commissioner's section 446(b) discretion.

The Commissioner would undoubtedly meet this argument with the assertion that requiring deduction when feed is consumed pursuant to section 461 is merely the proper application of the cash method. Admittedly Treasury Regulation section 1.461-1(a)(1), which provides that certain expenses are to be deducted over the life of the asset purchased, deals with the proper application of the cash method. Cattle feed, however, is not the type of asset contemplated by this requirement. The most obvious example of an asset covered by this section is depreciable property or improvements.[158] In addition, such expenses as prepaid interest or rent may be covered by this section because these assets, like depreciable property, decrease in value through the passage of time, independent of the

156. I.R.C. § 446(b) (emphasis added). In *Owens*, 568 F.2d at 1246, the court may have recognized this argument, although its language was somewhat vague. The courts in *Heinold*, 39 T.C.M. (CCH) at 691, and *Haynes*, 38 T.C.M. (CCH) at 954, specifically relied on this point in holding for the taxpayer.

157. *See Van Raden*, 71 T.C. at 1107-08.

158. *See* Treas. Reg. § 1.461-1(a)(1) (1970).

production process. On the other hand, the value of cattle feed decreases in direct proportion to the production process (as consumed by the cattle), not through the mere passage of time.

Another reason why section 461 should not apply to cattle feed is that cattle feed is a "product cost" and even cash basis taxpayers, with the exception of farmers, must treat product costs as an element of cost of goods sold. If section 461 were to apply to product costs, then manufacturers who elected the cash method of accounting could deduct certain product costs as the assets were used. For example, the monorail car manufacturer discussed earlier in this comment could elect the cash method, and, relying on Treasury Regulation section 1.461, deduct the cost of seats, windows, and other component parts as they were used in the production process. This would conflict with the requirement in section 471 that manufacturers use an "inventory" method, and such a conflict should not be mystically created by the Service without clear proof of authority for such an interpretation of section 461.[159]

A persuasive argument against the Service's position that immediate deduction materially distorts income, recognized in numerous cases, is that the very nature of the cash method, a method approved in section 446(c), will naturally produce a mismatching of income and expense in certain years.[160] Such a result, however, is not a material distortion because consistent application of the cash method will cause the mismatching to correct itself. It is difficult to understand how an accounting method specifically allowed by the Code, and properly applied, could create a material distortion of income in violation of section 446(a). Even the regulations recognize the propriety of the cash method: "[A] method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business . . . will ordinarily be regarded as clearly reflecting income . . . ."[161] In addition, the regulations tolerate the cash method's mismatching when they state that the foregoing rule is subject to the requirement that "all items of gross income and expense [must be] treated consistently from year to year" (presumably so that the mismatching will be corrected.)[162]

Although the preceding arguments would be sufficient to over-

159. *See* note 34 *supra*.
160. *See, e.g., Van Raden*, 71 T.C. at 1104; *Haynes*, 38 T.C.M. (CCH) at 955, De La Cruz v. Commissioner, 37 T.C.M. (CCH) 24, 27-28 (1978).
161. Treas. Reg. § 1.446-1(a)(2) (1980).
162. *Id.*

come the Service's opposition, there are additional arguments favorable to the taxpayer. Perhaps the strongest policy argument against the Commissioner's position is that historically, farmers have been allowed to use the most simplified accounting procedures available. Although the origin of the preference is not clear, the numerous justifications for it indicate that this concession is very important to farmers. The Commissioner has acknowledged that under section 471 farmers are given an option not to inventory, but then tries to distinguish away this option by arguing that requiring deduction when feed is consumed is not tantamount to requiring an inventory method.[163] Although a literal interpretation of the regulations may support the Commissioner's argument,[164] such tunnel vision does not allow a proper view of the damage being done to farmers by such an intepretation. The basic rationale behind the farmers' historical preference to choose the cash method is their need for simplified accounting methods. This need is apparent, for example, in the case of a farmer who purchases one hundred bushels of corn at ten dollars per bushel on December 31. Then, in order to maintain a large supply of corn (to protect against shortage or rising prices), he purchases ten bushels at the first of each succeeding month. If this farmer were required to deduct feed expense as the feed is consumed, not only would he have to take physical inventories, he would also have to use a more complex accounting method to value that inventory. Such requirements severely undermine the rationale of providing a more simplified accounting method to farmers.

Congress, too, has recognized the need for most farmers to have a simplified accounting system. Although it had a perfect opportunity to require all farmers to deduct feed expense when the feed is consumed, Congress limited sections 447 and 464 to farming corporations and syndicates—operations that better possess the ability to deal with complex accounting systems.[165] This congressional restraint implies legislative approval of the immediate deduction of prepaid feed expense by farmers not covered by sections 447 and 464. Although the Service's arguments do have some basis in logic, the Code, the regulations, policy considerations and Congress all compel rejection of the Service's position.

---

163. See the Commissioner's argument in *Clement*, 580 F.2d at 432, 78-2 USTC at 84,779.

164. *See* note 34 *supra*.

165. *See* notes 43, 45 & 46 *supra*.