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WHEN FEED IS DEEMED PAID

— by Neil E. Harl

A major question in some farm operations on the cash method of accounting is when payment is considered made for purposes of income tax deductibility for feed and other supplies. In particular, the issue is often whether anything short of an actual cash payment will support an income tax deduction.

Basic rule

For taxpayers on the cash method of accounting, amounts paid for feed or other supplies may properly be deducted when "paid." The question is when amounts are deemed "paid."

Promissory note as payment

It is well settled that a taxpayer on the cash method of accounting who gives a promissory note as payment for feed or other supplies is not entitled to an income tax deduction even though the note is secured by collateral. By contrast, a taxpayer who borrows money and uses the borrowed funds to pay an obligation for which a deduction is allowable (such as feed and other supplies) may claim an income deduction. The income tax deduction may be claimed when the borrowed funds are paid to the vendor for the purchased items.

The issuance of a promissory note or similar obligation represents only a promise to pay. The payment required to support an income tax deduction is the payment of cash or its equivalent; the giving of a promissory note is not the equivalent of cash for this purpose.

Chapman v. United States

In a 1981 case, Chapman v. United States, the taxpayers had deducted $30,000 for the cost of cattle feed to a feedlot. A cash payment of $15,000 had been paid with the balance payable when the cattle were sold. At that time, the unpaid feed balance was to be paid before the rest of the sale proceeds were paid to the taxpayer. To secure the ultimate payment for the feed, the taxpayer gave the feedlot a promissory note for $15,000 and a secured letter of credit for the same amount. Thus, of the $30,000 feed bill, the taxpayers paid $15,000 and essentially gave a secured promissory note for the balance. The letter of credit was never drawn upon and expired by its own terms.

IRS disallowed the $15,000 amount that was not represented by a cash payment.

The taxpayers argued that they should be entitled to a deduction for the full $30,000. As for the $15,000 not paid in cash, the taxpayers argued that they had paid the amount with borrowed funds.

The court denied a deduction except for the $15,000 paid in cash. The amount secured by the letter of credit was viewed as analogous to a promissory note secured by collateral.

The taxpayers had argued that the letter of credit arrangement was similar to a situation where a bank certifies a check and this should be viewed as payment. The court rejected that comparison and stated that a certified check is a cash equivalent but a letter of credit "is similar to a consumer credit card waiting to be used."

In conclusion.

Various types of arrangements similar to secured promissory notes and letters of credit are in use in feedlots currently. In those situations, a feedlot customer would generally not be entitled to an income tax deduction for feed until the earlier of — (1) actual payment by the customer for the feed or (2) application of proceeds from the sale of cattle to payment of the unpaid feed balance.

FOOTNOTES

6 Id.
7 Id.
8 Rev. Rul. 70-647, 1970-2 C.B. 38. See Helvering v. Price, 309 U.S. 409 (1940) (question of whether payment made in discharge of liability to bank was effected by substituting new note for earlier note). See also Don E. Williams Co. v. Comm’r, 429 U.S. 569 (1977) (secured promissory notes were not payment of contributions to retirement plan).
HOSTILE USE. The land involved was originally one parcel but the owner divided the parcel into two equal parcels and sold the west half first. The new owner (west side owner) erected a fence on what the owner thought, as informed by the real estate agent, was the property line but which was actually 60 feet on to the owner’s property. The owner did not otherwise improve the property and allowed the real estate agent to pasture cattle on the property. The east half of the property was purchased later with the fence already in place; therefore, the new owners (east side owners) also thought the fence was the actual boundary. The east side owners also did not improve their property and allowed the real estate agent to pasture horses on the property, including the disputed strip. The only other activity on the strip was watering by the sprinkler system by the east side owners. A flood cut away much of the west side property and carried away some of the fence and some of the disputed strip. The east side owners leased the house to the real estate agent as a residence and for a ranch for the agent’s cattle. The cattle were tethered because of the broken fence. The east side owners then sold their parcel to the plaintiff through the same real estate agent, who informed the plaintiff that the fence was the true boundary. The plaintiff replaced the fence after the flood damage was restored. The west side parcel was then sold to the defendant with the former west side owner taking a deed of trust on the property. Three years later, the defendant had a survey done which finally showed that the fence was 60 feet on the west parcel and the plaintiff filed a quiet title action as to the defendant and as to the holder of the deed of trust. Although the plaintiff had clearly adversely possessed the disputed strip after their possession, the length of possession was insufficient to acquire title by adverse possession; therefore, the plaintiff needed to demonstrate adverse possession by the previous possessors. The defendant argued that because the real estate agent’s lease of the land did not include using the land for cattle, the agent’s use of the disputed strip could not be considered as adverse possession by the previous owners. The court held that the previous owners did not restrict the agent’s use of the land; therefore, the agent’s use of the disputed strip to graze tethered cattle was sufficient adverse possession to attribute that possession to the previous owner and could be tacked onto the plaintiff’s adverse possession. The court also held, however, that the adverse possession did not include the portion of the disputed strip which was washed away in the flood, because use of that portion was made by the agent and the washed away area became open range visited by cattle from several other ranches. The deed of trust holder argued that the adverse possession did not apply to the lien on the property. The court agreed that title by adverse possession could not accrue against the lienholder because the lienholder had no cause of action against the adverse possessor until the debtor defaulted on the loan. Berryhill v. Moore, 881 P.2d 1182 (Ariz. Ct. App. 1994).

BANKRUPTCY

AVOIDABLE TRANSFERS. Prior to filing for bankruptcy, the debtor was involved in a suit against a manufacturer of cattle feed for damages resulting from defective feed. Prior to 90 days before filing for bankruptcy, the debtor assigned to a creditor a portion of the anticipated damages. The debtor received the damage award within the 90 days before filing for bankruptcy and the creditor received the portion of the award before the bankruptcy case commenced. The court held that the transfer to the creditor was not avoidable as a preferential transfer because the effective date of the transfer was the date the assignment of the damage award was executed, not the date the award was paid to the creditor. In re Wagner, 173 B.R. 916 (N.D. Iowa 1994), aff’d, 144 B.R. 430 (Bankr. N.D. Iowa 1992).

ESTATE PROPERTY. The debtor’s mother had created an inter vivos trust with a one-third remainder for the debtor. The mother died one month after the debtor filed for Chapter 7 and the debtor became entitled to one-third of the trust property. The debtor claimed the interest in the trust as exempt under Section 541(a)(5)(A), arguing that the trust property was not received “by bequest, devise or inheritance.” The court held that recent U.S. Supreme Court and Second Circuit Court of Appeals rulings required a “plain meaning” interpretation of Section 541 and that receipt of property through a remainder interest in an inter vivos trust was not receipt of property by bequest, devise or inheritance. However, the court held that the debtor’s interest in the trust was estate property under Section 541(a)(1) which included all interests in property held by the debtor. The holding is not clear as to whether the court intended that all of the debtor’s share of the trust was included or just the value of the remainder interest at the time of the filing of the petition. In re Crandall, 173 B.R. 836 (Bankr. D. Conn. 1994).

EXECUTORY CONTRACTS. The debtor entered into an installment contract to purchase a meat-processing business, including real and personal property and goodwill. The debtor received possession of all assets and the seller agreed to satisfy all existing liens against the property and to hold the debtor harmless for any liabilities which arose prior to the sale. The seller retained title to the property until all payments were made. The debtor initially filed a motion to assume the contract but the debtor’s Chapter 12 plan provided for payments only to the extent of the value of the property, treating the contract as a security agreement. The