Rolling Over Lines Of Credit

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ROLLING OVER LINES OF CREDIT

— by Neil E. Harl

Difficult times in the agricultural sector inevitably lead to unpaid lines of credit at year-end with credit line balances often rolled over into the following year's line of credit. One important question is how the rollover is treated for income tax purposes.

**General rule**

The general rule, for loans coming within the exception (for loans with fixed interest payable in one year or less) to the original issue discount rules is that an interest deduction will be denied in a rollover of a remaining line of credit into the following year. Therefore, a taxpayer should avoid borrowing funds for interest payments from the same lender that furnished the original loan even if unrestricted control is maintained over the loan proceeds. In an era of financial and economic trauma, it is often unrealistic for a financially troubled borrower to be able to establish a line of credit elsewhere.

**OID complication**

A rollover of an old loan into the following year's line of credit may cause the original issue discount (OID) rules to apply if the old loan does not become payable until more than one year after the original loan was obtained. The result is that the interest amount is spread over the term of the loan with a portion deductible in the year the loan is rolled.

**Example:** a taxpayer borrows $100,000 from a bank on May 1, 2000, at 10 percent simple interest with interest and principal due six months later on November 1, 2000. Because of low prices, the taxpayer and the bank on November 1 agree to defer payments on the loan until November 1, 2001, with the interest continuing to accrue at a 10 percent rate. Because no payment is due until after May 1, 2001, under the renegotiated terms of the loan, the OID rules apply. Under the new terms, the "issue price" is $100,000 and the "stated redemption price at maturity" is the $100,000 as of November 1, 2000, plus the half-year interest to that date ($5,000) plus the interest expected to November 1, 2001, for a total of $115,500. Since the $115,500 due November 1, 2001, exceeds the $100,000 issue price, there is OID of $15,500. That would mean that the taxpayer could deduct, in 2000, (including interest on the $5,000 of interest not paid) the $5,000 of interest as OID through November 1, 2000, plus two months of OID for November and December of 2000 (one-sixth of $10,500) or approximately $1,750.

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$1,750 for a total deduction of $6,750 for 2000. The rest of the OID would be deductible in 2001 in the amount of $8,750.

Thus, the total of interest for the two years ($15,500) would be deductible to the extent of $6,750 in 2000 and $8,750 in 2001. Whether that is an advantage (compared to obtaining the full deduction in 2001 when actually paid) depends upon the value to the taxpayer of the $6,750 deduction in 2000. If the deduction results in a larger net operating loss (and, possibly a tax refund) or a smaller 2000 tax bill, the outcome could be advantageous.

**How are payments applied?**

An important issue is how payments are allocated, for federal income tax purposes, between principal and interest. The OID rules require that payments first be allocated to OID, to the extent of the OID that has accrued as of the date the payment is due, and then to payment of principal. Thus, paying down on principal and leaving the interest amount to be rolled does not avoid the OID characterization.

**In conclusion**

Negotiations with a lender over a line of credit rarely leave room for a discussion of the finer points of income tax treatment of the interest. However, it may be in the best interest of the borrower to plan carefully the rollover of unpaid balances with an eye to interest deductibility.

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**FOOTNOTES**

5. See Davison v. Comm’r, 107 T.C. 35 (1996), aff’d, 141 F.3d 403 (2d Cir. 1998) (cash basis borrower not entitled to interest deduction where funds used to satisfy interest obligation were borrowed for that purpose from same lender); Stone v. Comm’r, T.C. Memo. 1996-507 (interest payments in form of promissory notes; interest not considered paid).

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**CASES, REGULATIONS AND STATUTES**

by Robert P. Achenbach, Jr.

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**ADVERSE POSSESSION**

**PERMISSIVE USE.** The original owner of the disputed land, just over seven acres, had acquired the land by patent from the United States and the land bordered federal land. To separate the owner’s land from the federal land, the owner erected a fence of barbed wire along the boundary. The barbed wire was loosely strung between existing trees and some added posts and the owner did not intend that the fence was the trust boundary between the properties. The neighboring federal land was later transferred to private ownership and the fence remained, although all owners recognized that the fence was not the true boundary. The fence also meandered in various curves and angles along the boundary, which was represented as a straight line on transfer documents. The plaintiff and defendant became the eventual owners of the land on each side of the fence. One of the plaintiff’s children built a residence on one acre of the disputed land more than ten years prior to the present suit. The court held that the fence was a fence of convenience and the plaintiff’s use of the disputed land was permissive, because (1) the fence was never intended to mark the true boundary, (2) the fence was erected only to separate the properties, and (3) the fence was not constructed in a method to indicate that it was intended to be the boundary. As to the last holding, the court noted that most governmental patents divided land with straight lines and the fence meandered from tree to tree. The court allowed the daughter’s one acre to pass to the daughter by adverse possession because the building of a house on the property was an open and hostile declaration of ownership which went beyond the implied permissive use that arose from the fence of convenience. Kimball v. Turner, 993 F.2d 303 (Wyo. 1999).

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**ANIMALS**

**HORSES.** The plaintiff was injured when bitten by a horse in a stable owned by the defendant. The plaintiff was invited to the stables to watch a friend take a horse riding lesson. After the lesson, the plaintiff was walking through the stable when one of the stalled horses bit the plaintiff on the arm. The defendant raised the defense that the Michigan Equine Activity Liability Act, Mich. Stat. § 691.1661 et seq., barred suit for any damages. The statute provided that participants in an equine activity could not sue for damages arising out of the equine activity. The plaintiff argued that the plaintiff did not participate in any equine activity when the bite occurred. The court held that the plaintiff’s presence at the stables to watch the riding lesson was a participation in an equine activity and included walking in the stables past horse stalls; therefore, the plaintiff was...