PREPAID FEED EXPENSE: ANOTHER LOOK AT THE DEPOSIT, BUSINESS PURPOSE, AND DISTORTION OF INCOME TESTS

I. INTRODUCTION

Few topics have engendered as many law review articles,[1] court decisions,[2] and legislative pronouncements,[3] as have the prepaid feed expenses of farmers using the cash receipts and disbursements method of tax accounting. Conceptually the problem is simple enough: should a cash-basis farmer raising cattle deduct the feed expense of fattening the cattle when the feed is purchased, when the feed is used, or when the cattle are sold? Unfortunately, the question is much easier to state than it is to answer.

The starting point of any analysis of a business expense lies in the requirements of Internal Revenue Code section 162.[4] These guidelines have been amplified for farmers by Treasury Regulations which provide:

> [a] farmer who operates a farm for profit is entitled to deduct from gross income as necessary expenses all amounts actually expended in the carrying on of the business of farming. The cost of ordinary tools of short life or small cost, such as hand tools, including shovels, rakes, etc., may

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1. *E.g.*, Klein, *Treasury's Prepaid Feed Ruling: Tough New Tests and Retroactivity Raise Questions*, 40 J. TAX. 96 (1974); Phelan & Bright, *The Prepaid Feed Expense Deduction: What is the Current Outlook in View of Mann?*, 39 J. TAX. 292 (1973); Pinney & Olsen, *Farmers' Prepaid Feed Expenses*, 25 TAX. L. 537 (1972); Ward, *Tax Postponement and the Cash Method Farmer: An Analysis of Revenue Ruling 75-152*, 53 TEX. L. REV. 1119 (1975); Willingham, *Cattle Feeding as a Tax Shelter - Alive But Cumbersome*, 25 S.D.L. REV. 497 (1980); Willingham & Kasmir, *Prepaid Feed Deductions: How to Cope With I.R.S.' Restrictive New Ruling*, 43 J. TAX. 230 (1975); Wright & Wright, *The Continuing Saga of Prepaid Feed Expense: The Fat Lady has not Sung*, 8 FLA. ST. U.L. REV. 233 (1980).

2. *E.g.*, Commissioner v. Van Raden, 650 F.2d 1046 (9th Cir. 1981); Frysinger v. Commissioner, 645 F.2d 523 (5th Cir. 1981); Owens v. Commissioner, 568 F.2d 1233 (6th Cir. 1977); Mann v. Commissioner, 483 F.2d 673 (8th Cir. 1973); Shippy v. United States, 308 F.2d 743 (8th Cir. 1962); Cravens v. Commissioner, 272 F.2d 895 (10th Cir. 1959); Dunn v. United States, 468 F. Supp. 991 (S.D.N.Y. 1979); Gaddis v. United States, 330 F. Supp. 741 (S.D. Miss. 1971); Clement v. Commissioner, 580 F.2d 422 (Ct. Cl. 1978), *cert. denied*, 440 U.S. 907 (1979); Heinhold v. Commissioner, 39 T.C.M. (CCH) 685 (1979); Rocco, Inc. v. Commissioner, 72 T.C. 140 (1979); Lillie v. Commissioner, 45 T.C. 54 (1965), *aff'd per curiam*, 370 F.2d 562 (9th Cir. 1966); Ernst v. Commissioner, 32 T.C. 181 (1959); Haynes v. Commissioner, 38 T.C.M. (CCH) 950 (1979), *appeal dismissed;* De La Cruz v. Commissioner, 37 T.C.M. (CCH) 24 (1978); Smith v. Commissioner, 35 T.C.M. (CCH) 1246 (1976); Estate of Cohen v. Commissioner, 29 T.C.M. (CCH) 1221, (1970).

3. *See* I.R.C. §§ 447, 464.

4. I.R.C. § 162(a). In general - "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 . . . ." *Id.*

> be deducted. The purchase of feed and other costs connected with raising livestock may be treated as expense deductions insofar as such costs represent actual outlay, but not including the value of farm produce grown upon the farm or the labor of the taxpayer.[5]

Naturally, cash-basis farmers took the position that the phrases "actually expended"[6] and "actual outlay"[7] meant that cattle feed was deductible when the cash expenditure was made.[8] Initially, the Commissioner seemed to acquiesce to this viewpoint.[9] The seeds of conflict were soon sown, and a number of disputes flared into litigation.[10] The earlier cases focused on whether the cash expenditure constituted a deductible payment or was merely a non-deductible deposit.[11] As a result of further litigation, the Commissioner developed two other theories[12] from which to attack the expense deduction. First, he argued that a valid business reason must exist for the timing of the feed prepayment.[13] His second theory consisted of the argument that income was materially distorted if feed expenditures could be deducted before the feed was actually used.[14]

These three theories were to be formalized by the Internal Revenue Service in Revenue Ruling 73-530.[15] Before the ruling could be formally issued, however, an Oklahoma district court enjoined the promulgation of the ruling.[16] This decision was later reversed on appeal[17] and the ruling issued as Revenue Ruling 75-152.[18] One year later, in the Tax Reform Act of 1976, Congress acted to curb what it perceived to be abuses in cattle feeding tax shelters.[19] In 1979, the Internal Revenue Service

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5. Treas. Reg. § 1.162-12(a) (1958).

6. *Id.*

7. *Id.*

8. *See, e.g.*, Ernst v. Commissioner, 32 T.C. 181, 186 (1959) (poultry farmer allowed to deduct amount of out of pocket expenses incurred for feed to be delivered at a later date).

9. *Ernst* was acquiesced to by the Commissioner. *See* 1959-2 C.B. 4. A letter ruling from the Deputy Commissioner to the Collector in Des Moines, Iowa stated the position of the Service: "In the case of a taxpayer on the cash receipts and disbursements basis, the amounts expended for feed should be deducted as an expense in the year in which the feed is paid for, irrespective of the fact that it may not be consumed until the following year." Letter Ruling, T. Mooney, Deputy Commissioner (Dec. 16, 1943) (reprinted in Pinney & Olsen, *supra* note 1, at 539).

10. For a good history of the development of this conflict, see Pinney & Olsen, *supra* note 1, at 539-43.

11. *E.g.*, Cravens v. Commissioner, 272 F.2d 895, 898 (10th Cir. 1959); Ernst v. Commissioner, 32 T.C. at 186.

12. *See* text accompanying notes 13-14 *infra*.

13. *See* Lillie v. Commissioner, 45 T.C. 54, 62 (1965), *aff'd per curiam*, 370 F.2d 562 (9th Cir. 1966).

14. *See* Cravens v. Commissioner, 272 F.2d at 900.

15. The announcement that the Service intended to promulgate Rev. Rul. 73-530 is reported at 7 STAN. FED. TAX. REP. ¶ 6951 (1973).

16. Cattle Feeders Tax Comm. v. Schultz, 74-1 U.S.T.C. (CCH) ¶ 9121 (W.D. Okla. 1973), *rev'd*, 504 F.2d 462 (10th Cir. 1974). For an excellent description of the history of this process, see Ward *supra* note 1, at 1122-23.

17. Cattle Feeders Tax Comm. v. Schultz, 504 F.2d 462 (10th Cir. 1974).

18. Rev. Rul. 75-152, 1975-1 C.B. 144. A thorough analysis of this ruling is contained in Ward, *supra* note 1.

19. *See generally* Willingham, *supra* note 1. *See also* I.R.C. §§ 447, 464.

issued Revenue Ruling 79-229,[20] which superseded the earlier ruling. This latest statement of position regarding prepaid feed deductions is substantially the same as its predecessor.[21] The broad statement of the ruling's summary contains the current Internal Revenue Service position on prepaid feed expenses:

> A cash-method taxpayer engaged in the business of raising or feeding livestock may deduct in the year of payment amounts paid for livestock feed to be consumed in a subsequent year provided (1) the expenditure is for the purchase of feed rather than a deposit, (2) the prepayment is made for a business purpose and not for tax avoidance, and (3) the deduction will not result in a material distortion of income.[22]

Case law,[23] as well as the revenue ruling,[24] has added substance to the three skeletal tests outlined above. This Note will examine that development[25] as it studies the various attempts of taxpayers to avoid the triple threat posed by Revenue Ruling 79-229.

II. Payment v. Deposit

The first threat posed by the ruling is the characterization of a cash outlay for feed as a deposit. Such a characterization would prevent the expenditure from being deductible in the current period.[26] The statutory rationale for such a rule is contained in the "paid or incurred"[27] language of Internal Revenue Code section 162 which requires a cash-basis taxpayer to have actually made a payment before he is entitled to a deduction.[28] The description of an "actual outlay"[29] contained in the regulations mirrors this requirement. Once a payment is found, courts have had little trouble finding cattle feed to be an ordinary and necessary expense of raising cattle.[30]

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20. Rev. Rul. 79-229, 1979-2 C.B. 210.
21. *See* notes 36, 129, 147, 180 *infra*.
22. Rev. Rul. 79-229, 1979-2 C.B. 210.
23. *See* note 2 *supra*.
24. Rev. Rul. 79-229, 1979-2 C.B. 210.
25. For other commentators' approaches to these developments, *see* Pinney & Olsen, *supra* note 1, at 538-43; Ward, *supra* note 1, at 1123-78; Willingham, *supra* note 1, at 503-08; Wright & Wright, *supra* note 1, at 243-59.
26. Rev. Rul. 79-229, 1979-2 C.B. 210, 211. *See also* Shippy v. United States, 308 F.2d 743, 747-48 (8th Cir. 1962); Smith v. Commissioner, 35 T.C.M. (CCH) 1246, 1253 (1976); Estate of Cohen v. Commissioner, 29 T.C.M. (CCH) 1221, 1229 (1970) (contract 204KA); Lillie v. Commissioner, 45 T.C. 54, 63 (1965), *aff'd per curiam*, 370 F.2d 562 (9th Cir. 1967). In each of the above cases, the deduction was denied because the expenditure was characterized as a deposit. For the same result regarding fertilizer prepayments, see Stice v. United States, 540 F.2d 1077, 1081 (5th Cir. 1976); Schenk v. Commissioner, 41 T.C.M. (CCH) 455, 460 (1980).
27. I.R.C. § 162(a).
28. The regulations provide: "Under the cash receipts and disbursements method of accounting, amounts representing allowable deductions shall, as a general rule, be taken into account for the taxable year in which paid." Treas. Reg. 1.461-1(a)(1) (1957).
29. Treas. Reg. 1.162-12(a) (1958).
30. *E.g.*, Gaddis v. United States, 330 F. Supp. 741, 752 (S.D. Miss. 1971); Clement v.

Unfortunately, courts have had a great deal of trouble properly using the words "payment," "deposit," "expense," and "expenditure."[31] As used in this Note, and in Revenue Ruling 79-229, a "payment" is a deductible cash disbursement under the tests discussed below,[32] a "deposit" is a non-deductible disbursement under the same tests[33] and an "expenditure" merely denotes the actual cash disbursement.[34] While these definitions are not strictly accurate when compared to a dictionary,[35] they do represent a valuable convention of useage. Therefore, the crucial question for a farmer's prepaid feed expenditure is whether the expenditure is a *payment* or a *deposit*.

Revenue Ruling 79-229[36] provides that an expenditure will be treated as a payment if it is not refundable,[37] and is made as part of an enforceable sales contract.[38] The ruling also outlines the following items which may indicate a deposit: (1) lack of specific quantity terms designating the amount of

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United States, 580 F.2d 422, 427 (Ct. Cl. 1978), *cert. denied*, 440 U.S. 907 (1979); *see also* Treas. Reg. § 1.162-12(a) (1958).

31. *See* Ward, *supra* note 1, at 1124 n.27.

32. *See id.* at 1124.

33. *Id.*

34. *Id.*

35. Mann v. Commissioner, 483 F.2d 673, 678 (8th Cir. 1973) (non-refundable deposit characterized as a partial payment).

36. The pertinent portion of Revenue Ruling 79-229, 1979-2 C.B. states:

> Whether a particular expenditure is a deposit or a payment depends on the facts and circumstances of each case. When it can be shown that the expenditure is not refundable and is made pursuant to an enforcable sales contract, it will not be considered a deposit. The following factors, although not all inclusive, are indicative of a deposit rather than a payment: the absence of specific quantity terms; the right to a refund of any unapplied payment credit at the termination of the contract, . . . ; the treatment of the expenditure as a deposit by the seller; and the right to substitute other goods or products for the feed ingredients specified in the contract. However, a provision permitting substitution of ingredients for the purpose of varying the particular feed mix to accommodate the current diet requirements of the livestock for which the feed was purchased will not be considered indicative of a deposit. The fact that adjustment is made to the contract price to reflect market value at the date of delivery, is not, standing alone, conclusive of a deposit.

Id. at 211.

37. *Id.* Recent circuit courts of appeals decisions have emphasized refundability of an expenditure as a key test in determining if a payment exists. *See* Owens v. Commissioner, 568 F.2d 1233, 1243 (6th Cir. 1977); Mann v. Commissioner, 483 F.2d 673, 678 (8th Cir. 1973). In situations where a refund was actually received, the deduction has been denied. *See* Lillie v. Commissioner, 45 T.C. 54, 62 (1965), *aff'd per curiam*, 370 F.2d 562 (9th Cir. 1966); Smith v. Commissioner, 35 T.C.M. (CCH) 1246, 1252 (1976).

38. Rev. Rul. 79-229, 1979-2 C.B. at 211. A number of cases have sustained deductions based upon enforceable contracts that were subsequently performed. *See* Owens v. Commissioner, 568 F.2d 1233, 1245 (6th Cir. 1977); Mann v. Commissioner, 483 F.2d 673, 678 (8th Cir. 1973); Cravens v. Commissioner, 272 F.2d 895, 898 (10th Cir. 1959); Gaddis v. United States, 330 F. Supp. 741, 751 (S.D. Miss. 1971); Ernst v. Commissioner, 32 T.C. 181, 186 (1959). At least one court has denied a deduction because no contract existed. *See* Shippy v. United States, 308 F.2d 743, 746 (8th Cir. 1962).

feed being purchased;[39] (2) refundability of any remaining credit at the end of the contract;[40] (3) seller's handling of the funds he receives as a deposit;[41] (4) ability to substitute different items for the ones listed in the contract;[42] and (5) feed purchase price equivalent to market price on the delivery dates.[43] Revenue Ruling 75-152[44] discussed two other factors which have been dropped from the current ruling, namely, whether the feed had been delivered by the end of the tax year,[45] and whether the feed was actually mixed and in existence.[46] In addition, courts have considered relevant the

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39. Rev. Rul. 79-229, 1979-2 C.B. at 211. The lack of specific quantity terms in feed agreements has been used to justify the denial of the deduction. Shippy v. United States, 308 F.2d at 746; Estate of Cohen v. Commissioner, 29 T.C.M. (CCH) 1221, 1229 (1970). Other cases have not deemed the absence of this factor to be fatal to the deduction. Owens v. Commissioner, 568 F.2d at 1244 (explicitly rejects specificity as a factor); Cravens v. Commissioner, 272 F.2d at 898. Specific quantity terms have been cited favorably in cases where the deduction was upheld. Mann v. Commissioner, 483 F.2d 673, 675 (8th Cir. 1973); De La Cruz v. Commissioner, 37 T.C.M. (CCH) 24, 25 (1978); Estate of Cohen v. Commissioner, 29 T.C.M. (CCH) at 1229 (1970).

40. *See* note 37 *supra*.

41. Rev. Rul. 79-229, 1979-2 C.B. at 211. Courts denying the deduction have often cited the seller's treatment of the expenditure as a deposit to justify its characterization as such. *See* Shippy v. United States, 308 F.2d at 745; Estate of Cohen v. Commissioner, 29 T.C.M. (CCH) at 1229 (1970); Smith v. Commissioner, 35 T.C.M. (CCH) 1246, 1252 (1976).

42. Rev. Rul. 79-229, 1979-2 C.B. at 211. Substitution of non-feed items has been cited in cases where the deduction has been denied. Stice v. United States, 540 F.2d 1077, 1080 (5th Cir. 1976); Shippy v. United States, 308 F.2d at 745. Substitution of other kinds of feed, however, is not necessarily fatal to the deduction. *See* Mann v. Commissioner, 483 F.2d 673, 675 (8th Cir. 1973).

43. Rev. Rul. 79-229, 1979-2 C.B. at 211. Lack of a fixed price for the feed may be indicative of a deposit. *See* Shippy v. United States, 308 F.2d at 746; Smith v. Commissioner, 35 T.C.M. (CCH) at 1252; Lillie v. Commissioner, 45 T.C. 54, 62 (1965), *aff'd per curiam*, 370 F.2d 562 (9th Cir. 1966). Other courts, however, have allowed the deduction without a fixed price term. Cravens v. Commissioner, 272 F.2d 895, 898 (10th Cir. 1959); Ernst v. Commissioner, 32 T.C. 181, 183 (1959).

44. Rev. Rul. 75-152, 1975-1 C.B. 144.

45. *Id.*

46. *Id.* This requirement probably has its origins in an announcement from the Los Angeles District Director:

> Present law allows cash method farmers to deduct the cost of feed purchased and paid for and does not require the use of yearend inventories. However, it is the position of the Service that this rule is applicable only to feed which is in existence at the date of purchase in the form it is fed to the animals. Where the prepayment is for feed to be manufactured in the future no deduction is allowable whether the prepayment is in money or in the form of one of the ingredients which will ultimately be used in the manufactured feed.
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> The basis for this position is Section 2105(2) of the California Commercial Code *and similar provisions in other states*. This Section provides that goods *must be both existing and identified* before any interest in them can pass. Goods which are not both existing and identified are future goods. A purported sale of future goods operates as a contract to sell rather than a sale.
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> Since modern agricultural practices require the use of manufactured feed which

questions of whether title had passed to the buyer[47] and whether the seller was still obligated to perform future services to the buyer.[48]

Rather than attempting to detail exactly what combinations of the above factors would constitute a payment, Revenue Ruling 79-229 has used an "all the facts and circumstances"[49] standard. Since by its nature such a test is very broad, an examination of the cases in which the Commissioner ultimately prevailed on this issue will hopefully provide the reader with a taste of the considerations involved.

The Commissioner's first victory on this issue occurred in *Shippy v. United States.*[50] In *Shippy,* the taxpayer had delivered $23,000 to a grain elevator pursuant to a conversation with the operator whereby the elevator was to supply him with feed as he required it.[51] The operator testified that he considered the funds to be a deposit.[52] Various items, including feed at the market price on the date of delivery, were charged against the account.[53] Although no refund was ever received, the grain elevator operator testified that he would have given the taxpayer a refund had he requested one.[54] Holding that the conversation did not amount to a contract,[55] the deduction was disallowed by the court.[56] This decision is relatively easy to understand since almost all of the factors indicating a deposit were present. Most damaging to the taxpayer was the oral nature of the purported agreement,[57] which the court characterized as "more in the nature of an offer than a

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loses a substantial amount of its nutritional value if not consumed shortly after manufacture it is not economically feasible to acquire substantial amounts of feed for future use. Prepayments for feed not in existence at the date of purchase are not deductible.

Los Angeles District Director, *News and Notes for the Tax Practitioner,* (Number 72-1, 1972) (emphasis added) (quoted in Pinney & Olsen, *supra* note 1, at 545-46). The existing and identified criteria were rejected by the Eighth Circuit. Mann v. Commissioner, 483 F.2d 673, 677 (8th Cir. 1973).

47. Title has been rejected as a factor to be considered in making the payment-deposit determination. *See* Mann v. Commissioner, 483 F.2d at 677.

48. The obligation of the seller to provide future services to the buyer has been used to deny the deduction. *See* Lillie v. Commissioner, 45 T.C. 54, 62 (1965), *aff'd per curiam,* 370 F.2d 562 (9th Cir. 1966); Estate of Cohen v. Commissioner, 29 T.C.M. (CCH) 1221, 1229 (1970); Smith v. Commissioner, 35 T.C.M. (CCH) 1246, 1252 (1976). The Sixth Circuit, however, has upheld a contract substantially identical to the contract struck down in *Cohen* without future services being mentioned. *See* Owens v. Commissioner, 568 F.2d 1233, 1243-45 (6th Cir. 1977).

49. Rev. Rul. 79-229, 1979-2 C.B. at 211.

50. 308 F.2d 743 (8th Cir. 1962). For a more detailed explanation of the fact pattern, see Pinney & Olsen, *supra* note 1, at 541.

51. 308 F.2d at 745.

52. *Id.*

53. *Id.*

54. *Id.* at 747.

55. *Id.* at 746.

56. *Id.* at 748.

57. *Id.* at 746.

contract."[58]

The Commissioner next prevailed in this area in *Lillie v. Commissioner*.[59] In this case, the taxpayer owned cattle that were fed with grain purchased at the feedlot where the cattle were stored.[60] The feedlot was given $25,000 by the taxpayer for feed to be given his cattle at a later date.[61] As the feed was consumed, the account of the taxpayer was charged the current market price of the feed.[62] When the cattle were shifted to another feedlot, the taxpayer received a refund for the balance of his account.[63] The Tax Court denied the deduction finding the expenditure to be only a deposit since a refund was actually received and significant services remained to be performed by the feedlot.[64]

The most interesting victim of the deposit theory was Frank Cohen,[65] winner of the Irish Sweepstakes. Mr. Cohen entered into two contracts relating to the purchase of feed for his cattle.[66] The first contract provided for a set quantity of feed to be delivered for a certain price, although the price could be varied if the market price of delivered feed changed.[67] The second contract provided for payments of "22½¢ per pound weight gain"[68] of the cattle being fed. The deduction was allowed under the first contract since it specifically provided the quantity of feed being purchased.[69] The deduction was not allowed under the second contract since the expenditure included amounts for future services and the taxpayer did not actually purchase a set quantity of feed, but rather created an account that was decreased as the cattle gained weight.[70]

The Commissioner's latest victory in a deposit case is *Smith v. Commissioner*.[71] In this case, the Tax Court focused on refundability as the litmus test of a payment.[72] Emphasizing that the buyer had actually received a refund,[73] the court found his expenditure to be a deposit.[74] Additionally, the

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58. *Id.*

59. 45 T.C. 54 (1965), *aff'd per curiam*, 370 F.2d 562 (9th Cir. 1966). For another author's analysis of this case, see Pinney & Olsen, *supra* note 1, at 541-42.

60. *Id.* at 55-56.

61. *Id.* at 56.

62. *Id.* at 62.

63. *Id.*

64. *Id.*

65. *See* Estate of Cohen v. Commissioner, 29 T.C.M. (CCH) 1221 (1970). This case is also analzed at Pinney & Olsen, *supra* note 1, at 542-43.

66. 29 T.C.M. at 1229.

67. *Id.* at 1223.

68. *Id.* at 1224.

69. *Id.* at 1223.

70. *Id.* at 1229.

71. 35 T.C.M. (CCH) 1246 (1976).

72. *Id.* at 1252.

73. *Id.*

74. *Id.*

court noted that significant services were to be performed by the seller in feeding the cattle,[75] that no maximum price was established in the contract for feed,[76] and that the seller treated the funds he received as deposits.[77]

In the event that the above recital of Internal Revenue Service victories seems one sided, it should be noted that taxpayers have won a large number of decisions in this area.[78] Two early cases in this vein, *Ernst v. Commissioner*[79] and *Cravens v. Commissioner*,[80] hinted at the refundability test with decisions based on the finding that the taxpayer was irretrievably out of pocket the sums he had expended.[81] This rationale developed more fully into the refundability test used by the Eighth Circuit in *Mann v. Commissioner*,[82] and the Sixth Circuit in *Owens v. Commissioner*.[83] The Tax Court has also adopted this test.[84]

The precise nature of this test has been examined by numerous commentators.[85] Of particular interest is the article, *Tax Postponement and the Cash Method Farmer: An Analysis of Revenue Ruling 75-152*,[86] by Larry Ward. Ward characterized the deposit-payment test as actually consisting of either the legal obligation test[87] used by the Eighth Circuit in *Mann*,[88] or the completed sale test[89] used by the Tax Court in *Mann*.[90] According to Ward, the legal obligation test depends upon the enforceability of the agreement and the buyer's ability to demand a refund of his expenditure.[91] Ward then analyzed the provisions of the Uniform Commercial Code and deter-

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75. *Id.*

76. *Id.*

77. *Id.*

78. *E.g.*, Owens v. Commissioner, 568 F.2d 1233 (6th Cir. 1977); Mann v. Commissioner, 483 F.2d 673 (8th Cir. 1973); Cravens v. Commissioner, 272 F.2d 895 (10th Cir. 1959); Gaddis v. United States, 330 F. Supp. 741 (S.D. Miss. 1971); De La Cruz v. Commissioner, 37 T.C.M. (CCH) 24 (1978).

79. 32 T.C. 181 (1959). The facts of this case are fully described in Pinney & Olsen, *supra* note 1, 538-39.

80. 272 F.2d 895 (10th Cir. 1959). For additional material regarding this case, see Pinney & Olsen, *supra* note 1, at 539-40.

81. Cravens v. Commissioner, 272 F.2d at 898; Ernst v. Commissioner, 32 T.C. at 186.

82. 483 F.2d 673 (8th Cir. 1973). For an extensive analysis of the refundability test adopted by this court, see Ward, *supra* note 1, at 1128-36.

83. 568 F.2d 1233, 1243-44 (6th Cir. 1977). The facts of this case and an extensive analysis of the holding are set out in Wright & Wright, *supra* note 1, at 244-45.

84. *E.g.*, De La Cruz v. Commissioner, 37 T.C.M. (CCH) 24, 26 (1978).

85. Pinney & Olsen, *supra* note 1, at 544-45; Ward, *supra* note 1, at 1123-45; Willingham, *supra* note 1, at 503-04.

86. Ward, *supra* note 1.

87. *Id.* at 1128.

88. Mann v. Commissioner, 483 F.2d at 678.

89. Ward, *supra* note 1, at 1136.

90. Mann v. Commissioner, 31 T.C.M. (CCH) 808, 810 (1972), *rev'd*, 483 F.2d 673 (8th Cir. 1973).

91. *See* Ward, *supra* note 1, at 1128-30.

mined that in most instances the purchaser of feed will be entitled to partial restitution if he repudiates the contract.[92] Under a broad construction of refundability, Ward concluded, most contracts are refundable and the deduction could be denied.[93]

The technical argument that a buyer *could* repudiate an agreement so the deduction for feed payments should be denied, fails to consider the commercial reality that most buyers do not breach contracts.[94] It is for precisely this reason that the case law has stressed not only the fact that the agreement was enforceable, but that it was subsequently carried out.[95] In both *Lillie v. Commissioner*[96] and *Smith v. Commissioner*,[97] the Tax Court denied the deduction because the agreement was not carried out and a refund was actually received.[98]

Purists contend that making a deduction dependant upon a subsequent event, such as contract performance, violates the integrity of the taxable year.[99] According to this view, it would not be possible to determine tax liability at the close of the tax year if the deduction depends on a later event.[100] This view ignores the reality that most contracts are performed,[101] and so could be presumed performed at the close of the tax year. A later repudiation of the agreement could be handled with an amended return.[102] The current tax system already allows events occurring after the close of the tax year to govern the treatment accorded certain transactions.[103] In sales of principle residences[104] and certain involuntary conversions,[105] recognition of the current year's gain depends upon the purchase of facilities that may not take place until several years in the future.[106] In these types of transactions, Congress has realized that one year is not a sacrosanct time period and that the true nature of a transaction may not be apparent until a longer segment of time has passed. The facts and circumstances[107] test of refundability,

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92. *Id.* at 1130-31.
93. *Id.* at 1130.
94. *See* note 38 *supra.*
95. *Id.*
96. 45 T.C. 54, 62 (1965), *aff'd per curiam*, 370 F.2d 562 (9th Cir. 1966).
97. 35 T.C.M. (CCH) 1246, 1256 (1976).
98. *See* notes 96-97 *supra.*
99. *See* Ward, *supra* note 1, at 1143. *See also* Security Flour Mills v. Commissioner, 321 U.S. 281 (1944).
100. *See* Ward, *supra* note 1, at 1161.
101. *See* note 38 *supra.*
102. *See* Treas. Reg. § 1.161-1(a) (1957); § 1.151-1(a) (1957); The Commissioner has provided forms 1040X and 1120X for the purpose of correcting a return.
103. *See* text accompanying notes 104-05 *infra.*
104. *See* I.R.C. § 1034(a).
105. *See* I.R.C. § 1033(a).
106. *Id.*
107. Rev. Rul. 79-229, 1979-2 C.B. at 211.

which allows a court to examine subsequent events,[108] recognizes the validity of this view.

The completed sale test[109] formulated by the Tax Court in *Mann*[110] is not particularly clear in its meaning.[111] As Ward explains, if the test depends on the passage of title of the feed, then the test has been expressly rejected by the Eighth Circuit.[112] In all probability, the Tax Court was referring to the specificity of the quantity terms of the contract when it denied the deduction.[113]

Rather than using the refundability test utilized by the courts, Ward has suggested two other alternatives.[114] Initially, he suggests a performance standard[115] in which the test "would consider a feed prepayment 'paid' only to the extent the seller had completed his performance with respect to delivery, for, at that point, the seller has 'earned' payment."[116] While such a test would guarantee that no refund would be received by the farmer,[117] this test has equitable problems best illustrated in an example.

Andrew, a cash-basis farmer, buys 25 tons of feed with a cash payment of $2500. Because he lacks storage facilities, Andrew has the seller store the feed in seller's bin #1. Andrew plans to take delivery of the feed as his limited storage facilities allow. Under the Ward performance test Andrew is not entitled to a deduction because the seller has not completed performance with a delivery.

Brian, Andrew's more sophisticated neighbor, also pays $2500 for 25 tons of feed. Recognizing that his inability to store the feed could cost him a tax deduction, Brian leases bin #2 from the seller. Since the seller's performance is complete when the feed is delivered to the bin, Brian is entitled to a deduction.

The above example highlights the trap that would befall the unsophisticated taxpayer under a performance type of test. Likewise, the sophisticated taxpayer will have little trouble in manufacturing leasing arrangements that could satisfy the test. The facts and circumstances test of the Revenue Ruling[118] allows the economic substance of the transaction to govern, rather than the subtleties of performance.

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108. *E.g.*, Smith v. Commissioner, 35 T.C.M. (CCH) 1246 (1976); Lillie v. Commissioner, 45 T.C. 54 (1965), *aff'd per curiam*, 370 F.2d 562 (9th Cir. 1966).

109. *See* Ward, *supra* note 1, at 1136.

110. Mann v. Commissioner, 31 T.C.M. (CCH) 808, 810 (1972), *rev'd*, 483 F.2d 673 (8th Cir. 1973).

111. *See* Ward, *supra* note 1, at 1136.

112. *See* Mann v. Commissioner, 483 F.2d at 677.

113. *See* Ward, *supra* note 1, at 1137.

114. *Id.* at 1142, 1144.

115. *Id.* at 1142.

116. *Id.*

117. *Id.*

118. Rev. Rul. 79-229, 1979-2 C.B. at 211.

The second alternative proposed by Ward is to "confine deposit classification to those situations in which explicit agreement or business custom entitles the purchaser to a refund of the amount prepaid."[119] This test seems considerably closer to being able to reflect the substance of the transaction than does the performance test. As Ward notes, however, "this standard may stretch the consciences of some supplier witnesses."[120]

Rather than clarifying the issue, the alternative tests proposed by Ward create technicalities upon which the deposit-payment issue will turn.[121] Only a refundability standard encompassing all the facts and circumstances of the transaction can allow a court sufficient discretion to differentiate the legitimate payment from the legitimate-looking deposit.[122] For practitioners interested in drafting an agreement that will avoid the deposit issue, other authors have provided guidelines for drafting that should eliminate the problem.[123]

III. Business Purpose

In order for any business expense to be deductible, it must meet the "ordinary and necessary"[124] requirement of the Internal Revenue Code.[125] Court decisions have expanded on this language by holding that "appropriate and helpful"[126] are sufficient to satisfy the language of the statute.[127] Courts have also expressed an unwillingness to second guess a taxpayer who thinks an expenditure may be helpful.[128] Revenue Ruling 79-229, however, goes beyond this lax test by requiring a business purpose for the timing of the feed expenditure, rather then simply the expenditure itself.[129]

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119. *See* Ward, *supra* note 1, at 1144.
120. *Id.* at 1145.
121. *See* text accompanying notes 117-18 *supra*.
122. *See* note 108 *supra*.
123. *See* Pinney & Olsen, *supra* note 1, at 548-50; Willingham, *supra* note 1, at 508.
124. I.R.C. § 162(a). This section is quoted at note 4 *supra*.
125. *Id. See also* Treas. Reg. § 1.162-12(a) (1958).
126. Welch v. Commissioner, 290 U.S. 111 (1933).
127. *Id.*
128. *See* Ward, *supra* note 1, at 1169.
129. The text of the ruling states:

> The second test requires that the prepayment must be made for a valid business purpose and not merely for tax avoidance.
>
> Generally, the factor that distinguishes the earlier court decisions allowing a deduction for prepaid feed costs from those disallowing the deduction is the acquisition of, or the reasonable expectation by the taxpayer of receiving, some business benefit as a result of the prepayment. [Case citations omitted.] Examples of business benefits include, but are not limited to: fixing maximum prices and securing an assured feed supply or securing preferential treatment in anticipation of a feed shortage. Whether the prepayment was a condition normally imposed by the seller as an independent arm's length transaction and whether such condition was otherwise meaningful should also be taken into account in determining whether there was a business pur-

The authority for the Commissioner's position is not particularly persuasive in this regard.[130] The cases cited in the Ruling, *Ernst v. Commissioner*,[131] *Cravens v. Commissioner*,[132] *Shippy v. United States*[133] and *Lillie v. Commissioner*,[134] do not provide much support for the position that a business motive is required for the timing of the payment.[135] Commentators have cited *Gregory v. Helvering*[136] as holding that a business motive is required beyond mere tax avoidance.[137] This rationale does not seem particularly strong in the cattle feed context[138] since the taxpayer has shown a business motive for purchasing feed in that feed is necessary for cattle to survive.[139] Tax avoidance alone is not behind the feed purchase,[140] as was the case in the corporate reorganization in *Gregory* but only causes the timing of the purchase.[141]

Accordingly, a number of courts have clearly rejected the notion that a business motive for the timing of the feed prepayment is required.[142] Courts that have required such a motive have found it in the fixing of maximum feed prices,[143] as well as in the avoidance of potential feed shortages.[144]

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pose for the prepayment.

Rev. Rul. 79-229, 1979-2 C.B. at 211.

130. *See* Wright & Wright, *supra* note 1, at 260.

131. 32 T.C. 181 (1959). No suggestion of a business motive is contained in this decision since no maximum price was established or evidence of any feed shortage presented. *Id.* at 186.

132. 272 F.2d 895 (10th Cir. 1959). The court found that the taxpayer had a business motive in that he entered the contract to receive preferential treatment in a feed shortage. *Id.* at 899. The court, however, never stated that such a finding was necessary to sustain the deduction, noting only that Mr. Cravens had made a stronger case then had Mr. Ernst. *Id.*

133. 308 F.2d 743 (8th Cir. 1962). While the court did deny the deduction, alternative reasons were given for that holding. *Id.* at 746. Among the most prominent reasons seemed to be the lack of a contract between the farmer and the feedlot operator. *Id.* In dicta, the court went on to state: "With the contention that tax motive is unimportant if taxpayer does that which the law permits, we agree." *Id.* at 747.

134. 45 T.C. 54 (1965), *aff'd per curiam*, 370 F.2d 562 (9th Cir. 1966). Although the court found that the taxpayer had no business reason for making the feed prepayment, several alternative grounds were discussed for the decision. *See* 45 T.C. at 62.

135. *See* notes 131-34 *supra;* Ward, *supra* note 1, at 1174-77.

136. 293 U.S. 465 (1935).

137. *Id.* at 469. *See also* Goldstein v. Commissioner, 267 F.2d 127 (1st Cir. 1954).

138. *See* cases cited at note 142 *infra.*

139. Treas. Reg. § 1.162-12(a) (1958).

140. *See* Ward, *supra* note 1, at 1172.

141. 293 U.S. at 469.

142. *See* Mann v. Commissioner, 483 F.2d at 679-80 (business motive found in guaranteed maximum prices although court also recognized that tax savings may have influenced the decision; dicta that business motive was not important); Shippy v. United States, 308 F.2d at 747; Gaddis v. United States, 330 F. Supp. at 755 (taxpayer had right to reduce taxes by legal means available). *See also* Frank Lyon Co. v. United States, 435 U.S. 561, 580 (1978).

143. *E.g.*, Clement v. Commissioner, 580 F.2d 422, 429 (Ct. Cl. 1978), *cert. denied*, 440 U.S. 907 (1979); Frysinger v. Commissioner, 39 T.C.M. (CCH) 1287, 1292 (1980), *aff'd*, 645 F.2d 523 (5th Cir. 1981); Heinhold v. Commissioner, 39 T.C.M. (CCH) 685, 689 (1979); Haynes v. Commissioner, 38 T.C.M. (CCH) 950, 952 (1979), *appeal dismissed.*

Since the price of feed is traditionally lowest at the end of the calendar year,[145] most taxpayers have had little trouble showing a business motive.[146]

A section of Revenue Ruling 79-229,[147] not present in its predecessor,[148] asserts the Commissioner's position that only "traditional farmers" with significant capital investment in agricultural assets satisfy the business motive test.[149] The case law, however, simply does not support this assertion.[150] In *Haynes v. Commissioner*,[151] the Tax Court held that a passive investor in a limited partnership satisfied the business motive test.[152] Other cases have held that an investor whose only farming investment is cattle and feed held at a commercial feedlot may satisfy the business motive test.[153]

In light of the judicial ambivalence towards the business motive test,[154] as well as the relative ease of meeting the test,[155] the second prong of Revenue Ruling 79-229 has not proven much of a hinderance to taxpayers.[156]

IV. Clear Reflection of Income

The most difficult of the three hurdles for a taxpayer to overcome has been the last one, the clear reflection of income standard.[157] Closely related to this standard are the concepts of inventory[158] and capital expenditure.[159]

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144. Cravens v. Commissioner, 272 F.2d at 899.
145. *See* Frysinger v. Commissioner, 39 T.C.M. (CCH) at 1289.
146. *See* Wright & Wright, *supra* note 1, at 260.
147. The text of the new portion of the ruling states:

> However, in each of the above cases in which a business purpose was found, the taxpayers were traditional farmers and had a significant capital investment in agricultural assets in addition to the feed and animals involved. For this reason, the courts concluded that a business purpose existed when the entire farming business was benefitted.
>
> When the transaction in question is carried out in the context of closely held investor oriented groups, which are usually formed to take advantage of syndicated tax shelter schemes, there is little if any capital investment in assets other than feed. Generally, the "prepaid" feed is pledged as security to purchase the cattle to be fed. Consequently, the Service will look carefully at the substantive purpose behind such transactions to determine the motives behind them. A motive based on the federal income tax advantages of prepayment of feed costs and the consequent deferral of resulting income is not a valid business purpose.

Rev. Rul. 79-229, 1979-2 C.B. at 211.

148. Rev. Rul. 75-152, 1975-1 C.B. at 140.
149. *See* note 147 *supra*.
150. *See* text accompanying notes 151-52 *infra*.
151. 38 T.C.M. (CCH) 950 (1979), *appeal dismissed*.
152. *Id.* at 952.
153. *See* Owens v. Commissioner, 568 F.2d at 1245.
154. *See* note 142 *supra*.
155. *See* Wright & Wright, *supra* note 1, at 260.
156. *Id.*
157. I.R.C. § 446 (quoted in text at note 160 *supra*.).
158. *See* text accompanying notes 184-98 *supra*.
159. *See* text accompanying notes 199-215 *supra*.

The statutory underpinning of this third test of Revenue Ruling 79-229 lies in section 446 of the Internal Revenue Code which states:

> (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 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.[160]

For a cash-basis farmer, the appropriate time for taking a deduction is when a cash payment is made.[161]

Additionally, the Commissioner has broad powers under section 446(b) to determine if a taxpayer's method of accounting clearly reflects his income.[162] If the Commissioner determines that it does not, he may determine a method of accounting that does clearly reflect income.[163] The Commissioner could mandate an entirely different system of accounting,[164] or simply require that a single item be treated differently.[165] Before these powers can be asserted, however, the Commissioner must show that the taxpayer's current method of accounting materially misstated his income.[166] Some courts have held that a taxpayer has not materially misstated his income when he consistently follows the cash receipts and disbursements method specifically allowed him.[167] According to this rationale, cash receipts and disbursements,

> should not be taken out of the annual accounting system and, for the benefit of the Government or the taxpayer, treated on a basis which is neither a cash basis nor an accrual basis, because so to do would, in a given instance, work a supposedly more equitable result to the Government or to the taxpayer.[168]

Courts rejecting the above reasoning have usually struggled with the

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160. I.R.C. § 446.

161. I.R.C. § 461; *see also* Treas. Reg. § 1.461-1(a)(1) (1957).

162. *See* Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 532 (1979); Commissioner v. Hansen, 360 U.S. 446, 467 (1959); Lucas v. American Code Co., 280 U.S. 445, 449 (1930).

163. I.R.C. § 446(b). Whether an accounting method clearly reflects income is a question of fact. *See* Van Raden v. Commissioner, 71 T.C. 1083, 1104 (1979), *aff'd*, 650 F.2d 1046 (9th Cir. 1981).

164. Treas. Reg. § 1.446-1(b)(1) (1957).

165. *Id.*; Sandor v. Commissioner, 62 T.C. 469, 477 (1974), *aff'd per curiam*, 536 F.2d 874 (9th Cir. 1976).

166. More properly, the Commissioner determines that a taxpayer's method of accounting does not clearly reflect income. I.R.C. § 446(b). Such a determination will not be overturned unless the taxpayer can show a clear abuse of discretion. *See* Sandor v. Commissioner, 62 T.C. at 477.

167. *See, e.g.*, Frysinger v. Commissioner, 645 F.2d 523, 527 (5th Cir. 1981).

168. *See* Security Mills Co. v. Commissioner, 321 U.S. 281, 285-86 (1944).

concept of materiality.[169] Some courts merely examine the Commissioner's proposed adjustments, and if they are large enough, find a material misstatement of income.[170] Unfortunately, this technique presumes that the Commissioner's method of accounting is the true and correct one.[171] Since the cash receipts and disbursements method is specifically sanctioned within the Code,[172] while the Commissioner's method of cash receipts and feed consumed deductions is not,[173] this conclusion seems tenuous at best. As a result, at least one court has not changed the taxpayer's method of accounting because the Commissioner's method was no better than the taxpayer's.[174]

Perhaps the most unique theory that has been used is the one devised by the Tax Court.[175] Simply put, the Tax Court will not find a material distortion of income if the taxpayer has a substantial business motive for the feed prepayment.[176] Recent opinions of the various circuit courts of appeals,[177] although affirming Tax Court decisions,[178] do not mention this test.[179]

Revenue Ruling 79-229[180] describes several factors which may be con-

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169. *See, e.g.*, Clement v. Commissioner, 580 F.2d 422, 430-32 (Ct. Cl. 1978).

170. *See, e.g.*, Clement v. Commissioner, 580 F.2d at 431; Shippy v. United States, 308 F.2d 743, 747 (8th Cir. 1962).

171. These cases seem to assume that a true and correct method of accounting exists. No authority is ever cited for this proposition. Generally accepted accounting principles are not equivalent to the clear reflection of income standard. *See* Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 532 (1979).

172. I.R.C. § 446(c).

173. *Id.*

174. *See* Owens v. Commissioner, 568 F.2d at 1246.

175. *E.g.*, Van Raden v. Commissioner, 71 T.C. 1083, 1106 (1979), *aff'd*, 650 F.2d 1046 (9th Cir. 1981); Frysinger v. Commissioner, 39 T.C.M. (CCH) 1287, 1292 (1979), *aff'd*, 645 F.2d 523 (5th Cir. 1981); De La Cruz v. Commissioner, 37 T.C.M. (CCH) 24, 27 (1978).

176. *Id.*

177. *See* Commissioner v. Van Raden, 650 F.2d 1046 (9th Cir. 1981); Frysinger v. Commissioner, 645 F.2d 523 (5th Cir. 1981).

178. *Id.*

179. *Id.*

180. The ruling provides:

> Some of the factors to be considered in determining whether the deduction results in a material distortion of income include, but are not limited to: the useful life of resulting assets during and beyond the taxable year paid, Rev. Rul. 68-643, 1968-2 C.B. 76 (the relationship of the amount of the prepaid expenditure in question to the projected magnitude of the business in a subsequent year should therefore be considered, see *Cole v. Commissioner*, 64 T.C. 1091 (1975)); the materiality of the expenditure in relation to the taxpayer's income for the year, *Clement v. United States*, 580 F.2d 422 (Ct. Cl. 1978); the purpose for paying in advance, *Baird v. Commissioner*, 68 T.C. 115 (1978); the customary, legitimate business practice of the taxpayer in conducting livestock operations; the amount of the expenditure in relation to past purchases, and the time of the year the expenditure was made; whether the taxes paid by a taxpayer consistently deducting prepaid feed costs over a period of years are reasonably comparable to the taxes that would have been paid had the same taxpayer consistently not paid in advance.

sidered in order to determine if income is materially distorted.[181] In a recent case, the Court of Claims held that a substantial feed prepayment materially distorted income.[182] Later appellate decisions, however, have not followed this case.[183]

Clearly related to the distortion of income issue is the inventory requirement.[184] Most taxpayers are required to use an inventory method.[185] Farmers, however, are specifically exempt from this requirement by the regulations.[186] This historic benefit is based on the notion that farmers require a simplified accounting system.[187] This regulation has been the rationale used by many courts in finding that feed prepayments do not materially distort income.[188] It also prevents the Commissioner from attempting to match the cash revenues with the feed expenses by deferring the expenses until the cattle are sold.[189]

Ward, however, contends that this regulation does not prohibit the Commissioner from deferring the feed deduction to the point when the feed is actually used.[190] He bases this analysis on a theory of product costs and period costs.[191] In short, Ward contends that cattle feed costs are period costs rather than product costs.[192]

This theory can only be described as erroneous.[193] An example will clarify the point. No one would seriously doubt that tires are an integral part in producing an automobile. Likewise, the cost of tires clearly relates to the production of cars. While a stockpile of tires is undoubtedly consumed over a period of time, this is only because cars are being produced over the time period. If the production of cars would cease, no tires would be used at all. Cattle feed costs behave in much the same manner. Feed is consumed over a time period only because the cattle are being fattened for sale. Without the production of cattle, no feed would be consumed.

Rev. Rul. 79-229, 1979-2 C.B. 210, 212.

181. *Id.*

182. Clement v. Commissioner, 580 F.2d 422, 432 (Ct. Cl. 1978).

183. *See, e.g.*, Commissioner v. Van Raden, 650 F.2d at 1050 n.5; Frysinger v. Commissioner, 645 F.2d at 527.

184. I.R.C. § 471.

185. Treas. Reg. § 1.471-1 (1958).

186. Treas. Reg. § 1.471-6(a) (1958). *But see* I.R.C. § 447.

187. *See* Catto v. United States, 384 U.S. 102, 116 (1966).

188. *See, e.g.*, Frysinger v. Commissioner, 645 F.2d at 526-27; Cravens v. Commissioner, 272 F.2d at 900-01.

189. *See* Ward, *supra* note 1, at 1150.

190. *Id.* at 1155-56.

191. *Id.* "Period costs are those costs which can be identified with measured time intervals, rather than with goods delivered or services provided." R. GARRISON, MANAGERIAL ACCOUNTING: CONCEPTS FOR PLANNING, CONTROL, DECISION MAKING 26 (Rev. ed. 1979). Product costs are costs associated with the production of a particular item. *Id.* at 27.

192. Ward, *supra* note 1, at 1157.

193. *See* Frysinger v. Commissioner, 645 F.2d at 527.

More importantly, the basic concept of an inventory is the accumulation of product costs.[194] Whether the costs are accumulated until the feed is consumed or until the cattle are sold, an inventory system has still been imposed.[195] The proof of this theoretical pudding is the fact that deduction of feed as it is consumed requires the farmer to maintain a count of feed on hand.[196] Such a count is, of course, an inventory.[197] Since farmers are specifically excused from using an inventory method under the regulations, a farmer should not be forced to do so under the guise of a feed consumption method of accounting.[198]

Another concept frequently discussed in this area is the capital expenditure.[199] A taxpayer is not allowed to deduct the cost of a capital expenditure currently,[200] but must deduct a portion of that cost over the periods benefitted.[201] Some courts have mistakenly concluded that feed is not a capital expenditure since it is used only for the daily feeding of cattle.[202] Other courts have concluded that the inventory regulations prohibit the Commissioner from mandating capital expenditure treatment to prepaid feed.[203] Still other courts have not felt so restrained.[204]

The most unique decision in this field is the recent Ninth Circuit case of *Commissioner v. Van Raden*.[205] This court adopted a "one-year rule"[206] which "allows a full deduction in the year of payment where an expenditure creates an asset having a useful life of one year or less."[207] Since the taxpayer had used substantially all of the feed by the end of the next tax year[208] he was allowed a full deduction in the year of payment.[209]

This decision raises a number of questions. Initially, the court is not clear whether the deduction depends upon the actual use of the feed in the subsequent year,[210] or whether the deduction is contingent upon the tax-

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194. "Product costs are often called inventoriable costs. . . . The concept of an inventoriable or product cost is a key concept in managerial accounting, since these costs can end up on the balance sheet as *assets* . . . ." R. GARRISON, *supra* note 191, at 30.

195. *See* Frysinger v. Commissioner, 645 F.2d at 527.

196. Van Raden v. Commissioner, 71 T.C. at 1108.

197. *Id.*

198. *Id.*

199. *Id.*

200. Treas. Reg. § 1.461-1(a)(1) (1958).

201. *Id.*

202. Cravens v. Commissioner, 272 F.2d at 899; Gaddis v. United States, 330 F. Supp. at 757.

203. *E.g.*, Cravens v. Commissioner, 272 F.2d at 899.

204. Frysinger v. Commissioner, 645 F.2d at 528.

205. Commissioner v. Van Raden, 650 F.2d 1046 (9th Cir. 1981).

206. Zaninovich v. Commissioner, 616 F.2d 429, 432 (9th Cir. 1980) (one year rule formulated in prepaid rent context).

207. Commissioner v. Van Raden, 650 F.2d at 1050.

208. *Id.*

209. *Id.*

210. *Id.*

payer's intent to use the feed within the next year.[211] The distinction becomes quite important in situations similar to that which occurred in *Haynes v. Commissioner*,[212] where the taxpayer intended to use all the feed within twelve months,[213] but was unable to do so by circumstances beyond his control.[214] If actual use is the test, purists will contend that the integrity of the tax year has been violated, since this year's deduction depends on next year's use.[215]

The material distortion of income issue in prepaid feed cases has created an atmosphere of judicial confusion.[216] At least four different views of this issue have emerged.[217] Only Congress or the Supreme Court seem able to resolve the conflict at this point.[218]

V. Conclusion

Besides the three tests of Revenue Ruling 79-229, other considerations exist in contemplating a prepaid feed deduction. Initially, in order for the beneficial provisions of the regulation allowing a farmer to avoid inventories to apply, a taxpayer must be considered a farmer.[219] The definition of "farmer" contained within the regulations[220] is sufficiently broad that most cattle feeding taxpayers will have little trouble qualifying.[221] It should also be remembered that Congress has acted to remove some of the shine of prepaid feed expenses.[222] Some farm corporations are now required to use the accrual method of accounting.[223] Certain farm syndicates are prevented from taking any deductions for feed expenses until the feed is actually con-

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211. *Id.*

212. Haynes v. Commissioner, 38 T.C.M. (CCH) 950 (1979), *appeal dismissed.*

213. *Id.* at 953.

214. *Id.*

215. *See* notes 99-100 *supra.* To the extent *Van Raden* allows calculation of tax liability based upon a subsequent event, it provides support for that concept in the deposit-payment area.

216. *See* text accompanying notes 185-215 *supra.*

217. The four views may be summarized as follows: 1) Tax Court—Business purpose prevents distortion of income. Van Raden v. Commissioner, 71 T.C. 1083, 1106 (1979); Frysinger v. Commissioner, 39 T.C.M. (CCH) 1287, 1292 (1979); De La Cruz v. Commissioner, 37 T.C.M. (CCH) 24, 27 (1978). 2) Court of Claims—Prepaid feed expenses materially distort income. *See* Clement v. United States, 580 F.2d 422, 430 (Ct. Cl. 1978). 3) Fifth Circuit—Historical concession of regulations prevent distortion of income. *See* Frysinger v. Commissioner, 645 F.2d 523, 527 (5th Cir. 1981). 4) Ninth Circuit—No distortion if one year rule is followed. *See* Commissioner v. Van Raden, 650 F.2d 1046, 1050 (9th Cir. 1981).

218. Wright & Wright, *supra* note 1, at 233 n.*.

219. *See* Treas. Reg. § 1.471-6 (1958).

220. Treas. Reg. § 1.61-4(d) (1956).

221. Willingham, *supra* note 1, at 501.

222. *Id.* at 497.

223. I.R.C. § 447.

sumed.[224] Consideration should also be given the fact that the Internal Revenue Service may issue revenue rulings with retroactive impact.[225] Revenue Ruling 75-152 was issued in that manner,[226] and its application to a transaction consummated before its issuance has been upheld.[227]

The three tests of Revenue Ruling 79-229 have developed under the influence of more than twenty years of litigation. As can be seen, significant questions still remain as to how aspects of these tests are to be applied. The primordial question, however, still remains: When should a cash basis farmer deduct the expenses of fattening his cows? Utilizing the guidelines of the ruling and its judicial spawn, perhaps tax planners will be better able to answer that question for themselves.

Steven J. Roy

224. I.R.C. § 464.
225. I.R.C. § 7805(b).
226. Dunn v. United States, 468 F. Supp. 991, 995 (S.D.N.Y. 1979).
227. *Id.*