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Problems in Rolling Over Lines of Credit to the Following Year

-by Neil E. Harl*

The decline in recent months of farm commodity prices, especially crops, may threaten beginning farmers and those with limited resources.¹ In some instances, the ability to repay short-term production loans may be in question. It is important to note that late year-end payments by rolling over a loan into the following year's line of credit are likely to be challenged as to deductibility. The Internal Revenue Service in mid-1983 announced that rollovers involving the same lender, with the rollover of the unpaid interest amount treated as though the interest had been paid, would no longer be an accepted practice.² That announcement was made after IRS had won three cases relative to that issue.

Cases establishing authority limiting rollovers

The litigated cases blowing the whistle on interest rollovers and denying deductibility if from the same lender were decided prior to the IRS announcement in mid-1983. The first of those cases, *Battelstein v. Internal Revenue Service*,³ was decided in 1980 with an unsuccessful appeal to the U.S. Supreme Court. The second of those cases was *Wilkerson v. Commissioner*,⁴ in 1981 which reversed a Tax Court decision to the contrary.⁵ The third decision, *Menz v. Commissioner*⁶ which was not appealed to a Court of Appeal, was decided in 1983, the year of the announcement of the IRS position.⁷

In later cases the IRS position was followed, also. In *Davison v. Commissioner*,⁸ a borrower on the cash method of accounting was not entitled to an interest deduction where funds used to satisfy the interest obligation were borrowed for that purpose from the same lender. In *Stone v. Commissioner*,⁹ interest payments were in the form of promissory notes and the interest in similar circumstances was not considered paid. Similarly, in the latest case to be litigated, *Hargreaves v. Commissioner*,¹⁰ a Tax Court Summary Opinion (which is not appealable and cannot be cited as precedent) held that no interest deduction was allowed for interest not paid but added to the balance of the loan in what was termed a "negative amortization."

But what about the "Original Issue Discount" rules?

Under those rules, a rollover of an old loan into the following year's line of credit may cause the original discount (OID) rules to apply if the old loan does not become payable until more than one year after the original loan was obtained.¹¹

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EXAMPLE: A financially troubled taxpayer borrows \$100,000 from a bank on May 1, 2015 at 10 percent interest with interest and principal due November 1, 2015. Because of low prices, the borrower and the lender, hoping commodity prices will strengthen in 2016, agree to defer payments on the loan until November 1, 2016, with the interest continuing to accrue at the 10 percent interest rate. That makes the loan have a term of “more than one year” so that the OID amount of interest totaling \$15,500 for the 18 month term would make it possible to deduct part of the interest in 2015 and part of the interest in 2016.

Of course, some borrowers in financial difficulty may not need (or be able to use) a deduction in 2015.

The OID rules require that payments must first be allocated to OID and then to principal.¹²

It is also important to note that a commercial bank on cash accounting is not required to use original issue discounting (OID) rules for short-term loans.¹³ Banks are allowed to automatically change to cash accounting for stated interest on short-term loans.¹⁴

ENDNOTES

¹ See Harl, “Managing Losses in An Economic Downturn,” 26 *Agric. L. Dig.* 177 (2015).

² See IR News Rel. 83-93, July 6, 1983.

³ 631 F.2d 1182 (5th Cir. 1980), *cert. denied*, 451 U.S. 938 (1981).

⁴ 655 F.2d 980 (9th Cir. 1981).

⁵ 70 T.C. 240 (1978).

⁶ 80 T.C. 1174 (1983).

⁷ See note 2 *supra*.

⁸ 107 T.C. 35 (1996), *aff'd*, 141 F.3d 403 (2d Cir. 1998).

⁹ T.C. Memo. 1996-507.

¹⁰ T.C. Summary Opinion 2013-37.

¹¹ See I.R.C. §§ 1272(a)(1), (a)(2)(C); 1273(a)(1). *Cf.* Security State Bank v. Comm’r, 214 F.3d 1254 (10th Cir. 2000) (bank on cash method of accounting not required to accrue interest on original issue discount; TAM 200448047, Aug. 30, 2004 (three notes issued for purchase of business were aggregated for OID purposes; the result was that the interest amount was spread over the term of the loan with a portion deductible in the year the loan was taken out and a portion would be deductible in the year to which the loan was rolled).

¹² Treas. Reg. § 1.1275-2(a).

¹³ Security State Bank v. Comm’r, 214 F.3d 1254 (10th Cir. 2000), *acq.*, I.R.B. 2001-5, AOD-CC-201-01.

¹⁴ Rev. Proc. 2001-25, 2001-1 C.B. 913.

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr

FEDERAL FARM PROGRAMS

CROP INSURANCE. FCIC has adopted as final regulations amending the Area Risk Protection Insurance (ARPI) Regulations; ARPI Basic Provisions and ARPI Forage Crop Insurance Provisions. The intended effect of this action is to meet the goals of the Acreage Crop Reporting Streamlining Initiative, which is a USDA initiative and required by the Agricultural Act of 2014 (2014 Farm Bill), by aligning ARPI Forage Production with the Actual Production History Forage Production Crop Insurance Provisions and to address language contained in Section 12305(b) (1)(B) of the 2014 Farm Bill that prohibits the FCIC from offering the catastrophic level of coverage for any crops or grasses used for grazing. The changes will be effective for the 2017 and succeeding crop years. **80 Fed. Reg. 73637 (Nov. 25, 2015).**

FOOD LABELING. The FDA has announced the availability of a draft guidance for industry entitled “Voluntary Labeling Indicating Whether Food Has or Has Not Been Derived From

Genetically Engineered Atlantic Salmon: Guidance for Industry.” The FDA developed the draft guidance to assist food manufacturers that wish to voluntarily label their food product or ingredients (for humans or animals) derived from Atlantic salmon as either containing or not containing products from genetically engineered (GE) Atlantic salmon. **80 Fed. Reg. 73193 (Nov. 24, 2015).**

FOOD SAFETY. The FDA has adopted as final regulations establishing science-based minimum standards for the safe growing, harvesting, packing, and holding of fruits and vegetables grown for human consumption. These standards do not apply to produce that is rarely consumed raw, produce for personal or on-farm consumption, or produce that is not a raw agricultural commodity. In addition, produce that receives commercial processing that adequately reduces the presence of microorganisms of public health significance is eligible for exemption from the requirements of this rule. The rule sets forth procedures, processes, and practices that minimize the risk of serious adverse health consequences or death, including those reasonably necessary to prevent the introduction of known or reasonably foreseeable biological hazards into or onto produce and to provide reasonable assurances that the produce is not adulterated on account of such hazards. **80 Fed. Reg. 74353 (Nov. 27, 2015).**