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When Are Amounts Considered “Paid”?

-by Neil E. Harl*

It has been clear since the 1930s that vendor financing of feed, seed and other supplies (as well as some additional items) does not support an income tax deduction for the purchaser.¹ Yet questions continue to arise over the issue with many apparently unaware of the authority supporting that treatment of vendor-financed transactions.

Terms of the rule

The determination by the United States Supreme Court,² which is discussed in detail below, has been dealt with in regulations,³ a ruling⁴ and in further litigation in lower courts.⁵

The regulations state that, for taxpayers on the cash method of accounting, amounts for feed, seed and other supplies may be deducted in the year “paid.”⁶ Payment by promissory note, however, even when secured by collateral, such as a letter of credit, does not produce a deduction.⁷ A deduction can be claimed if funds are borrowed from a third party and used to pay for the feed, seed and other supplies.⁸ In one instance, the funds were borrowed from a bank.⁹

In recent years, questions have frequently been raised as to whether investors of cattle in a feedyard could claim a deduction for feed costs if they elected to sign a promissory note for the monthly charges for feed, with the notes paid off when the cattle were sold (it was generally agreed that no deduction could be claimed for tax purposes until the feed bill was actually paid out of the taxpayer’s own funds or from funds borrowed from a third party). Similarly, it is believed that no deduction can be claimed for seed purchases financed by the seed company until the amount is paid either from the taxpayer’s funds or from a loan by a third party. If the financing is coming from a wholly-owned subsidiary of the vendor, a serious question is raised whether that is a loan from a “third party” lender, particularly where the financing is provided on a preferential basis (one to three points under the prime rate, for example).

A relatively recent case focused on whether the rule should apply to improvements to office condominiums which were acquired and refurbished for sale.¹⁰ The Federal District Court for the Western District of Tennessee held that the rule did apply and the cost of improvements which were financed by vendors did not add to the income

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tax basis of the property owners for purposes of figuring the gain or loss on sale and for purposes of calculating depreciation that could be claimed on the properties. There was no evidence that payments were made on the obligations. Presumably, as payments were made on the vendor obligations by the property owners, such as a promissory note, the income tax basis for the property involved would be increased for those purposes.¹¹

Origins of the rule

The rule denying a deduction for vendor-financed acquisitions originated in the Great Depression era. In *Helvering v. Price*,¹² a leading case on this issue, the taxpayer was a shareholder in a bank which merged with another bank in 1932. The taxpayer and others executed a guaranty agreement providing that if the second bank failed to realize a designated sum on assets turned over to that bank, part of the deficiency would be made up by the taxpayers. No cash payment was ever made. The taxpayer attempted to claim a deduction for the loss. The Supreme Court said that the giving of a note or an assurance of payment was not the same as payment in cash. The loss deduction was denied.¹³

Other possible areas of application

With the rule limiting current deductibility for vendor-financed supplies and other improvements, an obvious question is whether the provision should apply to acquisition of real estate under an installment land contract or contract for deed. That type of transaction also involves vendor financing (the seller provides the financing in an installment land contract, for example). Likewise, the provision might be held to apply to the purchase of a pickup truck which is financed by the manufacturer or a financing arm of the manufacturer, a tractor or combine (or the repair of a tractor or combine) financed by the farm equipment maker or a business automobile financed by the manufacturer.

When this argument was made, following the decision in *Owen v. United States*,¹⁴ the reported IRS response was that the rule would apply only to supplies and improvements to property but not to whole goods such as a tractor or combine. Logically, the drawing of such a line seems arbitrary and could

well be subject to challenge. Nonetheless, IRS has not made a move in the past decade to extend the rule beyond supplies and improvements.

Endnotes

¹ *Helvering v. Price*, 309 U.S. 409 (1940). See Harl, Claiming Deductions for Seed and Other Inputs," 10 *Agric. L. Dig.* 33 (1999); Harl, "When Feed is Deemed Paid," 6 *Agric. L. Dig.* 17 (1995). See Harl, *Farm Income Tax Manual* § 3.07[4] (2008); Harl, *Agricultural Law* § 28.05[5] (2008); Harl, *Agricultural Law Manual* § 4.03[8] (2008).

² *Helvering v. Price*, 309 U.S. 409 (1940). See *Eckert v. Burnet*, 238 U.S. 140 (1931).

³ Treas. Reg. § 1.461-1(a)(1).

⁴ Rev. Rul. 77-257, 1977-2 C.B. 174.

⁵ *Chapman v. United States*, 527 F. Supp. 1053 (D. Minn. 1981); *Owen v. United States*, 34 F. Supp. 2d 1071 (W.D. Tenn. 1999).

⁶ Treas. Reg. § 1.461-1(a)(1).

⁷ *Chapman v. United States*, 527 F. Supp. 1053 (D. Minn. 1981).

⁸ Rev. Rul. 77-257, 1977-2 C.B. 174.

⁹ *Granan v. Comm'r*, 55 T.C. 753 (1971).

¹⁰ *Owen v. United States*, 34 F.2d 1071 (W.D. Tenn. 1999), reconsideration denied, 99-1 U.S. Tax Cas. (CCH) ¶ 50,380 (W.D. Tenn. 1999).

¹¹ See *Helvering v. Price*, 309 U.S. 409 (1941); *Patmon, Young & Kirk, Professional Corp. v. Comm'r*, 536 F.2d 142 (6th Cir. 1976).

¹² 309 U.S. 409 (1941).

¹³ *Id.*

¹⁴ 34 F. Supp. 2d 1071 (W.D. Tenn. 1999).

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