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## TENNESSEE FEDERAL COURT FOCUSES ON WHEN PAYMENT OCCURS

— by Neil E. Harl\*

A decision by the United States District Court for the Western District of Tennessee<sup>1</sup> on February 23, 1999, has drawn attention once again to the question of when payment occurs for taxpayers on the cash method of accounting.<sup>2</sup> The latest case, *Owen v. United States*,<sup>3</sup> involved improvements to office condominiums which were paid by promissory note. The District Court held that payment had not yet occurred for the taxpayer (who was on the cash method of accounting) so the improvements did not add to the property's income tax basis for purposes of figuring gain on sale.<sup>4</sup> The case has important potential implications for farmers.

### The general rule

The rule has been well established since *Helvering v. Price*<sup>5</sup> was decided by the U.S. Supreme Court in 1940 that the issuance of a promissory note by a taxpayer on the cash method of accounting, without any disbursement of cash or property having a cash value, does not give rise to a deduction.<sup>6</sup> The key ruling in this area, *Rev. Rul. 77-257*,<sup>7</sup> involved the question of whether the issuance of a promissory note resulted in an allowable deduction for expenses incurred. The ruling held that a deduction could not be claimed until the note was paid but noted that "...the actual payment of an expense with funds borrowed from a third party does give rise to a current deduction."<sup>8</sup> The 1977 ruling noted that, in the facts before the Internal Revenue Service, there was no borrowing from a bank or other third party lender.<sup>9</sup> The ruling concluded that the issuance of a promissory note represented only a promise to pay and was not payment for purposes of obtaining an income tax deduction.<sup>10</sup>

The general rule has been invoked in connection with when a deduction may be claimed for feed in a commercial feedlot<sup>11</sup> and has come up in recent months in situations involving the purchase of seed where the seed company (or a subsidiary of the seed company) provides the financing.<sup>12</sup>

### The Tennessee case

The fact situation in the case of *Owen v. United States*,<sup>13</sup> involved taxpayers on the cash method of accounting who had made improvements to office condominiums before the condominiums were sold. The key issue was whether the improvements, which had been paid by three promissory notes to a contracting firm controlled by the taxpayer, were considered "paid."<sup>14</sup> If the improvements were considered paid by issuance of the promissory notes, the amount of the improvements added to the income tax basis which affected the calculation of gain or loss on sale.<sup>15</sup>

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The court recognized that the Internal Revenue Code states that a taxpayer's initial basis in property is the cost of the property.<sup>16</sup> The regulations go on to state that "cost is the amount paid for such property in cash or other property."<sup>17</sup> The court then cited to authority<sup>18</sup> supporting the proposition that cost basis includes personal liabilities incurred by the purchaser and liabilities subject to which the property is taken. The court, however, stated that those cases were distinguishable because they dealt with the initial cost basis of property rather than adjustments to basis after purchase.<sup>19</sup> The court acknowledged authority that a cash basis taxpayer could not increase the basis in the year of acquisition for debt obligations that were not paid until a later year.<sup>20</sup>

The court then proceeded to hold that the taxpayers could not increase their basis in property for improvements made later which were financed with promissory notes.<sup>21</sup> The court noted that basis could be increased in subsequent years when payments are made on the notes.<sup>22</sup>

### Consequences of *Owen v. United States*

The holding in *Owen v. United States*<sup>23</sup> indicates that an expenditure for a new tractor engine or building improvement financed with a promissory note does not add to the income tax basis for the property (and thus is not depreciable) until the amount is paid.<sup>24</sup> It is pointed out that *Rev. Rul. 77-257*<sup>25</sup> would allow a deduction for an expense if funds were "borrowed from a third party."<sup>26</sup> The court in *Owen v. United States*<sup>27</sup> did not make that distinction but the opinion does recite that the promissory note was to a firm controlled by the taxpayer.

The court in *Owen v. United States*<sup>28</sup> concluded by saying—

"Allowing a cash basis taxpayer to increase his basis when he issues a promissory note for improvements to property would avail the taxpayer of an immediate increase in depreciation deductions and would afford him the opportunity to decrease any potential gain or increase any potential loss should the property be sold, without having made any cash outlay."<sup>29</sup>

It is pointed out that the same result obtains for debt instruments issued in connection with an initial purchase. However, as the court noted in *Owen*,<sup>30</sup> substantial authority supports including the debt amount in the basis in that situation.<sup>31</sup> The Supreme Court noted, in *Commissioner v. Tufts*,<sup>32</sup> "because of the obligation to repay, the taxpayer is entitled to include the amount of the loan in computing his basis in the property." Without that authority, depreciation deductions would be in jeopardy for financed farm machinery and equipment, at least that using dealer financing or, possibly, financing by a subsidiary of the manufacturer.

As it stands, it appears that the only transactions in some jeopardy (in terms of not being able to add the financed amount to basis which means no depreciation can be claimed until payment is made) are those involving improvements or additions to property *after the initial acquisition*.

Of course, *Owen v. United States*<sup>33</sup> may be appealed. Remember also, the Second<sup>34</sup> and Ninth<sup>35</sup> Circuit Courts of Appeal believe basis can be created with a personal promissory note. Clearly, we haven't heard the last word yet in this matter.

### FOOTNOTES

- 1 *Owen v. United States*, 34 F. Supp.2d 1071 (W.D. Tenn. 1999).
- 2 See generally 4 Harl, *Agricultural Law* § 28.05[5][a] (1999); Harl, "Claiming Deductions for Seed and Other Inputs," 10 *Agric. L. Dig.* 33 (1999).
- 3 See n. 1 *supra*.
- 4 *Id.*
- 5 309 U.S. 409 (1940).
- 6 *Id.*
- 7 1977-2 C.B. 174.
- 8 *Id.*
- 9 *Id.*
- 10 *Id.*
- 11 *Chapman v. United States*, 527 F. Supp. 1053 (D. Minn. 1981).
- 12 *Id.*
- 13 34 F. Supp.2d 1071 (W.D. Tenn. 1999).
- 14 *Id.*
- 15 *Id.*
- 16 I.R.C. §§ 1011, 1012.
- 17 Treas. Reg. § 1.1012-1.
- 18 *Bertoli v. Comm'r*, 103 T.C. 501,515 (1994); *Conroe Office Bldg., Ltd. v. Comm'r*, T.C. Memo. 1991-24.
- 19 34 F. Supp.2d 1071 (W.D. Tenn. 1999).
- 20 See, e.g., *Haymond v. Comm'r*, T.C. Memo. 1997-289 (unpaid commission on sale of stock). See also *Vaira v. Comm'r*, 52 T.C. 986 (1969), *rev'd and remanded on another issue*, 444 F.2d 770 (3d Cir. 1971) (unpaid appraisal fees).
- 21 *Owen v. United States*, 34 F. Supp.2d 1071 (W.D. Tenn. 1999).
- 22 *Id.*
- 23 34 F. Supp.2d 1071 (W.D. Tenn. 1999).
- 24 *Id.*
- 25 1977-2 C.B. 174.
- 26 *Id.*
- 27 34 F. Supp.2d 1071 (W.D. Tenn. 1999).
- 28 *Id.*
- 29 *Id.*
- 30 *Id.*
- 31 See *Crane v. Comm'r*, 331 U.S. 1 (1947); *Comm'r v. Tufts*, 461 U.S. 300 (1983).
- 32 461 U.S. 300, 307-08 (1983).
- 33 34 F. Supp.2d 1071 (W.D. Tenn. 1999).
- 34 *Lessinger v. Comm'r*, 872 F.2d 519 (2d Cir. 1989).
- 35 *Pericchi v. Comm'r*, 143 F.3d 487 (9th Cir. 1998).