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1999-03-05

# Claiming Deductions For Seed And Other Inputs

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Agricultural Law Press

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# Agricultural Law Digest

Volume 10, No. 5

March 5, 1999

ISSN 1051-2780

## CLAIMING DEDUCTIONS FOR SEED AND OTHER INPUTS

— by Neil E. Harl\*

Ordinarily, for taxpayers on the cash method of accounting,<sup>1</sup> a deduction may be claimed for production inputs—seed, fertilizer, chemicals, fuel and feed—in the year payment is made.<sup>2</sup> The question has arisen under various fact circumstances, as to when inputs are considered “paid.”<sup>3</sup>

### Payment with promissory note

It is clear that payment with a promissory note, even if secured by collateral, does not produce a deduction.<sup>4</sup> The same outcome results if the note is secured.<sup>5</sup>

Example: An investor in cattle being fed out in a commercial feedyard is offered a choice in paying the monthly feed bills. The investor could pay cash for the feed and other costs. That, of course, would produce an income tax deduction in the year paid.<sup>6</sup> In the alternative, the investor is offered a deal whereby the investor signs a promissory note each month for the cost of feed and other expenses, with the notes paid when the cattle are sold and the proceeds applied on the obligations. It is clear that merely signing a promissory note for the feed and other expense does not produce an income tax deduction at that time. The expense is deductible when the notes are paid, presumably after the cattle are sold.<sup>7</sup> In a 1981 Minnesota Federal District Court case, that question was litigated in a setting where an obligation to pay feed costs was secured by a letter of credit.<sup>8</sup> Even with that security, signing the secured promissory note was not considered payment.<sup>9</sup>

The key ruling in this area, *Rev. Rul. 77-257*,<sup>10</sup> involved the question of whether the issuance of a note resulted in an allowable deduction. In the facts of the ruling a limited partnership, X, was engaged in acquiring and holding land for investment and for farming. X was on the cash method of accounting. P, a partnership, was involved in management of farm properties. The two entities were not related and had no common owners.

In the year in question, X purchased farmland from P and then entered into a management agreement with P whereby P was to provide development services on the farmland produced by X. The management expenses were billed monthly to T with T paying S by checks drawn on its own bank account. T and S were merely accounts of the P partnership. When the development period was over, X gave P a note for the account receivable on T's books.

The ruling, citing *Helvering v. Price*,<sup>11</sup> stated that the issuance of a 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>12</sup> In a highly significant passage, the ruling goes on to state—

“However, the actual payment of an expense with funds borrowed from a third party does give rise to a current deduction.”<sup>13</sup>

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The ruling, citing to a 1971 Tax Court case, *Granau v. Commissioner*,<sup>14</sup> stated that, in *Granau*, the taxpayer borrowed money from a bank to pay an outstanding note to a hospital that represented a liability incurred for medical expenses. A deduction was allowed in the year the note to the hospital was paid with the funds borrowed from the bank (and not in subsequent years when the bank loan was repaid).<sup>15</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. Moreover, the issuance of a promissory note represented only X's promise to pay; it was not payment for purposes of obtaining an income tax deduction.<sup>16</sup>

#### Loan from a vendor's subsidiary

The issue is further complicated by the fact that, in at least one instance, seed is being sold to farmers with the purchase financed by a lending subsidiary of the seed company. The loan is generally set at three percentage points below the prime rate. The precise question is whether a deduction can be claimed by a participating farmer in the year the seed is sold and the farmer signs an obligation to pay the subsidiary or whether the deduction is delayed until the loan is actually paid off.

Returning to *Rev. Rul. 77-257*,<sup>17</sup> the ruling states that where funds are borrowed from a "third party," a deduction can be claimed in the year the funds are loaned by the third party. The key issue is whether funds loaned by a wholly-owned subsidiary at three percentage points under the prime rate are considered funds loaned by a "third party." Considering the fact that the lender is wholly owned by the vendor and the loans

are at rates well under the market rate of interest, a genuine question exists whether the subsidiary is a "third party" lender.

Further guidance in the form of a ruling or rulings or litigation will be needed before the question is fully answered.

#### FOOTNOTES

- <sup>1</sup> See generally 4 Harl, *Agricultural Law*, Ch. 25 (1998); Harl, *Agricultural Law Manual* § 4.01[1] (1998).
- <sup>2</sup> See Treas. Reg. § 1.461-1(a)(1).
- <sup>3</sup> *Id.*
- <sup>4</sup> Rev. Rul. 77-257, 1977-2 C.B. 174. See *Helvering v. Price*, 309 U.S. 409 (1940).
- <sup>5</sup> *Chapman v. United States*, 527 F. Supp. 1053 (D. Minn. 1981).
- <sup>6</sup> See Treas. Reg. § 1.461-1(a)(1).
- <sup>7</sup> See *Chapman v. United States*, 527 F. Supp. 1053 (D. Minn. 1981).
- <sup>8</sup> *Id.*
- <sup>9</sup> *Id.*
- <sup>10</sup> 1977-2 C.B. 174.
- <sup>11</sup> 309 U.S. 409 (1940).
- <sup>12</sup> Rev. Rul. 77-257, 1977-2 C.B. 174.
- <sup>13</sup> *Id.*
- <sup>14</sup> 55 T.C.753 (1971).
- <sup>15</sup> Rev. Rul. 77-257, 1977-2 C.B. 174.
- <sup>16</sup> *Id.*
- <sup>17</sup> 1977-2 C.B. 174.

## CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

### BANKRUPTCY

#### FEDERAL TAXATION-ALM § 13.03[7].\*

**DISCHARGE.** The debtors owed over \$300,000 in taxes for 1983 through 1990 and the debtors sought to have the taxes declared dischargeable. The debtors did not file the returns for the years involved until 1992 when they were audited. During the tax years involved, the debtors claimed excess exemptions on W-4 forms. The only taxes paid during these years was the small amount withheld from their wages. The evidence showed that the debtors had a lavish lifestyle and sufficient disposable income to pay the taxes owed. The court held that the evidence demonstrated that the debtors willfully attempted to evade payment of the taxes; therefore, the taxes were nondischargeable. *In re Thorngren*, 227 B.R. 139 (Bankr. N.D. Ill. 1998).

The debtor had filed three previous bankruptcy cases, with each case containing an IRS claim for 1992 taxes. At the filing of the third case, the IRS had two years and 264 days in which the automatic stay did not prevent collection of the 1992 taxes. However, by the time of the filing of the current case, the IRS

had more than three years to collect the taxes, excluding all the periods of the automatic stay for the three previous cases. The court held that the filing of a bankruptcy case tolled the running of the three-year period of Section 523(a)(1)(A); however, because the 1992 claim had been available for collection over three years by the time of the current case, the 1992 tax claim was no longer entitled to priority treatment and could be discharged in the current case. *In re Avila*, 99-1 U.S. Tax Cas. (CCH) ¶ 50,274 (Bankr. D. Mass. 1999).

The debtor had failed to file and pay income taxes for several years. The IRS filed assessments for the taxes and then the debtor filed returns for the years involved using the IRS assessments as the amount of tax due. The debtor sought to have the taxes declared dischargeable under Section 523(a)(1)(B) as taxes for which returns were filed more than three years before the filing of the bankruptcy petition. The court held that the late filed returns were not returns for purposes of Section 523(a)(1)(B) because the returns had no tax purpose. *In re Mickens*, 99-1 U.S. Tax Cas. (CCH) ¶ 50,265 (6th Cir. 1999), *aff'g*, 97-2 U.S. Tax Cas. (CCH) ¶ 50,784 (D. Ohio 1997).

**ESTATE PROPERTY.** Prior to the debtor's filing for Chapter 13, the IRS served a notice of levy on an employer of the debtor. The levied amount was paid by the employer and