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FARMERS' PREPAID FEED DEDUCTIONS

Mann v. Commissioner, 483 F.2d 673 (8th Cir. 1973)

Taxpayer, a cash-basis¹ farmer, paid \$21,000 for livestock feed during the final days of his 1966 tax year. Although the vendor's order form specified both price and quantity for each feed, the parties agreed that taxpayer was bound by neither in the event market prices declined or his animals required different feeds at the time of delivery.² Taxpayer deducted the entire payment as an "ordinary and necessary" business expense on his 1966 tax return.³ The Commissioner disallowed the deduction on the grounds that (1) the payment was a deposit against future purchases rather than a binding sales contract and (2) the payment was not an ordinary and necessary business expense for 1966.⁴ The Tax Court upheld the Commissioner on both grounds.⁵ On appeal, the Eighth Circuit Court of Appeals reversed and *held*: A cash-basis farmer may deduct the cost of prepaid feed in the year of payment if the payment is made pursuant to a binding contract and is not otherwise refundable.⁶

1. See notes 7-13 *infra* and accompanying text.

2. Taxpayer ordered \$20,731 worth of feeds on December 30, 1966, and paid for them in full the following day, December 31. The parties agreed that taxpayer would be charged the lower of either the contract prices or the prevailing market prices at the time of each delivery and that he would receive his usual discounts, irrespective of the price. In addition, taxpayer did not have to take delivery of the exact amounts of each feed ordered and could substitute different feeds if the condition of his livestock so required. The vendor could not remember at trial whether he had sufficient stocks on hand to fill the order when the contract was made. No deliveries were made until the following year and, until delivery, the vendor bore all risks of loss. The parties made no provision for a refund in the event taxpayer did not take delivery of all or part of the feed ordered. *Mann v. Commissioner*, 483 F.2d 673, 674-75 (8th Cir. 1973).

3. *Id.* at 675-76. INT. REV. CODE OF 1954, § 162(a) states:

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

4. *Mann v. Commissioner*, 483 F.2d 673, 677 (8th Cir. 1973).

5. Russell Mann, 41 P-H Tax Ct. Mem. 843 (1972).

6. *Mann v. Commissioner*, 483 F.2d 673 (8th Cir. 1973). In addition, the court held that, for a taxpayer to preserve his deduction, the feed must be an "ordinary and necessary" requirement of his business, the cash-basis method of accounting must prop-

Under the Internal Revenue Code of 1954, a taxpayer's accounting method⁷ determines the tax year in which he may deduct his business expenses from gross income.⁸ Treasury Regulations⁹ force most taxpayers engaged in the production of goods for sale to file their returns under an accrual method¹⁰ in order to allocate income and deductions

erly reflect his income, and the amount bought must not be so excessive as to require capital expenditure treatment. *Id.* at 680-81; *see* notes 49-51 *infra*.

7. The function of accounting is to match an enterprise's expenses with the revenues the expenses produce. *Accounting Principles Board Statement No. 4, Basic Concepts of Accounting Principles Underlying Financial Statements of Business Enterprises* ¶ 155, in 2 CCH APB ACCOUNTING PRINCIPLES provides:

Expenses are the costs that are associated with the revenue of the period, often directly but frequently indirectly through association with the period to which the revenue has been assigned. Costs to be associated with future revenue or otherwise to be associated with future accounting periods are deferred to future periods as assets.

8. INT. REV. CODE OF 1954, §§ 162(a), 446(a), 451(a), 461(a). The two most common accounting methods for filing tax returns are the cash-basis, or cash receipts and disbursements, method, *id.* § 446(c)(1), and the accrual method, *id.* § 446(c)(2). Under the cash-basis method, income and expenses are recorded in the year of receipt or disbursement. *See* note 13 *infra*. Accrual accounting methods, on the other hand, record income and expenses when the underlying obligations become fixed. *See* note 11 *infra*.

9. The Secretary of the Treasury has the authority to "prescribe all needful rules and regulations for the enforcement of [the Internal Revenue Code]." INT. REV. CODE OF 1954, § 7805(a). This rule-making authority has been delegated to the Commissioner of Internal Revenue. Treas. Reg. § 301.7805-1 (1960).

10. Neither the Code nor the Regulations expressly requires taxpayers engaged in the production of goods for sale to use an accrual method. The Code permits taxpayers to choose their method of accounting from those permitted either by the Code or by regulation so long as the method chosen "clearly reflect[s] income." INT. REV. CODE OF 1954, §§ 446(a)-(c). However, the Secretary of the Treasury or his delegate may require taxpayers to take inventories and may prescribe the methods to be used so that the tax returns clearly reflect income. *Id.* § 471. The Regulations require taxpayers who manufacture goods for sale to record their beginning and ending inventories each tax year. Treas. Reg. § 1.471-1 (1958); *id.* § 1.471-11 (1973). Whether or not engaged in the manufacture of goods for sale, taxpayers who use inventories must adopt the accrual method unless the Commissioner specifically determines that some other accounting method more clearly reflects income. *Id.* § 1.446-1(c)(2) (1957). *See generally* Hawkinson, *Farm Expenses and General Accounting Principles*, 22 TAX L. REV. 237 (1967). Hawkinson observes:

The theory of inventory accounting is that an inventory represents costs to be deferred to later years. Therefore, cost of goods sold is computed by subtracting costs to be deferred (closing inventory) from the total of costs deferred from earlier years (opening inventory) and costs incurred (for acquisition, production or development) in the current year.

Id. at 239.

There is no single accrual method of accounting. When Treasury Regulations do not require a specific method, several different methods may accurately reflect a taxpayer's

between goods which have been sold and those which have not.¹¹ Since 1915, however, the Regulations have permitted farmers to file their returns on the cash-basis method.¹² This allows them to deduct

income. *Photo-Sonics, Inc. v. Commissioner*, 357 F.2d 656, 658 (9th Cir. 1966). For accrual methods available to farmers, see note 12 *infra*.

11. Treas. Reg. § 1.446-1(c)(1)(ii) (1957); *id.* § 1.451-1(a) (1957); *id.* § 1.461-1(a)(2) (1957); *see, e.g.*, *Spring City Foundry Co. v. Commissioner*, 292 U.S. 182, 184-85 (1934) (emphasis original):

Keeping accounts and making returns on the accrual basis, as distinguished from the cash basis, import that it is the *right* to receive and not the actual receipt that determines the inclusion of the amount in gross income. When the right to receive an amount becomes fixed, the right accrues.

12. T.D. 2153, 17 TREAS. DEC. INT. REV. 101 (1915):

All gains, profits, and income derived from the sale . . . of farm products . . . shall be included in the return of income for the year in which the products were actually marketed and sold; and all allowable deductions, including the legitimate expenses incident to the production of that year or future years may be claimed . . . although the products to which such expenses and deductions are incidental may not have been sold . . . during the year for which the return is rendered.

The relevant language is now found in Treas. Reg. § 1.162-12(a) (1958):

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 purchase of feed and other costs connected with raising livestock may be treated as expense deductions insofar as such costs represent actual outlay

The historical reason for permitting farmers to file under the cash-basis method was to simplify their bookkeeping requirements. At the time the 1915 Regulations were issued, tax distortion was minimal under the tax rates in effect—1% on the first \$20,000 net income and a marginal rate of 6% on incomes in excess of \$500,000. Income Tax Act of 1913, ch. 16, § II A, 38 Stat. 166. In addition to the tax manipulation possibilities available to any cash-basis taxpayer, *see* notes 14 & 15 *infra*, the cash-basis farmer reaps tax windfalls from the capital gains treatment of livestock sales. *See* INT. REV. CODE OF 1954, §§ 1231(a), (b)(3). This provision adopted the result in *Albright v. United States*, 173 F.2d 339 (8th Cir. 1949). *See* S. REP. NO. 781, 82d Cong., 1st Sess. 32 (1951). *See generally* *United States v. Catto*, 384 U.S. 102, 106-08 & n.9 (1966); *Davenport, A Bountiful Tax Harvest*, 48 TEXAS L. REV. 1 (1969).

On the other hand, there is nothing in either the Code or the Regulations which precludes a cash-basis farmer from capitalizing his feed costs. *Sonnabend v. Commissioner*, 377 F.2d 42, 43 (1st Cir. 1967). An accrual method farmer may choose between four different inventory methods. The cost method, Treas. Reg. § 1.471-3 (1958), and the lower of cost or market method, *id.* § 1.471-4 (1958), are available to all taxpayers. The other two methods are the farm-price method, *id.* §§ 1.471-6(c), (d), (h) (1958), and the unit-livestock-price method, *id.* §§ 1.471-6(c), (e)-(g) (1958). In addition to these methods, farmers whose crops take longer than one year to mature may, with the consent of the Commissioner, use the crop method. *Id.* § 1.61-4(c) (1972); *id.* § 1.471-6(a) (1958). These methods are described in IRS PUB. NO. 225, *FARMERS TAX GUIDE* 21-22, 29 (1974). *See generally* *Branscomb, The Cash Method as Applied in Agriculture—A Reexamination*, 25 TAX LAWYER 125, 135-38 (1970); *Hawkinson, supra* note 10, at 243-49.

most production costs in the year of payment irrespective of when the associated income is earned.¹³ As a result, farmers may manipulate their taxable income by incurring expenses prematurely,¹⁴ thus shifting an equivalent increment of income to the subsequent year and postponing the tax on that increment.¹⁵ Although long aware of these tax ad-

13. Treas. Reg. § 1.446(c)(1)(i) (1957); *id.* § 1.451-1(a) (1957); § 1.461-1(a)(1) (1957); *see, e.g.*, *Helvering v. Price*, 309 U.S. 409 (1940). Constructive receipt of income is governed by Treas. Reg. § 1.451-2 (1957).

14. Tax law is unclear as to when cash-basis taxpayers may deduct prepaid expenses in the year of payment and when they may not. Because accrual method taxpayers may deduct expenses only when they are due, only cash-basis taxpayers face such timing problems. The Regulations recognize that businesses incur "overlapping deductions." So long as the item does not "materially distort income," a taxpayer may include such a deduction in the year of his consistent practice. Treas. Reg. § 1.461-1(a)(3)(i) (1957). In any event, a cash-basis taxpayer may not be able to deduct the entire cost, in the year of payment, of "an expenditure [which] results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year." *Id.* § 1.461-1(a)(1) (1957). *Compare* *Maple v. Commissioner*, 440 F.2d 1055 (9th Cir. 1971) (allowing deduction for prepaid tree growing services), *and* *Rev. Rul. 190, 1971-1 CUM. BULL. 70* (allowing deduction for prepaid state taxes), *with* *Main & McKenney Bldg. Co. v. Commissioner*, 113 F.2d 81 (5th Cir.), *cert. denied*, 311 U.S. 688 (1940) (disallowing full deduction for prepaid rent). *See also* *Waldheim Realty & Inv. Co. v. Commissioner*, 245 F.2d 823 (8th Cir. 1957) (allowing prepaid insurance premiums); *Commissioner v. Boylston Mkt. Ass'n*, 131 F.2d 966 (1st Cir. 1942) (disallowing prepaid insurance premiums), *overruling* *Welch v. DeBlois*, 94 F.2d 842 (1st Cir. 1938); *John D. Fackler*, 39 B.T.A. 395 (1939), *acquiesced in*, 1939-1 CUM. BULL. 11, *acquiescence withdrawn and nonacquiescence substituted*, *Rev. Rul. 643, 1968-2 CUM. BULL. 76* (prepaid interest); *Metropolitan Properties Corp.*, 24 B.T.A. 220 (1937) (expenses of securing a loan). By statutory provision, certain expenditures may be deducted in the year of actual payment rather than being amortized over the life of the asset created, regardless of the taxpayer's method of accounting. INT. REV. CODE OF 1954, § 174 (research and experimental expenditures); *id.* § 175 (soil and water conservation expenditures); *id.* § 180 (fertilizer expenditures); *id.* § 182 (land clearing expenditures). *See generally* 2 J. MERTENS, LAW OF FEDERAL INCOME TAXATION §§ 12.24-.26 (1967, Supp. 1974); *Irwin, Prepayments by a Cash Basis Taxpayer*, 15 U. So. CAL. 1963 TAX INST. 547; *Olinicy, Prepaid Income and Expenses—Where Are We Going?*, 19 U. So. CAL. 1967 TAX INST. 357.

15. The following tables depict the tax savings generated by accelerating a \$10,000 deduction one year to offset the greater net income of the earlier year. The tax is computed using the rates applicable to married individuals filing a joint return, INT. REV. CODE OF 1954, § 1(a).

TABLE I
BEFORE ACCELERATION

	Gross Income	Deductions	Net Income	Tax
Year 1	\$150,000	100,000	50,000	17,060
Year 2	125,000	100,000	25,000	6,020
			Total Tax	\$23,080

vantages available to farmers,¹⁶ Congress has not disturbed them¹⁷ except in two limited areas.¹⁸

TABLE II
AFTER ACCELERATION

	Gross Income	Deductions	Net Income	Tax
Year 1	\$150,000	110,000	40,000	12,140
Year 2	125,000	90,000	35,000	9,920
			Total Tax	\$22,060

The taxpayer saves \$1,020 over a two-year period. By accelerating similar deductions in succeeding years, a taxpayer may postpone paying taxes on that increment of income until he dies. The policy of the Commissioner, however, is to accelerate tax payments rather than postpone them. *Cf. American Auto. Ass'n v. Commissioner*, 367 U.S. 687 (1961).

16. H.R. REP. NO. 413, 91st Cong., 1st Sess. 62 (1969):

In general, where a significant factor in a business is the production or sale of merchandise, the taxpayer must use an accrual method of accounting and inventories. The effect of these accounting rules is to postpone the deduction of the costs of the merchandise until the accounting period in which the income from its sale is realized. These rules need not be followed, however, with respect to income or deductions from farming. In other words, a cash accounting method may be used for this purpose under which costs are deducted as incurred. A taxpayer in the business of farming is also allowed to deduct expenditures for developing a business asset which other taxpayers would have to capitalize.

Both reports on the Revenue Act of 1951, ch. 521, 65 Stat. 501, evidenced a congressional awareness of farm accounting methods. H.R. REP. NO. 586, 82d Cong., 1st Sess. 32 (1951); S. REP. NO. 781, 82d Cong., 1st Sess. 41-42 (1951). Accordingly, the Treasury Department has expressed doubt that it can administratively eliminate the tax windfalls permitted farmers under its longstanding regulations. Letter from John W. Snyder, Secretary of the Treasury, to Walter F. George, Chairman of the Committee on Finance, United States Senate, in 5 CCH 1952 STAND. FED. TAX REP. ¶ 6239. In *United States v. Catto*, 384 U.S. 102, 115 n.23 (1966), the Supreme Court expressly refused to resolve this question.

17. Congress has, in fact, permitted taxpayers "engaged in the business of farming" to deduct certain expenditures in the year of payment without regard to the otherwise proper year of deduction. INT. REV. CODE OF 1954, § 175 (soil and water conservation); *id.* § 180 (fertilizer); *id.* § 182 (land clearing).

18. Tax Reform Act of 1969 § 216(a), INT. REV. CODE OF 1954, § 278, requires farmers to capitalize their costs of planting and maintaining citrus groves during the first four tax years following planting. These expenditures are comparable to those a farmer incurs in feeding his livestock. This section was added to the Tax Reform Act as a floor amendment in the Senate to aid Florida citrus growers who were concerned that tax shelter promotions were stimulating overproduction. 115 CONG. REC. 37486-88 (1969) (remarks of Senator Holland). Almond groves were later added to this provision. Act of Jan. 12, 1971, Pub. L. No. 91-680, § 1, 84 Stat. 2064, *amending* INT. REV. CODE OF 1954, § 278. The prior law, which still applies to other orchards, is discussed in *Maple v. Commissioner*, 440 F.2d 1055 (9th Cir. 1971), and *Estate of Wilbur*, 43

As a result of the increased use of tax shelters in recent years,¹⁰ the Commissioner has questioned the year-end purchase of livestock feed to be used by the taxpayer in the next year.²⁰ In order to preserve his deduction, the taxpayer must qualify as a farmer²¹ and the feed

T.C. 322 (1964). See generally Lewis, *Farm and Hobby Losses After Tax Reform*, 23 U. So. CAL. 1971 TAX INST. 627, 663-65.

The Tax Reform Act of 1969 contained two other sections which limit use of some of the tax advantages of farming by nonfarmers. Tax Reform Act of 1969 §§ 213(a), 211(a), INT. REV. CODE OF 1954, §§ 183, 1251. Section 183 deals with "hobby losses" in general. Section 1251 creates a recapture provision which applies only to taxpayers whose nonfarm income exceeds \$50,000 and whose farm losses exceed \$25,000 in any tax year. See also note 19 *infra*.

19. The effect of the Tax Reform Act of 1969 on farming and tax shelters is discussed in *Hearings on General Tax Reform Before the House Comm. on Ways and Means*, 93d Cong., 1st Sess., pt. 3, at 1072-152 (1973); *id.*, pt. 4, at 1503-31; *Panel Discussion on General Tax Reform Before the House Comm. on Ways and Means*, 93d Cong., 1st Sess., pt. 5, at 613-94 (1973). See also Davenport, *supra* note 12; Diamond & Hornes, *Hobby Losses*, 23 TAX LAWYER 609, 609-13 (1970); Griffith & Joy, *What the Act Does to the Farmer: Farm Parity or Class Discrimination?*, 23 TAX LAWYER 495 (1970).

20. The Commissioner initially allowed taxpayers to deduct prepaid feed expenses in the year of payment, "irrespective of the fact that it may not be consumed until the following year." 4 P-H 1944 FED. TAXES ¶ 66,149 (Letter Ruling, Dec. 16, 1943). In the last fifteen years, he has contested such expenses. *Mann v. Commissioner*, 483 F.2d 673 (8th Cir. 1973), *rev'g* 41 P-H Tax Ct. Mem. 843 (1972); *Shippy v. United States*, 308 F.2d 743 (8th Cir. 1962), *aff'g* 199 F. Supp. 842 (D.S.D. 1961); *Cravens v. Commissioner*, 272 F.2d 895 (10th Cir. 1959), *rev'g* 30 T.C. 903 (1958); *Gaddis v. United States*, 330 F. Supp. 741 (S.D. Miss. 1971); *Estate of Cohen*, 39 P-H Tax Ct. Mem. 1331 (1970); *Tim W. Lillie*, 45 T.C. 54 (1965), *aff'd per curiam*, 370 F.2d 562 (9th Cir. 1966); *John Ernst*, 32 T.C. 181 (1959), *acquiesced in*, 1959-2 CUM. BULL. 4. See generally Pinney & Olsen, *Farmer's Prepaid Feed Expenses*, 25 TAX LAWYER 536 (1972).

Because accrual method taxpayers may not deduct a prepaid expense until payment is due, litigation over such deductions is rare. See, e.g., *Gold-Pak Meat Co.*, 40 P-H Tax Ct. Mem. 357, 364 (1971). See also note 11 *supra* and accompanying text.

21. See, e.g., *Hi-Plains Enterprises v. Commissioner*, 496 F.2d 520 (10th Cir. 1974); *United States v. Chemell*, 243 F.2d 944 (5th Cir. 1957). Treasury Regulations define "farm" and "farmer" as follows:

As used in this section, the term "farm" embraces the farm in the ordinary accepted sense, and includes stock, dairy, poultry, fruit, and truck farms; also plantations, ranches, and all land used for farming operations. All individuals, partnerships, or corporations that cultivate, operate, or manage farms for gain or profit, either as owners or tenants, are designated as farmers.

Treas. Reg. § 1.61-4(d) (1957). See also *id.* §§ 1.175-3, -4 (1957); *id.* § 1.182-2 (1965).

Both a dentist, *Tim W. Lillie*, 45 T.C. 54, 58-59 (1965), and an Irish Sweepstakes winner, *Estate of Cohen*, 39 P-H Tax Ct. Mem. 1331, 1338-40 (1970), have qualified as farmers. The Code contains several provisions which apply only to taxpayers "engaged in the business of farming." See note 18 *supra*.

must be an ordinary and necessary expense for his farm.²² Some courts have also required that the prepayment produce some special benefit to the taxpayer,²³ that it not be recoverable by the taxpayer,²⁴ or that it not include payment for services to be rendered in the future.²⁵ The existence of a special benefit resulting from the prepayment was the crucial factor in the early cases.²⁶ In determining whether the taxpayer benefited, the courts focused on whether the vendor conditioned his sale on prepayment²⁷ or whether the prepay-

22. INT. REV. CODE OF 1954, § 162(a). Justice Cardozo distinguished "ordinary" and "necessary" in *Welch v. Helvering*, 290 U.S. 111, 113-14 (1933):

We may assume that the payments . . . were necessary for the development of the petitioner's business, at least in the sense they were appropriate and helpful. . . . But the problem is not solved when the payments are characterized as necessary. Many necessary payments are charges on capital. . . . Now, what is ordinary, though there must always be a strain of constancy within it, is none the less a variable affected by the time and place and circumstances. Ordinary in this context does not mean that the payment must be habitual or normal in the sense that the same taxpayer will have to make them often. . . . [A]n expense is an ordinary one because we know from experience that payments for such purpose . . . are . . . common and accepted. . . .

23. Compare *Cravens v. Commissioner*, 272 F.2d 895, 899 (10th Cir. 1959), with *Shippy v. United States*, 199 F. Supp. 842, 843 (D.S.D. 1961), *aff'd on other grounds*, 308 F.2d 743 (8th Cir. 1962). See also *Tim W. Lillie*, 45 T.C. 54, 62 (1965) (alternative holding).

24. *Shippy v. United States*, 308 F.2d 743, 746-47 (8th Cir. 1962); *Gaddis v. United States*, 330 F. Supp. 741, 750-51 (S.D. Miss. 1971); *Tim W. Lillie*, 45 T.C. 54, 62-63 (1965); *John Ernst*, 32 T.C. 181, 185-86 (1959).

25. *Estate of Cohen*, 39 P-H Tax Ct. Mem. 1331, 1339-40 (1970); *Tim W. Lillie*, 45 T.C. 54, 62 (1965) (alternative holding). Courts have also considered whether the prepayment distorted income, *Shippy v. United States*, 199 F. Supp. 842, 843 (D.S.D. 1961), *aff'd on other grounds*, 308 F.2d 743 (8th Cir. 1962), or constituted a capital investment, *Cravens v. Commissioner*, 272 F.2d 895, 899 (10th Cir. 1959), in addition to determining the taxpayer's consistent practice when buying feed, *Shippy v. United States*, 308 F.2d 743, 747 (8th Cir. 1962); *John Ernst*, 32 T.C. 181, 186 (1959).

26. *Russell Mann*, 41 P-H Tax Ct. Mem. 843, 847 (1972):

Generally, the factor which distinguishes the cases allowing the deduction from those which disallow it is the existence of some benefit to the taxpayer's business which was acquired by the prepayment.

In its first consideration of prepaid feed deductions, however, the Tax Court focused on whether the taxpayer could recover his payment. See *R.D. Cravens*, 30 T.C. 903, 907-08 (1958). The appellate court reversed the Tax Court in *Cravens* because it thought that the special benefit acquired by the prepayment, a preference during a drought, presented a "stronger" case for allowing the deduction than had the facts in *John Ernst*, 32 T.C. 181 (1959). *Cravens v. Commissioner*, 272 F.2d 895, 899 (10th Cir. 1959). Compare *Shippy v. United States*, 199 F. Supp. 842, 843 (D.S.D. 1961), *aff'd on other grounds*, 308 F.2d 743 (8th Cir. 1962), with *Cravens v. Commissioner*, 272 F.2d 895, 899 (10th Cir. 1959).

27. Several courts have stated in dicta that the taxpayer could deduct the payment in the year paid if the vendor refused to sell the feed unless the taxpayer prepaid.

ment resulted in preferential treatment of the taxpayer.²⁸

In recent cases, the decisive issue has been whether the taxpayer can recover his payment.²⁹ The Commissioner has argued that the taxpayer incurs no current expense so long as he can recover the payment.³⁰ A payment is recoverable either when it is not made pursuant to a binding contract or when the contract permits a refund.³¹ The validity of the contract is a question of state law.³² When the contract

Shippy v. United States, 199 F. Supp. 842, 843 (D.S.D. 1961), *aff'd on other grounds*, 308 F.2d 743 (8th Cir. 1962); *Tim W. Lillie*, 45 T.C. 54, 57, 62 (1965). No vendor, however, has imposed such a condition in any of the reported cases.

28. *Cravens v. Commissioner*, 272 F.2d 895 (10th Cir. 1959). The taxpayer in *Cravens* was faced with the possibility of selling off his herd during a drought if he was unable to secure a source of feed. A feed shortage need not actually occur for a taxpayer to preserve his deduction, so long as he relies on predictions made by reputable publications. *Gaddis v. United States*, 330 F. Supp. 741, 750 (S.D. Miss. 1971).

29. *Mann v. Commissioner*, 483 F.2d 673 (8th Cir. 1973); *Gaddis v. United States*, 330 F. Supp. 741 (S.D. Miss. 1971); *Estate of Cohen*, 39 P-H Tax Ct. Mem. 1331 (1970); *Tim W. Lillie*, 45 T.C. 54 (1965). See also note 26 *supra*.

In *Gaddis*, the court found that the taxpayer believed he was bound by his contract. After guessing incorrectly that feed prices would increase, he paid \$21,000 above the market prices at the time the feed was delivered. 330 F. Supp. at 749-50. Although there was no mention of a refund in his contracts, the taxpayer in *Lillie* actually received one refund. On the basis of that refund, the court found that there was a possibility of a refund on each of his other feed contracts. 45 T.C. at 62-63.

The possibility of a refund, however, is not necessarily fatal to the taxpayer's claim. In *Cravens v. Commissioner*, 272 F.2d 895 (10th Cir. 1959), the taxpayer contracted to buy a specific quantity of feed at market prices at the time of delivery. He was entitled to a refund of any overpayment in the event his advance payment exceeded the ultimate cost of the feed. Even though the size of the refund could not be determined, the full amount of the prepayment was deductible.

30. If the taxpayer is not obligated to take delivery of the feed, he has not, at the time of payment, incurred an expense in carrying on his trade or business. He may receive a refund, in which case he has incurred no expense. INT. REV. CODE OF 1954, § 162(a). He may also apply the prepayment towards a personal expense, which is not deductible. *Id.* § 262. When the taxpayer has dealt amicably with the vendor for several years, the parties may have an unwritten understanding that the prepayment will be eventually exhausted even though it is not refundable. See *Russell Mann*, 41 P-H Tax Ct. Mem. 843, 846 (1972).

31. The payment is also recoverable in the event the farmer sells the feed to a third party. One court has held that if the farmer is a corporation selling its assets pursuant to a plan of complete liquidation, it may not take a deduction for its feed payments during the year of liquidation and at the same time qualify for nonrecognized gains treatment under INT. REV. CODE OF 1954, § 337. *Spitalny v. United States*, 430 F.2d 195 (9th Cir. 1970).

32. See, e.g., *Jefferson Mills, Inc. v. United States*, 259 F. Supp. 305, 313 (N.D. Ga. 1965), *aff'd per curiam*, 367 F.2d 392 (5th Cir. 1966). Compare *Mann v. Commissioner*, 483 F.2d 673, 678 (8th Cir. 1973), with *Shippy v. United States*, 199 F. Supp. 842, 844 (D.S.D. 1961), *aff'd on other grounds*, 308 F.2d 743 (8th Cir. 1962).

See also 10 J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 61.06, at n.73 (1970).

is silent as to refundability, courts have considered the subsequent actions of both parties³³ and the vendor's treatment of the transaction as indicative of the intent of the parties.³⁴

The Eighth Circuit previously considered prepaid feed deductions in *Shippy v. United States*.³⁵ The vendor in *Shippy* treated the transaction as a deposit against which he charged deliveries to the taxpayer. At the time of payment, the parties made no agreement on either price or quantity.³⁶ Relying heavily on the vendor's testimony, the court characterized the payment as a refundable deposit³⁷ without determining whether there was a contract.³⁸

Although the agreement between vendor and taxpayer in *Mann v. Commissioner* was similar to that in *Shippy*, the court analyzed the problem differently.³⁹ It initially rejected a new position taken by the Commissioner that deductibility depended on passage of title.⁴⁰ In resolving

33. See, e.g., *Mann v. Commissioner*, 483 F.2d 673, 678-79 (8th Cir. 1973); *Cravens v. Commissioner*, 272 F.2d 895, 898 (10th Cir. 1959); *Tim W. Lillie*, 45 T.C. 54, 56-57, 63 (1965).

34. See, e.g., *Shippy v. United States*, 308 F.2d 743, 744-45, 746-47 (8th Cir. 1962). But see *John Ernst*, 32 T.C. 181, 186 (1959):

We need not go into the question of whether or not the payments here involved constituted income to the grain dealer in the years when they were received. . . . The manner in which the grain dealer treated these payments taxwise is not relevant to a determination of petitioners' tax liability.

35. 308 F.2d 743 (8th Cir. 1962).

36. *Id.* at 745-46.

37. The vendor testified at trial that the payment was a "deposit" which he would have refunded to the taxpayer. *Id.* at 744-45, 746-47. The court of appeals ignored, however, the vendor's testimony that such a refund would have been limited to the situation where the taxpayer "had to sell his cattle and had no need for the grain . . ." *Id.* at 747. A limited possibility of a refund need not be fatal to the taxpayer's claim. See note 29 *supra*.

38. 308 F.2d at 746-47. The taxpayer contended that, although the agreement with the vendor was a "contract to sell future goods," it was nevertheless an enforceable contract. *Id.* at 746. The court of appeals characterized the transaction as "more in the nature of an offer than a contract," but did not decide the issue. It held the existence of a contract to be a question of fact and found that there was ample evidence to support the district court's findings. *Id.* at 746-47.

39. The court found that there were sufficient "factual distinctions" between *Mann* and *Shippy*. 483 F.2d at 681. In both cases, however, the vendor treated the transaction as a deposit on his books and the taxpayer was not required to take delivery of a specific quantity of feed. Compare *Mann v. Commissioner*, 483 F.2d 673, 675 (8th Cir. 1973), with *Shippy v. United States*, 308 F.2d 743, 745 (8th Cir. 1962).

40. The Commissioner argued that the feed must be "in existence at the date of purchase" for the deduction to be allowed. This argument was initially proposed by the IRS Los Angeles District Director in *News & Notes for the Tax Practitioner* (Number 72-1), cited in *Pinney & Olsen*, *supra* note 20, at 545-46. The argument is premised

the question of recoverability, the court emphasized the Tax Court's characterization of the payment as a "nonrefundable deposit"⁴¹ and stated that a "nonrefundable deposit is, quite simply, a payment" which is made for "expenses incident 'to carrying on a trade or business.'"⁴² The court then limited its analysis of recoverability to determining whether there was a contract under the Iowa Statute of Frauds.⁴³ It found that when either party has partially performed, either may enforce an otherwise unenforceable contract.⁴⁴ Therefore, either party could enforce the contract because taxpayer had fully performed his obligation.⁴⁵

on UNIFORM COMMERCIAL CODE § 2-105(2): "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." The court found that none of the prior cases had relied on the present existence of the feed and that in *John Ernst*, 32 T.C. 181, 185 (1959), the Tax Court had expressly noted that the vendor did not have the feed on hand. In addition, the court found that the Internal Revenue Code does not premise deductibility "on the passage of 'title.'" 483 F.2d at 677.

41. *Russell Mann*, 41 P-H Tax Ct. Mem. 843, 846 (1972).

Even if petitioner's transfer . . . were irrevocable, we fail to see how this fact altered the substance of the transaction. Petitioner merely made a nonrefundable deposit, which is nevertheless a deposit and not a purchase of specific goods.

42. 483 F.2d at 678.

43. IOWA CODE ANN. § 554.2201(1) (1967). Under this section, a contract for the sale of goods for more than five hundred dollars is not enforceable unless (1) there is a writing, (2) signed by the party to be charged, which (3) specifies a quantity. See also UNIFORM COMMERCIAL CODE § 2-201, Comment 1.

44. 483 F.2d at 678-79. The court was interpreting IOWA CODE ANN. § 554.2201 (3)(c):

A contract which does not satisfy the requirements of subsection (1) but which is valid in other respects is enforceable . . . with respect to goods for which payment has been made and accepted or which have been received and accepted

45. The Tax Court believed that only the taxpayer, who had fully performed, could employ this exception to the Statute of Frauds, see notes 43 & 44 *supra*, to force delivery of the feeds, and that the vendor could not have forced taxpayer to accept delivery. *Russell Mann*, 41 P-H Tax Ct. Mem. 843, 846 (1972). If, however, this interpretation is combined with the court's earlier characterization of the payment as a "nonrefundable deposit," see note 41 *supra*, the taxpayer would risk losing his \$21,000 payment if he did not accept delivery. The Tax Court conjectured that the vendor would allow taxpayer to charge other purchases against the payment. 41 P-H Tax Ct. Mem. at 846; see note 30 *supra*.

The court of appeals followed the majority view that the exception to the Statute of Frauds is available to either party. See *Augustin Bros. v. Wright Grain Co.*, 460 F.2d 376 (8th Cir. 1972); *Lake Village Implement Co. v. Cox*, 252 Ark. 206, 478 S.W.2d 36 (1972); *Bridgewater Washed Sand & Stone Co. v. Bridgewater Materials, Inc.*, — Mass. —, 282 N.E.2d 912 (1972); *Cohn v. Fisher*, 118 N.J. Super. 286, 287 A.2d 222 (L. Div. 1972). *Contra*, *In re Flying W Airways, Inc.*, 341 F. Supp. 26 (E.D. Pa. 1972). The court's interpretation assumes that the payment constituted the price of the

The court ignored the fact that the quantity of each feed was not fixed by contract.

Observing that agricultural prices have risen sharply in recent years,⁴⁶ the court found that the taxpayer received two business benefits from the transaction: (1) the price guaranty protected him from further price increases,⁴⁷ and (2) he had the right to insist upon delivery of the feed in the event of a feed shortage.⁴⁸ The Commissioner would have had to demonstrate at least one of the following to deny the deduction successfully: (1) livestock feed was not an "ordinary and necessary" business expense for taxpayer;⁴⁹ (2) the cash-basis accounting method did not properly reflect taxpayer's income;⁵⁰

goods and follows the Official Comment to the section. UNIFORM COMMERCIAL CODE § 2-201, Comment 2: "Receipt and acceptance either of goods or of the price constitutes an unambiguous overt admission by both parties that a contract actually exists."

There have been no reported Iowa decisions which interpret this section of the UCC, but *Mann* is in accord with Iowa cases decided under prior law. See, e.g., *King v. Farmer's Grain Co.*, 194 Iowa 979, 188 N.W. 720 (1922); *Peake v. Conlan*, 43 Iowa 297 (1876). See generally Squillante, *Sales Law in Iowa Under the Uniform Commercial Code—Article 2*, 20 DRAKE L. REV. 1, 59-65 (1970).

46. 483 F.2d at 680. The Board of Governors of the Federal Reserve System formerly published time series charts depicting the movement of agricultural prices relative to those of industrial commodities. Compare *National Summary of Business Conditions*, 59 FED. RES. BULL. 381, 382 (1973), with *National Summary of Business Conditions*, 54 FED. RES. BULL. 455, 456 (1968).

47. 483 F.2d at 679. The Tax Court had emphasized that the prepayment had not in fact protected taxpayer against a rise in market prices above the contract prices. On two occasions, the vendor charged taxpayer prices in excess of the agreed prices. Taxpayer had not, therefore, received the claimed benefit. *Russell Mann*, 41 P-H Tax Ct. Mem. 843, 847 (1972). The court of appeals dismissed these overcharges, which totaled \$4 on a \$21,000 transaction, as a "trivial variation." 483 F.2d at 679.

48. *Id.* at 679-80; see note 28 *supra*. The court refused to decide whether the timing of the prepayment must provide some business benefit in addition to that provided by the purchase itself. So long as the expense was otherwise deductible, the court held that the tax savings motives of the taxpayer were not relevant. 483 F.2d at 680. See also *Shippy v. United States*, 308 F.2d 743, 747 (8th Cir. 1962); *Cravens v. Commissioner*, 272 F.2d 895, 898 (10th Cir. 1959). But tax savings must not provide the *only* business benefit in the transaction. See *Gregory v. Helvering*, 293 U.S. 465, 469-70 (1935).

49. 483 F.2d at 680; see INT. REV. CODE OF 1954, § 162(a). The benefits of prepayment found by the court will generally be applicable to all farmers; thus this limitation should not pose any difficulty to a taxpayer who qualifies as a farmer. See note 21 *supra*.

50. 483 F.2d at 680; see INT. REV. CODE OF 1954, §§ 446(a)-(c). Given the nearly sixty years of Treasury Department acquiescence in the use of the cash-basis method by farmers, the Commissioner might find a change in policy difficult to defend, both in the courts and in Congress.

(3) taxpayer had bought so much feed that his purchases required capital expenditure treatment;⁵¹ or (4) taxpayer could recover his payment.⁵²

The decision in *Mann* substantially eases a farmer-taxpayer's burden in preserving a deduction for prepaid feed. When planning similar transactions, a farmer may anticipate all of the court's requirements except the appropriateness of the cash-basis accounting method. Since the cash-basis method is appropriate for farmers, the court reached the correct result. However, it should be noted that this result permits a farmer-taxpayer to distort his income for a given year. In contrast, the tax laws require other taxpayers to use the accounting method that clearly reflects their income.⁵³ Whether farmers should be subjected

51. 483 F.2d at 680-81; *see* INT. REV. CODE OF 1954, § 263(a). The court found the taxpayer's estimate of his needs to be reasonably accurate and did not object to the length of time, one year, for which he was buying feed. 483 F.2d at 680. *Compare* *Cravens v. Commissioner*, 272 F.2d 895, 897 (10th Cir. 1959) (prepayment not exhausted for more than twenty-two months allowed), *with* *Shippy v. United States*, 308 F.2d 743, 745 (8th Cir. 1962) (prepayment to meet taxpayer's needs for seven months disallowed).

52. 483 F.2d at 681; *see* notes 41-45 *supra* and accompanying text.

53. INT. REV. CODE OF 1954, § 446(b):

[I]f the method used [by the taxpayer] does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income.

In *Security Flour Mills v. Commissioner*, 321 U.S. 281, 285-86 (1944), the Court held that this language

was not intended to upset the well-understood and consistently applied doctrine that cash receipts or matured accounts due on the one hand, and cash payments or accrued definite obligations on the other, 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.

Following the decision in *Mann*, the Commissioner attempted to specify the situations when he would not contest the deduction of prepaid livestock feed expenses:

First, the expenditure must be a payment for the purchase of feed rather than a mere deposit; *second*, the prepayment must be made for a business purpose and not merely for tax avoidance; and *third*, the deduction of such costs in the taxable year of prepayment must not result in a material distortion of income.

Technical Information Release No. 1261, in 7 CCH 1973 STAND. FED. TAX REP. ¶ 6951 (emphasis original). Publication of these criteria as Revenue Ruling 73-530 was prevented by a suit brought by tax shelter promoters on the grounds that the third criterion, the income distortion test, was contrary to existing Treasury Regulations. *Cattle Feeders Tax. Comm. v. Schultz*, CCH 1974 STAND. FED. TAX REP., U.S. TAX CAS. (74-1, at 83,067) ¶ 9121 (W.D. Okla. Dec. 6, 1973), *rev'd, id.* ¶ 9732 (10th Cir. Oct. 4, 1974). *But see* Treas. Reg. §§ 1.461-1(a)(1), (3)(i) (1957).

to the same accounting methods as other taxpayers is not answered in *Mann*. That is a question of balancing the nation's farm and tax policies.⁵⁴

54. It would appear that farmers find the advantages of the cash-basis method to be significant. One participant in the 1973 congressional hearings on tax reform stated that "over 97 percent of those filing returns reporting farm income and losses [in 1968] used the cash basis." *Hearings on General Tax Reform Before the House Comm. on Ways and Means*, 93d Cong., 1st Sess., pt. 3, at 1074 (1973). Given this decided preference for the cash-basis method, it would appear that any change in farm tax accounting methods would require the acquiescence of farmers.

While such a drastic shift in accounting preference may not seem likely, the following scenario suggests how it may occur. Large numbers of non-farmers qualify as farmers for tax purposes. Because their incentive to produce farm products arises from the tax benefits, these "tax farmers" are relatively indifferent to the prices they receive for their products. See generally Davenport, *supra* note 12. So long as farm prices are high, traditional farmers have no strong objections to tax farmers. But if farm prices become depressed, traditional farmers may perceive tax farmers as the cause and believe it to be in their interest to force all farmers to adopt accrual accounting methods to preclude tax manipulation. See notes 10-15 *supra* and accompanying text. Citrus growers have found it to their advantage to restrict the use of cash-basis accounting in their segment of agriculture. See note 17 *supra*.