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Prepaid Feed Deductions for Farmers

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COMMENT

Prepaid Feed Deductions for Farmers

Many farmers buy corn based feed for their livestock each year. Since this grain is harvested in the fall months, supply exceeds demand and thus the price of grain often reaches a low price in the late fall. Then in the spring and summer the supply dwindles and the price often increases.[1] Thus, farmers very often choose to buy feed for their livestock in the fall months, to minimize their costs. When a farmer buys feed in the late fall, the question arises whether he can take an income tax deduction in the year he actually buys this prepaid feed, or whether the farmer must wait until the next year to take the deduction. Both the Internal Revenue Code and the Treasury Regulations treat prepaid feed differently than other prepaid expenses of an ordinary businessman.

A farmer is allowed a deduction for any ordinary and necessary expenses in his business just as any businessman can.[2] However, a farmer may elect to use either the cash receipts and disbursements method or the inventory method of accounting.[3] If the farmer chooses the latter method, he can deduct this expense only in the year in which the feed is actually consumed. But, if a farmer uses the cash method of accounting, he can deduct the expense in the year the feed is purchased, provided certain requirements are met. The problems addressed herein are the exact requirements that must be met before a cash receipts and disbursements

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1. Many grain farmers prefer to sell grain in the fall rather than the spring. The reasons vary from the farmer needing cash to pay debts, to the farmer not having a storage place for the grain. Farmers who purchase grain in the fall do so for a number of business reasons. *See infra* note 51 for examples of these reasons.

2. I.R.C. § 162(a) (1976) states:

> In general.—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. . . .

3. Treas. Reg. § 1.471-6(a) (1958) allows the farmer to elect between the cash method and the inventory method of accounting. *See infra* note 62 for a text of the regulation.

method farmer can deduct prepaid feed expense in the year of purchase.

To deduct prepaid feed expenses in the year of purchase, (the current year) the taxpayer must be classified as a "farmer" rather than a farm syndicate,[4] farm corporation,[5] or hobby farmer.[6] The Treasury Regulations define farm in the ordinarily accepted sense, including ranches, and defines farmer as any individual, partnership or corporation that operates the farm for profit, including both owners and tenants.[7]

In addition to being a "farmer" electing the cash method of accounting, the IRS, in Revenue Ruling 79-229[8] has set out three tests that must be met before the cost of prepaid feed can be deducted in the current year. The first test in the ruling is that the expenditure must be a payment for the purchase of feed and not a mere deposit.[9] The second test requires that the payment be made for a business purpose and not merely for tax avoidance.[10] The final test is that there cannot be a material distortion of income resulting

4. Farm syndicates cannot use the cash receipts and disbursements method of accounting, but must deduct the expenses for feed, seed and fertilizer as they are actually used or consumed.

Farm syndicates include any entity that is required to be registered with any securities regulatory agency and any enterprise that allocates more than 35% of its losses to limited partners or limited entrepreneurs that are not actively participating in the management of the enterprise. Basically, a "farm syndicate" is the businessman who is a passive investor in agriculture. I.R.C. § 464 (1976).

5. Farm corporations cannot use the cash receipts and disbursements method of accounting, but are required to use the accrual method of accounting. A farm corporation does not include subchapter S corporations, family corporations and corporations with gross receipts of less than one million dollars. I.R.C. § 447 (1976).

6. A farmer not engaged in the business of farming will be classified as a hobby farmer and will not be allowed to use the cash receipts and disbursements method of accounting. I.R.C. § 183 (1976).

7. Treas. Reg. § 1.61-4(d) (1957) states:

> [f]arm embraces the farm in the ordinarily 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.

8. Rev. Rul. 79-229, 1979-2 C.B. 210 (*superseding* Rev. Rul. 75-152, 1975-1 C.B. 144).

9. *Id.* at 210.

10. *Id.*

from the prepayment.[11] The first two tests of Revenue Ruling 79-229 have been settled by case law, the Internal Revenue Code, and the Treasury Regulations, and the farmer can comply with their requirements. There is a question of whether the third test is contrary to the Internal Revenue Code and Treasury Regulations. Each of these tests will be discused separately.

DEPOSIT OR PURCHASE TEST

The IRS first attempted to prevent the deduction of the cost of prepaid feed in the current year by arguing that the prepayment was not a purchase of feed, but merely a deposit. Since the taxpayer using the cash method of accounting to compute taxable income can only deduct items for which he has actually paid, the IRS contended nothing had actually been purchased. In *Cravens v. Commissioner*,[12] a taxpayer made an advance payment to the feed company. The feed company agreed to give the taxpayer preferential treatment in return for the payment, but refused to guarantee deliveries during the next year.[13] The taxpayer was entitled to a refund if the price was less when the feed was delivered.[14] The United States Court of Appeals for the Tenth Circuit held that the deposit was security for payment and that the contract was binding and the payment was therefore a purchase and not a deposit.[15] Similarly, in *Ernst v. Commissioner*,[16] a taxpayer was allowed to deduct the prepayment of chicken feed even though advance payment was not required and the taxpayer did not pay insurance or storage fees.[17] The Tax Court held that, since the taxpayer could not be reimbursed if he did not take the feed, the payment was "absolute," and thus deductible in the current year.[18]

11. *Id.*
12. 272 F.2d 895 (10th Cir. 1959).
13. *Id.* at 897.
14. *Id.* at 898.
15. *Id.* at 900.
16. 32 T.C. 181 (1959).
17. *Id.* at 183.
18. *Id.* at 186. The United States Court of Appeals for the Tenth Circuit in

The IRS, however, has been successful in disallowing some prepayments. In *Lillie v. Commissioner*,[19] a deduction was disallowed when the payment included services[20] and the taxpayer received a refund.[21] Also, in *Estate of Frank Cohen*,[22] the taxpayer was not allowed to deduct a payment based on the amount of weight his cattle gained.[23] The Tax Court said that a payment based on weight gain included payment for services and disallowed the deduction in the current year, classifying the payment as a deposit.[24]

The most important case in this area in *Mann v. Commissioner*.[25] A hog farmer gave the feed company a check on the last day of the year and did not specify the amount or type feed that he was ordering.[26] Yet the United States Court of Appeals for the Eighth Circuit allowed the deduction holding that if the payment is not refundable it is not a

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Cravens stated that the case for the taxpayer was stronger in *Cravens* than in *Ernst*. 272 F.2d at 899. The court stated:

> In Ernst there was no condition such as the drought which confronted Cravens and no hazard of a distress liquidation. The fact that Cravens had the possibility of a refund if the cost of the 745 tons of feed was less than $50,000, an eventuality which did not occur, did not make his contractual obligation any less binding than that of Ernst.

272 F.2d at 900.

However, in Weisbart v. Commissioner, 564 F.2d 34 (10th Cir. 1977), the court correctly found that the transfer of contract rights in exchange for cattle feed was merely a deposit when the taxpayer owned 100% of the stock in the cattle company and 92% of the stock in the feed company. *See also* Gaddis v. United States, 330 F. Supp. 741 (S.D. Miss. 1971).

19. 45 T.C. 54 (1964).

20. Services are only deductible in the year rendered. *See* Georgia, Fla. & Ala. R.R. Co. v. Commissioner, 31 B.T.A. 1 (1934); Farming Corp. v. Commissioner, 11 B.T.A. 1413 (1928). *See generally* RIA FEDERAL TAX COORDINATOR 2D ¶ H-2900.

21. 45 T.C. at 63. The Tax Court in *Lillie* distinguished Ernst v. Commissioner, 32 T.C. 181 (1959) by stating: "(1) petitioners [in *Lillie*] actually received in 1961 what we regard as a refund for feed not consumed; and (2) the price of "feed" here included the cost of valuable services to be rendered in the future." 45 T.C. at 63.

22. 1970 T.C.M. (P-H) ¶ 70,272.

23. *Id.* at 1340. However, the taxpayer was allowed to deduct payment of a fixed price for feed pursuant to another contract. *Id.* at 1339.

24. *Id.* at 1340. Prepayment of services is not a purchase but merely a deposit because the services will be performed in the future. Lillie v. Commissioner, 45 T.C. 54, 62 (1965).

25. 483 F.2d 673 (8th Cir. 1973).

26. *Id.* at 675.

deposit.[27] The court found a valid contract because "[p]assing title to the feed is not an essential element of a binding contract to sell feed."[28]

In response to these cases, the IRS issued Revenue Ruling 79-229,[29] which in part adopted the *Mann* holding.[30] The test given is that "the expenditure for the feed must be a payment for the purchase of feed rather than a deposit."[31] Whether the payment is a purchase or a deposit depends on the facts and circumstances of the case, but if it can be shown that the payment is nonrefundable and made pursuant to an enforceable sales contract the payment will not be considered a deposit.[32] The IRS suggested some factors that will tend to show a deposit rather than a purchase: (1) the "absence of specific quantity terms"; (2) the right to a refund at the termination of the contract;[33] (3) treatment of the payment as a deposit by the seller; and (4) the right to substitute ingredients.[34] Other factors, however, do not show a deposit. For example, substitution of ingredients solely to accomodate the current requirements of the livestock for which the feed was purchased is acceptable and adjusting the price to the market rate is allowed.[35]

Thus, the IRS's first test that requires the payment to be for the purchase of feed and not merely a deposit has been settled by case law, the Internal Revenue Code, and the Treasury Regulations. The test can be met by the farmer using the cash method of accounting as long as the payment is a purchase and not a deposit and the payment is not for

27. *Id.* at 678. The court stated, "[W]e think both the Dictionary [sic] definition and the common usage of the word clearly suggest that a nonrefundable deposit is, quite simply, a payment." *Id.*

28. *Id.* at 679.

29. Rev. Rul. 79-229, 1979-2 C.B. 210. This portion was first adopted in Rev. Rul. 75-152, 1975-1 C.B. 144 which preceeded Rev. Rul. 79-229.

30. Rev. Rul. 79-229 does not cite *Mann*, but the ruling specifically states: "When it can be shown that the expenditure is not refundable and is made pursuant to an enforceable sales contract, it will not be considered a deposit." Rev. Rul. 79-229, 1979-2 C.B. 210 at 211.

31. *Id.* at 210.

32. *Id.* at 211.

33. *Id. See* Lillie v. Commissioner, 45 T.C. 54 (1965).

34. Rev. Rul. 79-229, 1979-2 C.B. 210 at 211.

35. *Id.*

services.[36]

BUSINESS PURPOSE

The IRS also attempted to disallow the deduction of prepaid feed by arguing that the prepayment was not for a business purpose, but only for tax avoidance. I.R.C. section 162 permits the taxpayer to deduct "all *ordinary and necessary* expenses paid . . . during the taxable year in carrying on any trade or business."[37] The accompanying regulations state that a farmer can deduct all amounts actually expended in carrying on the business of farming.[38] The IRS incorporated this rule in its second test in Revenue Ruling 79-229,[39] stating, "prepayment must be made for a valid business purpose and not merely for tax avoidance."[40]

The IRS had some success with the business purpose test. For example, the United States Court of Appeals for the Eighth Circuit[41] stated in dictum that mere leveling of partnership income from year to year was not "ordinary and necessary"[42] and therefore was without business purpose.[43] Also, the Tax Court[44] found no genuine business reason for prepayment of feed since there was no shortage and the taxpayer received no preferential treatment.[45] But in *Cravens v.*

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36. After *Mann*, if the payment is nonrefundable and made pursuant to an enforceable sales contract, the payment will be a purchase. *See* Rev. Rul. 79-229, 1979-2 C.B. 210 at 211.

37. I.R.C. § 162 (1976) (emphasis added). See *supra* note 2 for the full text of the statute. *See also* Welch v. Helvering, 290 U.S. 111 (1933), interpreting the "ordinary and necessary" clause.

38. Treas. Reg. § 1.162-12(a) (1958) states:

> 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.

39. Rev. Rul. 79-229, 1979-2 C.B. 210. This portion was first adopted in Rev. Rul. 75-152, 1975-1 C.B. 144 which preceeded Rev. Rul. 79-229.

40. Rev. Rul. 79-229, 1979-2 C.B. 210.

41. Shippy v. United States, 308 F.2d 743 (8th Cir. 1962).

42. *See supra* note 2.

43. 308 F.2d at 747-48.

44. Lillie v. Commissioner, 45 T.C. 54 (1964).

45. *Id.* at 62. The court stated:

> While the *Cravens*, *Ernst*, and *Shippy* cases appear to be factually similar to the instant case, we think each is distinguishable. Unlike *Cravens*, where the taxpayer had a compelling business reason for the large end-of-year pay-

Commissioner,[46] the United States Court of Appeals for the Tenth Circuit found a valid purpose when the taxpayer entered into a contract which gave him preferential treatment during a drought because the taxpayer needed the feed to stay in business.[47] The Service's argument that no business purpose existed also failed in *Clement v. United States*[48] where the United States Court of Claims noted the common practice of buying corn during the fall months and held that businessmen are to be allowed discretion in timing their purchase.[49]

In Revenue Ruling 79-229, the IRS recognized the effect of these cases and gave examples of valid business purposes.[50] The Revenue Ruling includes fixing maximum prices, securing an assured feed supply, and securing preferential treatment as valid business purposes.[51] With these guidelines from the Revenue Ruling and the case law, a farmer can meet the requirements of the business purpose test,[52] since the Revenue Ruling is consistent with the case

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ment for feed, these petitioners had no genuine business reason for making advance payments other than the creation of a tax savings. There was no shortage of feed and the payments secured no preferential treatment for them.

46. 272 F.2d 895 (10th Cir. 1959).

47. The court stated:

> An expense may be ordinary even though it happen[s] but once in the taxpayer's lifetime. For an expenditure to be necessary it is not essential that there be an absolute and compelling reason. When the expenditure is appropriate and helpful to the taxpayer's business, the courts are loath to override the taxpayer's judgment.

Id. at 898-99 (footnotes omitted).

48. 580 F.2d 422 (Ct. Cl. 1978).

49. *Id.* at 429.

50. Rev. Rul. 79-229, 1979-2 C.B. 210 (*superseding* Rev. Rul. 75-152, 1975-1 C.B. 144).

51. Rev. Rul. 79-229, 1979-2 C.B. 210 at 211 states:

> Examples of business benefits include, but are not limited to: fixing maximum prices and securing an assured feed supply or securing preferential treatment in anticipation of a feed shortage. Whenever the prepayment was a condition normally imposed by the seller as an independent arm's length transaction and whether such condition was otherwise meaningful should also be taken into account in determining whether there was a business purpose for the prepayment.

52. The key to the courts finding a business purpose seems to be having expert testimony that the price of corn increases in the spring of a normal year. *See* Clement v. United States, 580 F.2d 422, 429 (Ct. Cl. 1978).

law, Internal Revenue Code, and the Treasury Regulations.

MATERIAL DISTORTION OF INCOME TEST

The third test formulated in Revenue Ruling 79-229 is that "(t)he deduction of such costs in the taxable year of prepayment must not result in a material distortion of income."[53] In effect, the IRS claims administrative discretion to change the farmer's taxable income if the Commissioner finds that the income was materially distorted when it was reported. The IRS in its ruling bases this broad administrative power on sections 461(a)[54] and 446(b)[55] of the code. Section 446(b) states that if a taxpayer's method of accounting does not clearly reflect income, then the Commissioner can choose a method that does clearly reflect income.[56] Thus, the IRS argues that, because of section 446(b), the Commissioner can impose another method of accounting on the farmer when the farmer deducts payments for prepaid feed.

There are definite weaknesses in this rule. First, section 446(b) states that "if the *method* used does not clearly reflect income"[57] the Commissioner may exercise his discretion to choose a more accurate representative method. However, the material distortion of income test in Revenue Ruling 79-229 gives the Commissioner discretion whenever the tax-

53. Rev. Rul. 79-229, 1979-2 C.B. 210 (*superseding* Rev. Rul. 75-152, 1975-1 C.B. 144).

54. I.R.C. § 461(a) (1976) states:

> The amount of any deduction or credit allowed by this subtitle shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income.

55. I.R.C. § 446(b) (1976) states:

> If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.

56. Rev. Rul. 79-229, 1979-2 C.B. 210 at 211, *citing* Burch v. Commissioner, 533 F.2d 768 (2d Cir. 1976); Cole v. Commissioner, 64 T.C. 1091 (1975); Sandor v. Commissioner, 62 T.C. 469 (1964), *aff'd*, 536 F.2d 874 (9th Cir. 1976) (without further discussion of the cases).

57. I.R.C. § 446(b) (1976) (emphasis added). *See supra* note 55 for a full text of the statute.

payer's income is materially distorted.[58] Thus the Commissioner can exercise his discretion under Revenue Ruling 79-229 by requiring the farmer to use the inventory method of accounting for his prepaid feed deductions, while leaving the farmer's remaining deductions based on the cash method of accounting.[59] But section 446(b) requires that the Commissioner look at the farmer's entire accounting method to see if the *method* does not clearly reflect income.[60] Under the Revenue Ruling, the Commissioner is isolating a particular deduction rather than viewing the farmer's entire accounting procedures.

Second, Congress could have required the taxpayer farmer to use the inventory method. Section 471[61] gives the Secretary the discretion to require the inventory method whenever it is necessary clearly to determine the income of any taxpayer. But Treasury Regulation section 1.471[62] specifically states that a farmer can use the inventory method instead of the cash method, but it is "*optional* with the *taxpayer* which of these methods is used."[63] Under the material distortion test the IRS is attempting to make the farmer use the inventory method, which the regulations state he does not have to do.[64] This, in effect, requires the farmer to de-

58. Rev. Rul. 79-229, 1979-2 C.B. 210 at 211 states that "[t]he legitimate use of the cash or accrual methods of accounting does not encompass certain tax shelter techniques," and thus the IRS will disallow such deductions.

59. *See* Clement v. United States, 580 F.2d 422, 430 (Ct. Cl. 1978), where the court realizes that the Commissioner is not rejecting the taxpayer's accounting method.

60. I.R.C. § 446(c) (1976) states that the cash receipts and disbursements method is a permissible method of accounting. However, § 446(c) is subject to §§ 446(a) and 446(b).

61. I.R.C. § 471 (1976) states:

> Whenever in the opinion of the Secretary the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer on such basis as the Secretary may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

62. Treas. Reg. § 1.471-6(a) (1958) states:

> A farmer may make his return upon an inventory method instead of the cash receipts and disbursements method. It is *optional* with the *taxpayer* which of these methods is used . . . (emphasis added).

63. *Id.* (emphasis added).

64. In Helvering v. Winmill, 305 U.S. 79, 82 (1938) the court held:

duct his prepaid feed expenses in subsequent years and prevents any deferral of income taxes in the current year.

The IRS also bases its broad administrative powers of finding a material distortion of income in Revenue Ruling 79-229 on the concept that the prepaid feed is an asset that must be capitalized. The IRS asserts in the ruling that Treasury Regulation section 1.461[65] justifies the material distortion test since the regulation states that an asset which has a useful life substantially beyond the end of the taxable year either may not be deducted at all, or may only be deducted in part of the current year.[66] The IRS relies on *Commissioner v. Boylston Market Assoc.*,[67] which held that a taxpayer on the cash method could not deduct prepaid insurance premiums,[68] and *Lovejoy v. Commissioner*,[69] which held that a taxpayer could not deduct fees prepaid in securing a loan, but had to capitalize costs.[70] The IRS then applies these cases to farming and further cites *Clement v. United States*.[71] In *Clement*, the court ruled that there was a material distortion of income, citing Treasury Regulation section 1.461, and therefore the taxpayer had to deduct the feed when it was

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Treasury regulations and interpretations long continued without substantial change, applying to unamended or substantially reenacted statutes, are deemed to have received congressional approval and have the effect of law.

Thus, since treasury regulation § 1.471 has remained unchanged since 1938 it has the force of law and must be considered in evaluating the amount of discretion the Commissioner has in disallowing prepaid feed deductions in the current year. In Auburn Packing Co. v. Commissioner, 60 T.C. 794 (1973) the conflict between § 446(b)'s "clearly reflect income" standard and the special rules that apply to farmers was tested. The court held that the Commissioner was unable to exercise his discretion under § 446(b) because the special rules that applied to farmers in the regulations governed the outcome of the case.

65. Treas. Reg. § 1.461-1(a)(1) (1957) states:

If an expenditure results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year, such an expenditure may not be deductible, or may be deductible only in part, for the taxable year in which made.

66. *Id.*

67. 131 F.2d 966 (1st Cir. 1942).

68. *Id.* at 968.

69. 18 B.T.A. 1179 (1930).

70. *Id.* at 1183.

71. 580 F.2d 422 (Ct. Cl. 1978).

consumed.[72] The court distinguished Treasury Regulation section 1.471 which gives farmers the option to use the cash method or the inventory method by stating that inventories were not imposed on the farmer.[73]

The authority cited for the Revenue Ruling is not persuasive. Both *Boylston* and *Lovejoy* are distinguishable since they dealt with "period costs" and not a farmer's "product costs."[74] In *Clement* the United States Court of Claims recognized the special rule in Treasury Regulation section 1.471 which gives farmers the option to use the cash method or the inventory method, but it avoided the regulation by stating that inventories were not imposed.[75] Yet the court required the farmer to deduct the feed in the year that it was consumed, which is the basis of an inventory method of accounting. The Revenue Ruling also relies on Treasury Regulation section 1.461, which states that if the item purchased lasts beyond the end of the taxable year, the taxpayer may only deduct part of the expenditure in the current year.[76] Again, a special rule for farmers exists. Treasury Regulation section 1.162 provides that the purchase of feed for livestock is an *expense* deduction.[77] Thus, the prepayment of feed is an expense deduction in the current year, and

72. *Id.* at 431. The court also cites *Boylston* and *Lovejoy* as authority. *See supra* notes 67-70 and accompanying text.

73. 580 F.2d at 432.

74. S. DAVIDSON, J. SCHINDLER, C. STICKNEY & R. WEIL, MANAGERIAL ACCOUNTING 283-84 (1978) makes the distinction between period and product costs. "Costs incurred in changing the physical form of goods being manufactured are product costs. . . . Period expenses, on the other hand, are treated as expenses in the same period in which the costs are incurred (for example, selling and administrative expenses)." In *Boylston* the prepaid insurance premiums are period costs and must be deducted in the year incurred. Likewise, in *Lovejoy* the prepaid fees paid in securing a loan are period costs. But in the case of a farmer, prepaid feed expenses should be classified as a product cost. Since inventories, which are generally associated with product costs, are not required of the farmer, the farmer can deduct in the year paid. *See* Treas. Reg. § 1.471-6(a) (1958) quoted *supra* at note 62.

75. 580 F.2d at 432.

76. *See supra* note 65.

77. Treas. Reg. § 1.162-12(a) (1958) states:

> The purchase of *feed* and other costs connected with raising livestock may be treated as *expense* deductions insofar as such costs represent actual outlay . . . (emphasis added).

none of the prepaid feed should be deducted in subsequent years.

The Service's position was not adopted in the case of *Cravens v. Commissioner*.[78] In *Cravens*, the United States Court of Appeals for the Tenth Circuit distinguished *Boylston* and similiar cases as "situation[s] of fixed liabilities payable ordinarily in periodic installments."[79] The court in *Cravens* also realized that the prepayment of feed did not create a capital asset since the payment for feed was not an "addition, a betterment, or an advantage of a permanent character . . ." but rather was for the "day by day supply of food without which the herd could not survive."[80] The court also stated that the fact that the feed was consumed in a time period longer than twelve months did not convert it into a capital expenditure, reasoning that putting a "clearly reflect income"[81] standard into the tax system would create too much confusion, and that it is much simpler to deduct the item when paid under the cash receipts and disbursements method.[82]

Two important cases have been decided since Revenue Ruling 79-229 was published. The first case, *Frysinger v. Commissioner*,[83] decided by the United States Court of Appeals for the Fifth Circuit directly rejects the material distortion test in Revenue Ruling 79-229. In *Frysinger* the taxpayer purchased feed on December 30, 1975, and deducted the purchase in 1975, under the cash receipts and disbursements method of accounting.[84] The taxpayer did not purchase any cattle until May, 1976, and did not use all the

78. 272 F.2d 895 (10th Cir. 1959).

79. *Id.* at 899.

80. *Id.* The court in effect made the distinction between period and product costs without using the technical terminology. *See supra* note 74. In James F. Haynes, 1979 T.C.M. (P-H) ¶ 79,240, the court recognized that Treas. Reg. § 1.461-1(a)(1) (1957) deals with period costs.

81. I.R.C. § 43 (1939) was at issue in this case.

82. In *Cravens*, the court stated that "[I]f each transaction must be analyzed to determine whether a distortion of income will result from the allowance of a business expense deduction, § 43 is, in our opinion, given a meaning which Congress did not intend." 272 F.2d at 901.

83. 645 F.2d 523 (5th Cir. 1981).

84. *Id.* at 524.

feed purchased until 1977.[85] The court allowed the 1975 deduction and held that Treasury Regulation section 1.162, which allowed the taxpayer to treat feed as an expense item, controlled the clearly reflecting income standard of section 446(b) and therefore the Commissioner had no discretion in this case.[86] The court also rejected the *Clement* holding, which had disallowed a feed deduction because it was an expenditure which created an asset having a useful life extending substantially beyond the close of the taxable year.[87] Specifically, the court in *Frysinger* held that:

> [W]here the taxpayer is a farmer covered by the special provisions allowing farmers to take current deductions for feed expenses, where the prepayment is for a business purpose and not merely tax avoidance, and where it is in line with normal business practices and not unreasonable, the Commissioner cannot use his discretionary authority to vitiate the benefits granted the taxpayer by his own regulations merely because the taxpayer's method may otherwise result in a distortion of income.[88]

In the second of these recent cases, *Commissioner v. Van Raden*,[89] the facts were similar, but the result was different. In *Van Raden*, the United States Court of Appeals for the Tenth Circuit adopted a "one-year rule."[90] This rule allows

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85. *Id.*

86. The court also cited Treas. Reg. § 1.471-6(a) (1958). 645 F.2d at 526.

87. In rejecting *Clement*, the court made an important distinction between "period costs" and "product costs."

> We think the Court of Claim's reliance [in *Clement*] on Treas. Reg. § 1.461-1(a)(1) is misplaced and contrary to the historical concession granted to farmers. "Period costs" are costs which arise with respect to time intervals. They are easily allocable to more than one accounting period by dividing the total cost by the number of months over which the asset's useful life extends. Feed expenditures on the other hand are more akin to "product costs," which vary according to the magnitude of the production process and do not lend themselves to easy allocation because the rate of consumption does not depend solely upon the passage of time.

645 F.2d at 527-28.

88. 645 F.2d at 528.

89. 650 F.2d 1046 (9th Cir. 1981).

90. The court adopted the "one-year rule" from Zaninovich v. Commissioner, 616 F.2d 429 (9th Cir. 1980), where a taxpayer prepaid rent and was allowed to deduct the whole payment in the current year since the asset's useful life was less than one year. The court in *Van Raden* found no reason to distinguish feed payments from rental payments. Neither *Zaninovich* nor *Van Raden* recognized the distinction be-

a deduction in the current year only if the expenditure creates an asset with a life of one year or less.[91] The court reasoned that since the main reason for allowing farmers to use the cash method was because the cash method is simple, this simple one-year rule should be adopted.[92] However, there is little support for the "one-year rule" in the code or the regulations.[93]

Section 7805 of the Internal Revenue Code of 1954 states that "the Secretary shall prescribe all needful rules and regulations for the enforcement of this title."[94] This is not the power to make the law, however, but only to "carry into effect the will of Congress as expressed by the statute."[95] If the Revenue Ruling does not express the will of Congress it is "a mere nullity."[96] The material distortion test of Revenue Ruling 79-229 is in conflict with many statutes and regulations, as explained above, and therefore may be contrary to the law and a mere nullity.

CONCLUSION

Revenue Ruling 79-229 adopted three tests; the prepayment of feed must be a purchase and not a deposit, the purchase must be for a business purpose, and the purchase must not result in a material distortion of income. The material distortion of income test is contrary to the Internal Revenue Code and the Treasury Regulations. It is currently being litigated in the courts, with mixed results.

PATI HOFFMANN

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tween period and product costs that was vital in the *Frysinger* decision. *See supra* note 74. By missing this distinction the *Zaninovich* and *Van Raden* decisions missed the critical issue, and sought instead to develop a simple rule that has no support in the code or regulations.

91. 650 F.2d 1050.

92. *Id.*

93. *See infra* note 90.

94. I.R.C. § 7805 (1976).

95. Manhattan General Equipment Co. v. Commissioner, 297 U.S. 129, 134 (1936).

96. *Id.*