BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
)
VERNE D. AND JOANNE 0. FREEMAN)

Appearances:

For Appellants: Gordon M. Weber
Attorney at Law

F. W. Pearson, Jr.
Certified Public Accountant

For Respondent: John A. Stilwell, Jr.
Counsel

O P I N I O N

This appeal is made pursuant to section 18593 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of Verne D. and Joanne 0. Freeman against a proposed assessment of additional personal income tax in the amount of $39,560.90 for the year 1971.

Appellant Verne D. Freeman is a corporate executive who in 1971 and subsequent years was also engaged in a number of other business and investment ventures. On his 1971 California personal income tax return, he reported a salary of $73,009 and net capital gains of $1,215,379. In that year he aiso reported losses of $36,380 from partnerships, $207,609 from rental properties, and $359,550 from cattle raising. Of this last amount, $321,821 was attributable to payments for cattle feed. Appellants used the cash receipts and disbursements method of accounting for reporting their income.

In November and December of 1971, appellants purchased 3,004 head of cattle from Oakdale Commercial Feed Yards, Inc. (hereinafter "Oakdale".) The cattle remained on Oakdale's premises with all services of caring for them performed by Oakdale. The agreement for the purchase, care, and sale of the cattle and the purchase of feed was oral. However, on January 10, 1973, a written recitation of the terms previously agreed upon (and by that time, performed) was signed by appellant and Oakdale.

On December 23, 1971, appellant paid Oakdale $321,821 for cattle feed. Apparently $61,868 of this amount was for feed consumed in 1971; the remaining $259,953 was for feed delivered in the first half of 1972. The printed-form invoice for this latter amount of feed, dated December 30, 1971, states:

> This account is due on the first of the month following month of purchase, past due at the end of the month following month of purchase.

Appellant sold the cattle in 1972, but apparently continued in the cattle-feeding business with new stock. Additional feed was purchased in 1972 for $263,010, part of which was not delivered and used until 1973.

In 1973, respondent was notified of an adjustment made by the Internal Revenue Service ("IRS") on appellants' federal tax return for 1971, disallowing the deduction claimed for prepaid cattle feed in the amount of $259,953. The deduction was apparently allocated to 1972. The disallowance for 1971 was based on the IRS position that the payment created a material distortion of appellants! 1971 income and that appellants received

no business benefit from the prepayment. Respondent adopted the federal adjustment in its notice of proposed assessment dated December 17, 1973. Appellants protested, stating that they acquiesced in the federal adjustment only because it did not result in an overall additional tax liability for the several years covered by the federal audit due to the availability of operating loss carrybacks and carryovers under federal law. Notwithstanding their acquiescence, appellants contended that the determination was erroneous.,

The issue presented is whether appellants are entitled to deduct the expense of $259,953 prepaid in 1971 for feed delivered and fed to their cattle in the following year.

Respondent takes the position that appellants must satisfy the three tests for deductibility of prepaid cattle feed expenses set forth in Revenue Ruling 75-152, 1975-1 Cumulative Bulletin 144.[1/] Revenue rulings are merely the official IRS interpretations of certain laws as applied in certain circumstances, used to promote uniform application of tax laws by IRS employees and to advise taxpayers of the Service's official position. They do not have the force and effect of Treasury Department regulations and they are not binding on the courts. (Dunn v. United States, 468 F.Supp. 991, 993 (D.C.S.D.N.Y. 1979); Kenneth H. Van Raden, 71 T.C. 1083, 1096 (1979), app. pending 9th Cir.; Andrew A. Sandor, 62 T.C. 469, 481-482 (1974).) However, some courts have analyzed this issue in the context of this ruling (see e.g., Clement v. United States, 580 F.2d 422 (Ct. Cl. 1978); Dunn v. United States, supra; Kenneth H. Van Raden, supra), and the parties in this appeal have done so as well. We therefore find it convenient to use Revenue Ruling 75-152 as a guide for our analysis.

In Revenue Ruling 75-152, the IRS takes the position that a farmer keeping his books on the cash method of accounting may deduct the cost of feed in the taxable year of payment, where the feed will be

1/ Revenue Ruling 75-152 has, subsequent to the briefing in this appeal, been superseded by Revenue Ruling 79-229, 1979-2 Cumulative Bulletin 210. However, since the parties have not referred to this new ruling and it merely restates and amplifies the preaious ruling, we refer here only to Revenue Ruling 75-152.

consumed in the following taxable year, only if all of the following three-tests are satisfied:

(1) The expenditure for the feed must be a payment, not merely a deposit;

(2) The prepayment must be for a business purpose and not merely for tax avoidance; and

(3) The deduction of such costs in the taxable year of payment must not result in a material distortion of income.

Respondent contends that appellants fail to meet any of the three tests of the revenue ruling. Appellants challenge the use of the revenue ruling criteria, maintaining that, except for the first test of payment versus deposit, they have not been applied by the courts. In any case, appellants maintain that they have satisfied each of the tests in the ruling.

The Payment Versus Deposit Test

The first requirement of the revenue ruling is that the expenditure must be an actual payment for feed, not simply a refundable deposit. Respondent contends that appellants' failure to execute a written contract regarding their purchase of cattle -feed indicates that the agreement was revocable until the feed was delivered. It concludes from this that the prepayment was merely a refundable deposit which should not have been deducted until the feed to which it was attributable was consumed.

Several cases have held that prepayments which were refundable deposits were not deductible expenses in the year paid. (Shippy v. United States, 308 F.2d 743 (1962); Tim W. Lillie, 45 T.C. 54 (1965); James A. Smith, ¶ 76,279 P-H Memo. T.C. (1976).) The cases cited, however, are clearly distinguishable. In Shippy v. United States, supra, the feed seller testified that he considered the payment a deposit and would have refunded the amount if the buyer had not needed the feed. Additionally, the prepayment in that case was a deviation from the ordinary business practice of the taxpayer and was not done either before or after the year in issue. In Tim W. Lillie, supra, and James A. Smith, supra, refunds were actually received and the-

payments also included the cost of services to be performed in the following taxable-year:"

In this appeal, appeliants have submitted a written agreement which deals with refundability, but only in the event of a disaster loss of the cattle. This is hardly the kind of refund which the cases contemplate in disallowing a deduction on this basis. Respondent points out that this written agreement should be given little weight since it was signed a year after the payment was made and since the feed seller allegedly stated that the agreement was signed only because all liability under it had already passed. The fact that the agreement was not put into written form until a year later, while raising some question as to its credibility, does not mean that there was no such agreement at the time of payment. As appellants point out, the acceptance of payment by the seller creates an enforceable contract for goods under the California Uniform Commercial Code, section 2201, subdivision (3)(c). Oakdale's statement of its reason for signing the agreement also indicates that it had considered itself to have been obligated under the oral agreement to deliver the feed. We find, therefore, that the expenditure was not a mere deposit.

The Business Purpose Test

In regard to the business purpose test, Revenue Ruling 75-152 states:

> The second test is that the prepayment must be made for a valid- business purpose and not merely for tax avoidance. Generally, the factor that distinguishes the court decisions allowing a deduction for prepaid feed costs from those disallowing the deduction is the acquisition of, or the reasonable expectation by the taxpayer of receiving, some business benefit as a result of the prepayment. [Citations.] Examples of business benefit 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. Whether the prepayment was a condition imposed by the seller and whether such condition was meaningful should also be taken into consideration in determining whether there was a business purpose for the prepayment.

Respondent contends that the primary motive in this case was tax avoidance, as demonstrated by the large tax advantage appellants would receive if allowed the feed expense deduction in 1971. It also finds indicative of tax avoidance appellants' payment for the feed before such payment was required under the terms stated on the invoice from Oakdale. Respondent questions the validity of the written agreement signed in 1973 as probative evidence of a business purpose and points out that there has been no showing of a feed shortage, which would make a preferential feeding agreement advantageous.

Appellants state, and their written agreement with Oakdale reflects, that their payment prior to December 31, 1971 provided them with a preferential feed guarantee. They also contend that they thereby fixed the price of the feed for the cattle they had already purchased.

Since there is clearly a business benefit to one engaged in cattle raising from the purchase of feed for the cattle, this second criterion of the revenue ruling must go to the timing of the expenditure. The courts which have addressed the business purpose test of Revenue Ruling 75-152 have found it unnecessary to consider whether this test is appropriate, either because they have found a business purpose with respect to the timing of the expenditure or because the parties have not challenged the relevance of the test. (Clement v. United States, supra; Kenneth H. Van Raden, supra.) Although we question the propriety of requiring a business purpose for the timing of an expenditure (see Mann v. Commissioner, 483 F.2d 673, 680 (8th Cir. 1973)), we too find it unnecessary to decide that question, since under the standards of the revenue ruling a sufficient business purpose for the timing of the expenditure is present in this appeal.

We believe that there was clearly the reasonable expectation by the taxpayer of receiving some business benefit as a result of the timing of the prepayment. "When an expenditure is appropriate and helpful to the taxpayer's business, the courts are loath to override the taxpayer's judgment." (Cravens v. Commissioner, 272 F.2d 895, 899 (10th Cir. 1959).) Appellants have made a sufficient showing that they would receive a business benefit from paying for the feed when they did by fixing the price and assuring their feed supply. Although we agree with respondent

that tax avoidance was a factor in appellants' decision to prepay for feed, we do not believe the prepayment was merely for tax avoidance.

The Material Distortion of Income Test

Respondent's final contention, based on the third test of Revenue Ruling 75-152, is that allowance of a deduction for cattle-feed expenses in 1971 would materially distort appellants' income for that year. It finds distortion evident in the fact that there would be no matching of the cattle-raising income and expenses for 1971 or 1972. It finds the distortion to be material when the expense of $259,953 is compared to appellants' 1971 reported taxable income of $680,699 and because the resulting tax saving to appellants over 1971 and 1972 is $38,440.90.

Appellants maintain that, as cash basis livestock raisers, they are entitled to the special treatment. accorded farmers which allows them to choose the cash method of accounting instead of an inventory method and to currently deduct feed expenses, even though this may cause some distortion of income.

Respondent's argument appears to rely basically on Revenue and Taxation Code sections 17561(b)[2/] and 17601 and the regulations accompanying section 17561. The material distortion of income test is derived from section 17561(b), which 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 Franchise Tax Board, does clearly reflect income. (Corresponding federal statute, Int. Rev. Code of 1954, § 446(b).)

Respondent is granted broad discretion by this section. which will not be interfered with absent a clear showing of abuse of discretion in its application. (Clement v. United States, supra, 580 F.2d at 430.)

2/ Unless otherwise indicated, all section references are to the Revenue and Taxation Code.

Regulation 17561 provides that the term "method of accounting" includes the accounting treatment of any particular item as well as the overall method of accounting. (Cal. Admin. Code, tit. 18, reg. 17561, subd. (a)(1).) It also states that a method of accounting will not be acceptable unless, in the opinion of the Franchise Tax Board, it clearly reflects income. (Cal. Admin. Code, tit. 18, reg. 17561, subd. (a)(2).)

Section 17601 provides that whenever, in the opinion of the Franchise Tax Board, the use of inventories is necessary to clearly determine income, the taxpayer shall take inventories on such basis as the Franchise Tax Board may prescribe, conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting income.

Appellants' argument is supported by sections 17561(a) and the regulations thereunder, section 17591, and the regulations under sections 1.7202 and 17601. Section 17561(b), relied on by respondent, is an exception to section 17561(a) which provides that taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books. The regulations under that section specify that a consistently applied method of accounting, which is in accordance with the accepted practices and conditions of a particular business, will ordinarily be regarded as clearly reflecting income. (Cal. Admin. Code, tit. 18, reg. 17561, subd. (a)(2).)

Section 17591 provides that deductions shall be taken by the taxpayer in the taxable year which is proper under the method of accounting used in computing taxable income.

Regulation 17202(1) states that "Thepurchase of feed and other costs connected with raising livestock may-be treated as expense deductions insofar as such costs represent actual outlay,. ..." '(Cal. Admin. Code, tit. 18, reg. 17202(1), repealed eff. March '23, 1979.)

The regulations accompanying section 17601 provide, in part:

> Inventories of Livestock Raisers and Other Farmers. (1) 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 methodsof accounting is used but, having elected one method, the option so exercised will be binding upon the taxpayer for the year for which the option is exercised and for subsequent years unless another method is authorized by the Franchise Tax Board'.... (Cal. Admin. Code, tit. 18, reg. 17601(f), subd. (1).)

With this statutory background, we turn to the cases which support the respective positions taken by the parties in this proceeding. Respondent cites the case of Clement v. United States, supra, in support of its assertion that it may require a change in a farmer's accounting method whenever, in respondent's opinion, the method does not clearly reflect (or materially distorts) income.

In Clement; the Court of Claims found the income of the taxpayer, who was a limited partner in a cattle-feeding partnership, to be materially distorted by a cattle-feed prepayment and therefore upheld the Commissioner's, disallowance of the deduction in the year paid. The court found a material distortion of income using the criteria set forth in Revenue Ruling 75-152, supra, and a requirement of "'substantial identity of results between [the taxpayer's accounting] method and the method selected by the Commissioner.'" (Clement v. United States, supra, 580 F.2d at 430.) It went on to reject the trial court's holding that the taxpayer, since he was a farmer using cash-basis accounting, was entitled to the deduction in the year the expense was paid, due to the special treatment accorded farmers by the regulations.

The Court of Claims found the Commissioner's method to be consistent with the cash method of accounting under Treasury Regulation section 1.461-1(a)(1) by characterizing the expenditure as one which resulted in the creation of an asset having a useful life which extended substantially beyond the close of the taxable year. It stated that, therefore, "the feed-deduction must be taken, where there would otherwise be a material distortion of income, in the year or years that that kind of asset is consumed or utilized." (Clement v. United States, supra, 580 F.2d at 432.) 'In reaching its conclusion, the court determined that feed expenses

were "period costs"[3] rather than "product costs,"[4] and as such, were properly deducted as the feed was consumed, even under the cash method of accounting.

On the material distortion of income issue, however, we find the analysis of Kenneth H. Van Raden, supra, to be much more persuasive. In that case a majority of the United States Tax Court allowed a prepaid cattle-feed expense deduction to a cash-basis limited partner in a cattle-feeding partnership, finding that the Commissioner had abused his discretion in applying the federal counterpart to section 17561(b). The court stated:

> The cash method of accounting will usually result in some distortion of income because the benefits derived from payments for expenses or materials extend to varying degrees into more than one annual accounting period. If the cash method is consistently utilized and no attempt is made to unreasonably prepay expenses or purchase supplies in advance, the distortion is not material and over a period of years the distortions will tend to cancel out each other. (Kenneth H. Van Raden, supra, 71 T.C. at 1104.)

The court asserted that distortion of income must be examined "in light of the business practice or business activities which give rise to the transaction which the Commissioner has determined must be accorded a different accounting treatment." (Kenneth H. Van Raden, supra, 71 T.C. at 1105.) It then held that, at least in the context of an approved and consistently used accounting method, a substantial legitimate business purpose satisfies the distortion of income test.

3/ "'Period costs' arise with respect to time intervals rather than with particular products or services. Examples are rent, insurance, interest and supplies consumed over time." (Clement v. United States, 580 F.2d 422, 432, fn. 8.)

4/ "'Product costs' are incurred in producing 'a product and are accounted for, under the inventory method, only on the sale of the products to which they relate. ..." (Clement v. United States, supra, fn. 7.)

The Van Raden court went on to reject the characterization of feed expenses in Clement v. United States, supra, as creating assets having useful lives extending substantially beyond the taxable year or as period costs, similar to prepaid rent or prepaid insurance premiums. It distinguished period costs, which are ongoing regardless of the magnitude of the business, from product costs, which vary with the magnitude of the business, and determined that feed expenses were the latter. To treat such expenses as allocable to the period of consumption would, the court concluded, impose an inventory method of accounting on a farmer as to those expenses in contradiction of the historical concessions granted farmers and reflected in the regulations. (See Cal. Admin. Code, tit. 18, regs. 17561, subd. (a)(2); 17601(f), subd. (1); and 17202(1), supra.)

Van Raden held that finding a substantial legitimate business purpose would satisfy the distortion of income test. While we would not necessarily find that to be true in every situation, we believe that in the case of prepaid cattle-feed expenses, viewed in the context of the special treatment accorded farmers in regard to their accounting practices, it is an abuse of respondent's discretion to require'what is 'essentially an inventory method of accounting as to feed expenses, where a legitimate business purpose is found for incurring such expenses. Where such a business purpose is found, there is no abuse by farmers reporting on the cash basis or any unreasonable prepayment of expenses. We find that appellants have shown a sufficient-business purpose, under the analysis of the Van Raden case, to satisfy the material distortion of income test. As Judge Tannenwald said in his concurring opinion in Van Raden, supra, at 1111, "If respondent is dissatisfied with this result, his course of action is to persuade the legislature to open up a path from the corner into which he has historically painted himself."5/

For the reasons discussed above, respondent's action in this matter must be reversed.

5/ We note that section 17599.1, operative for taxable years beginning in 1977, limits the deduction by farming syndicates of feed and other supplies to the taxable year of consumption. However, this statute affects neither the taxable year before us nor individual taxpayers, such as appellants.

Appeal of Verne D. and Joanne 0. Freeman

O R D E R

Pursuantto the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 18595 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Verne D. and Joanne 0. Freeman against a-proposed assessment of additional personal income tax in the amount of $39,560.90 for the year,, 1971, be and the same is hereby reversed.

Done at Sacramento, California, this 23rd day of June , 1981, by the State Board of Equalization, with Board Members Mr. Dronenburg, Mr. Reilly, Mr. Bennett and Mr. Nevins present.

Ernest J. Dronenburg, Jr. , Chairman

George R. Reilly , Member

William M. Bennett , Member

Richard Nevins , Member

, Member