STATE OF ALABAMA DEPARTMENT OF REVENUE,	§	STATE OF ALABAMA DEPARTMENT OF REVENUE ADMINISTRATIVE LAW DIVISION
v.	§	DOCKET NO. INC. 85-169
EMERY F. & MARY E. MCDONALD 111 Highland Place Sheffield, AL 35660,	§	
Taxpayers.	§	

ORDER

This case involves two preliminary assessments of income tax entered by the Revenue Department against Emery F. & Mary E. McDonald (hereinafter "Taxpayers') for the calendar years 1983 and 1984. A hearing was conducted in the matter on August 5, 1986. The Taxpayers were present and represented themselves. The Revenue Department was represented through assistant counsel Mark Griffin. Based on the evidence as presented at the hearing, the following findings of fact and conclusions of law were herein made and entered.

FINDINGS OF FACT

The assessments in issue are the result of a denial by the Department of certain farm loss deductions claimed by the Taxpayers on Schedule F, "Farm Income and Expenses", filed with their Alabama income tax returns for 1983 and 1984. The relevant facts, largely undisputed, are as follows:

In 1983, the Taxpayer, Mrs. McDonald, purchased from her son, Michael L. McDonald, 170 head of cattle located at the Harrington Van-Housen feed lot in Nebraska. Mr. McDonald is an investment

banker in Denver, Colorado, but was at the time in question also involved in the Harrington Van-Housen operation. The sales price for the cattle was $75,305.00, of which $10,000.00 was paid by check ($4,865.50 by check dated December 18, 1983 with the balance of $5,137.50 by check dated January 5, 1984), with the remainder of $65,305.00 secured by a promissory note dated December 18, 1983 from Mrs. McDonald to her son, payable on or before June 18, 1984. Mrs. McDonald also signed a promissory note for $50,000.00 dated December 18, 1983, payable to her son, for feed for the cattle. Mr. McDonald was responsible for the maintenance and eventual sale of the cattle. The cattle were sold prior to June 18, 1984, as agreed by the parties, with the proceeds going in part to pay the above promissory notes. The Taxpayers provided the Department with complete records indicating the exact amounts spent to feed the cattle during 1984.

In 1984, Mrs. McDonald again purchased cattle, this time directly from the Harrington Van-Housen feed lot operation. Her son was again empowered to administer the maintenance and eventual sale of the cattle. The 1984 cattle purchase was for $101,000.00, of which $20,000.00 was paid down by check from Mrs. McDonald to the Harrington Van-Housen partnership dated December 5, 1984, with the balance covered by a promissory note for $81,000.00 to the Harrington Van-Housen partnership, also dated December 5, 1984. On that same date, Mrs. McDonald also signed a $100,000.00 promissory

note payable to the Harrington Van-Housen partnership for cattle feed.

On their 1983 Alabama return, the Taxpayers claimed a $50,000.00 deduction for "feed purchase" on Schedule F. On their 1984 return, the Taxpayers again filed a Schedule F, and thereon reported the sale of the cattle that had been purchased in 1983. The gross sales price was $109,871.00. After deducting the cost basis of $75,305.00, the net profit from the sale of the cattle was $34,566.00. Also reported was income of $21,474.00 from the sale of surplus feed. The Taxpayers claimed deductions for interest of $4,324.00, rent of $2,703.00 and cattle feed of $100,000.00. The net farm loss claimed by the Taxpayers on Schedule F for 1984 was $50,987.00.

Upon audit, the Revenue Department examiner disallowed the $50,000.00 feed expense claimed in 1983 and the $100,000.00 feed deduction taken in 1984. However, the examiner did allow as a deduction in 1984 the $50,000.00 feed deduction claimed for 1983 which related to the cattle that were sold in 1984, thus resulting in a net reduction in 1984 of $50,000.00. The 1984 deduction was later reduced by the Department to allow for

only the amount (per the Taxpayers' records) that was actually expended in 1984 for cattle feed.

The Department disallowed the claimed feed expenses of $50,000.00 in 1983 and $100,000.00 in 1984 on several grounds:

First, the Department disputes that the Taxpayers qualify as farmers under Reg. 810-3-14-.03; second, as cash basis taxpayers, the Department argues that the Taxpayers can only deduct actual outlays and not expenses evidenced by an indebtedness such as a promissory note; third, the Department argues that the allowance of the claimed deductions would unduly distort the Taxpayers' income for the years in dispute, citing Code of Alabama 1975, §40-18-13.

CONCLUSIONS OF LAW

The Department argues that the Taxpayers were not farmers within the purview of Department Reg. 810-3-14-.03 and therefore should have reported the cattle sales and related expenses on Schedule D, and not Schedule F. Reg. 810-3-14-.03 requires that a taxpayer is engaged in the business of farming if he "cultivates, operates or manages a farm for gain or profit, either as owner or tenant". It does not appear that the Taxpayers in the present case would qualify as farmers under the above definition because they merely invested in a farming (cattle) business, and did not actively participate in the management of the operation. However, a final decision of that issue is not necessary because the determinative issue is whether the Taxpayers can deduct (either on Schedule F as claimed by the Taxpayers, or on Schedule D as claimed by the Department) the $50,000.00 and $100,000.00 claimed as feed expenses in 1983 and 1984, respectively. As set out above, the Taxpayers did not actually pay the expenses in those years, but only executed

promissory notes for the amounts due.

The Taxpayers employ the cash basis method of accounting, and therefore must report all income in the year received and take all expense deductions in the year paid. Blitzer v. U.S., 684 F.2d 874; IRC Regulation 1.461-1(a)(1). In Blitzer, the court specifically held that delivery of a promissory note does not entitle a cash basis taxpayer to take a deduction in the year in which the note is delivered. As stated by the court:

> A cash-basis taxpayer qualifies for a deduction only when he pays an obligation for a deductible item in cash or its equivalent. Delivery of a promissory note does not constitute payment for purposes of obtaining an allowable deduction. Don E. Williams Company v. Commissioner, 429 U.S. 569, 97 S.Ct. 850, 51 L.Ed.2d 48 (1977); Eckert v. Burnett, 283 U.S. 140, 51 S.Ct. 373, 75 L.Ed. 911 (1931); Helvering v. Price, 309 U.S. 409, 60 S.Ct. 673, 84 L.Ed. 836 (1940). As the Court explains in Don E. Williams Company, supra, 429 U.S. at 578, 97 S.Ct. at 856, "The reasoning is apparent: the note may never be paid, and if it is not paid, 'the taxpayer has parted with nothing more than his promise to pay.' [Citation omitted.]'

Accordingly, the Department acted properly in disallowing the $50,000.00 feed expense deduction claimed in 1983 and the $100,000.00 feed expense deduction taken in 1984. Those deductions were evidenced only by the execution of promissory notes by the Taxpayers, and not by the actual payment of the expenses in those years. Further, the allowance of the claimed deductions would clearly distort the taxable income of the Taxpayers for both 1983 and 1984. The Department was correct in allowing the feed expenditures which were actually incurred by the Taxpayers in 1984,

as documented by the Taxpayers' records.

Based on the above, it is hereby determined that the assessments as computed by the Department are correct and should be made final, with interest accruing as required by law.

Done this 19th day of December, 1986.

_____

BILL THOMPSON
Chief Administrative Law Judge