IN THE UNITED STATES COURT OF APPEALS

FOR THE FIFTH CIRCUIT

No. 93-5158

O.L. GRAGG, ET AL.,

Plaintiffs,

BILLY HARDIN GRAGG,
in his capacity as Independent Executor
of the Estate of O.L. Gragg,
and
INEZ GRAGG,

Plaintiffs-Appellants,

versus

UNITED STATES OF AMERICA,

Defendant-Appellee.

Appeal from the United States District Court
for the Eastern District of Texas
(92-CV-113)

(June 17, 1994)

Before KING and SMITH, Circuit Judges, and KAZEN,[*] District Judge.

PER CURIAM[**]

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[*] District Judge for the Southern District of Texas, sitting by designation.

[**] Local Rule 47.5.1 provides: "The publication of opinions that have no precedential value and merely decide particular cases on the basis of well-settled principles of law imposes needless expense on the public and burdens on the legal profession." Pursuant to that rule, the court has determined that this opinion should not be published.

Billy Gragg, executor of the estate of O.L. Gragg (Gragg)[1], appeals a summary judgment in favor of the government which disallowed certain prepaid feed deductions on Gragg's income tax returns for 1986 and 1987 and imposed penalties for negligence. Concluding that Gragg has failed to meet his burden of showing that the prepaid expenses served a valid business purpose and finding no error in the assessment of the negligence penalty, we affirm the summary judgment.

I. Background

A. The Deductions at Issue

O.L. Gragg had been in the oil and ranching businesses for many years. For a number of years, up to and including those in issue)) 1986 and 1987)) Gragg had maintained approximately 4,500 to 5,000 head of cattle on his ranches. During this time, he owned a number of ranches throughout Texas totaling approximately 31,000 acres, most of which was suitable for cattle grazing.

In December 1986, Gragg purchased 135,000,000 pounds of feed from Cargill, Inc. (Cargill), in Amarillo, Texas, for $4,995,000 in a contract providing that Cargill would purchase back at Gragg's option any open contract balance[2] at the then-market price. In January 1987, Gragg sold back to Cargill the entire amount of feed purchased the previous month for $4,657,000, at a loss of $338,000. In December 1987, he purchased 125,000,000 pounds of feed from

[1] The taxpayers in question are Mr. and Mrs. Gragg, but for simplicity, we refer to them in the singular as "Gragg."

[2] An "open contract balance" is any amount of the feed that had not been delivered.

Cargill pursuant to a similar contract, and in January 1988, sold the entire amount back to Cargill.

Gragg had a history of taking prepaid feed deductions for his cattle for many years prior to 1986 and 1987, the tax years in question.[3] In 1983, Gragg began to buy larger amounts of feed at year-end and to resell the feed back to Cargill early in the following year, resulting in an escalating pattern of deductions. Beginning in 1983, Gragg's year-end feed purchases became incrementally larger, with the resales to Cargill becoming larger as well. From 1983 to 1987, the records show:

Year	Feed Bought[4]	Feed Sold Back	Deduction Claimed
1983	$1,782,293	$ 402,825	$1,379,468
1984	3,138,508	1,079,000	2,059,508
1985	4,089,651	2,700,000	1,389,651
1986	5,352,560	3,805,000	1,547,560
1987	5,336,700	4,657,000	679,700

Brandon Darnell, manager of Cargill's Amarillo operation, was familiar with Gragg's business at that office. According to Darnell, Gragg would begin discussions with the office sometime in November or December with a view toward purchasing a large quantity of grain and then would buy the grain in December. In January, Gragg would call Cargill about the price of grain and then resell to Cargill the grain purchased at the end of the prior year. There was no evidence that Gragg ever took shipment of the grain

[3] His December 1978 feed purchases were $180,000; in 1979 they were $325,000, in 1980 they were $220,000, in 1981 they were $265,000, and in 1982 they were $941,000. In several of those years, Gragg sold back all or part of the year-end feed purchases early in the following year. Gragg contends that there was no resale of the grain bought in 1979, 1980, or 1981.

[4] The numbers in this column represent the total feed purchased during each calendar year.

purchased from Cargill.

Gragg included the prepaid feed purchases as part of his feed expense deductions for 1986 and 1987. The government contends that, rather than taking the sale proceeds into income from the resale of the feed in January of the following year, Gragg reduced the amount of feed expense for that year by the proceeds from the January resale of the prior December's feed purchase. According to the government, Gragg's 1986 return reveals a feed expense deduction of only $1,547,560, when his feed purchases aggregated $5,352,560. Similarly, it claims that Gragg reduced his actual 1987 feed expense of $5,336,700 by $4,657,000, the proceeds from the resale in January of the previous December's feed purchase, thus deducting a feed expense on his 1987 return of only $679,000.

Gragg counters that the transactions were legitimate, not merely sham transactions. He contends that he bought a large quantity of grain because of significantly low prices)) namely a nine-year low price for corn. He then sold this stock as prices continued to plummet. He argues that he bought more than immediately necessary because of a desire to expand his herd in the future. Finally, because of illness and blindness, in 1988, he sold the grain purchased in December of 1987 and made no new purchase. The government offered the sworn statements and deposition testimony of several witnesses challenging Gragg's testimony.

B. The Instant Litigation

Gragg was audited. The IRS decreased his feed expense

deductions by $4,745,049 for tax year 1986 and by $5,000 for tax year 1987. The IRS also imposed penalties for negligence under 26 U.S.C. § 6653(a)(1) of $356,133 for 1986 and $12,877 for 1987.

Gragg paid the IRS assessments in order to prevent further accrual of interest and then sought a refund of the amounts paid through the appropriate IRS administrative channels, which was denied. Finally, he brought suit seeking a refund pursuant to 26 U.S.C. §§ 1346 & 7422. Gragg died during the pendency of the suit, and his son, Billy Hardin Gragg, executor of the estate, was substituted as a plaintiff.

Both parties filed motions for summary judgment, and, in June 1993, the district court entered an order granting the IRS' motion for summary judgment and denying Gragg's motion.[5] The district court held that the large year-end feed purchases in each of the years in question that generated prepaid feed expense deductions, followed by resales in the beginning of the next year, were sham transactions lacking any business purpose other than tax avoidance. The court held that Gragg had failed to raise a genuine issue of material fact that he had a valid business purpose for the large feed prepayments. The court also upheld the additions to tax for negligence.

[5] At oral argument in this appeal, Gragg confirmed that this case could be decided on the record presented and argued that it should be decided as a matter of law since there were no material factual disputes.

II. Analysis

A. Standard of Review

This court reviews summary judgment issues de novo. Hanks v. Transcontinental Gas Pipe Line Corp., 953 F.2d 996, 997 (5th Cir. 1992). Summary judgment is appropriate "if the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law." FED. R. CIV. P. 56(c). The party seeking summary judgment carries the initial burden of demonstrating that there is an absence of evidence to support the non-moving party's case. Celotex Corp. v. Catrett, 477 U.S. 317, 325 (1986); Russ v. Int'l Paper Co., 943 F.2d 589, 591 (5th Cir. 1991). After a proper motion for summary judgment is made, the non-movant must set forth specific facts showing that there is a genuine issue for trial. Hanks, 953 F.2d at 997.

We begin our determination by consulting the applicable substantive law to determine what facts and issues are material. King v. Chide, 974 F.2d 653, 655-56 (5th Cir. 1992). We then review the evidence relating to those issues, viewing the facts and inferences in the light most favorable to the non-movant. Id. If the non-movant sets forth specific facts in support of allegations essential to his claim, a genuine issue is presented. Celotex, 477 U.S. at 327 ("Rule 56 must be construed with due regard not only for the rights of persons asserting claims and defenses, . . . but also for the rights of persons opposing such claims and defenses to

demonstrate . . . prior to trial, that the claims and defenses have no factual basis."). The non-movant "must present more than a metaphysical doubt about the material facts." Washington v. Armstrong World Indus., 839 F.2d 1121, 1123 (5th Cir. 1988). "If the factual context renders the [non-movant's] claim implausible)) if the claim is one that simply makes no economic sense)) [the non-movant] must come forward with more persuasive evidence to support [its] claim than would otherwise be necessary." Matsushita Elec. Indus. Co. v. Zenith Radio Corp., 475 U.S. 574, 587 (1986).

The taxpayer bears the burden of demonstrating entitlement to a deduction. INDOPCO, Inc. v. Commissioner, 112 S. Ct. 1039, 1043 (1992) (noting the "`familiar rule' that `an income tax deduction is a matter of legislative grace and that the burden of clearly showing the right to the claimed deduction is on the taxpayer'") (quotation omitted). We view the summary judgment evidence through the "prism" of this substantive evidentiary burden. Bienkowski v. American Airlines, 851 F.2d 1503, 1504 (5th Cir. 1988). Further, we look to the subjective intent of the parties only when the application of objective indicia is inconclusive. Texas Farm Bureau v. United States, 725 F.2d 307, 312 (5th Cir. 1984), cert. denied, 469 U.S. 1106 (1985).

B. The Test for Deductible Feed Prepayments

Under 26 U.S.C. § 162(a), a taxpayer may deduct "ordinary and necessary" business expenses. Under § 162(a), payments must be ordinary and necessary, not in the sense that they are habitually or normally made by the specific taxpayer, but only in the sense

that they are of a sort commonly made by persons in the type of business carried on by the taxpayer. Tulia Feedlot v. United States, 513 F.2d 800, 804 (5th Cir.), cert. denied, 423 U.S. 947 (1975).

When a taxpayer prepays in one year an expense that is a business expense of a succeeding taxable year or years, the expense generally is not an ordinary and necessary business expense of the year of payment. Farmers and ranchers, however, enjoy a special rule that allows deductions for prepayments for business purposes. Under Revenue Ruling 79-229, to deduct the cost of prepaid feed (1) the expenditure must be a current "payment," rather than a "deposit"; (2) a substantial business purpose must have been accomplished by prepaying the item; and (3) the deduction of such costs in the taxable year of prepayment must not result in a material distortion of income. Rev. Rul. 79-229, 1979-2 C.B. 210; see also Schenk v. Commissioner, 686 F.2d 315, 318 (5th Cir. 1982); Stice v. United States, 540 F.2d 1077, 1079 (5th Cir. 1976) (applying former Rev. Rul. 79-152, which was superseded, but not substantively modified by, Rev. Rul. 79-229). A valid business purpose exists for prepaying feed costs when the taxpayer acquires, or has a reasonable expectation of receiving, some business benefit as a result of the prepayment. Rev. Rul. 79-229; see also Stice, 540 F.2d at 1081; Golden Rod Farms, Inc. v. United States, 652 F. Supp. 972, 988 (N.D. Ala. 1986); cf. Keller v. Commissioner, 725 F.2d 1173, 1181 (8th Cir. 1984) (applying a variation of the Rev. Rul. 79-229 tripartite test and holding that the prepayment of

intangible drilling and development costs did not serve a valid business purpose because there was no evidence that any business advantage)) such as performance or price guarantee)) was obtained by prepayment). For example, a valid business purpose has been found to exist for a prepayment of feed if the prepayment fixes maximum prices for feed, secures an assured feed supply, or secures preferential treatment in anticipation of a feed shortage. Crisp v. Commissioner, 58 T.C.M. (CCH) 1011 (1989); Packard v. Commissioner, 85 T.C. 397, 429 (1985). Because Gragg has not met his burden of showing that the feed prepayment accomplished a "substantial business purpose," Gragg cannot satisfy the tripartite test of Revenue Ruling 79-229; accordingly, we hold that he has not proven entitlement to the deduction.

As noted above, Gragg bears the burden of showing that he was entitled to deduct the prepaid feed expenses for 1986 and 1987. INDOPCO, 112 S. Ct. at 1043. Gragg offers three justifications for the massive 1986 and 1987 purchases: (i) that he needed to assure an adequate supply of feed at the lowest possible price, (ii) that he intended to use the feed as back-up in case of flooding of his lowlands, and (iii) that he anticipated future cattle purchases which would consume the grain. Although the federal courts have previously held that there is a business purpose in purchasing large quantities of grain in the winter months, after harvest when it is more plentiful, to "lock in" a price or to guarantee supply,[6]

[6] See, e.g., Frysinger v. Commissioner, 645 F.2d 523, 527 (5th Cir. Unit B. May 1981) (observing that the tax court had made unchallenged finding that (continued...)

the size of the transactions at issue belies any claim that the feed was purchased for supplemental or alternative feeding. Thus, the dispositive issue is whether Gragg has met his Celotex burden of demonstrating that the enormous feed purchases served a "substantial business purpose" in permitting him to speculate upon expanding his herds. Gragg's expert witnesses testified that the feed could have been consumed on a feedlot by approximately 30,000 cattle per year and that it is an ordinary business occurrence for cattlemen of lesser means than Gragg to purchase as many as 30,000 cattle in a year. Further, they opined that it is an ordinary practice for cattlemen who own a large number of cattle or who anticipate purchasing a large number of cattle to make large purchases of grain in anticipation of feeding those cattle, particularly when grain prices are low and cattlemen can anticipate a rise in prices.

We find that the summary judgment evidence is simply insufficient in this regard. The sum total of Gragg's evidence is (i) a statement, in response to a leading question by his attorney, that he "always did want to get more [cattle],"[7] (ii) evidence that

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(...continued)
the advance purchase had been made to obtain lowest possible price for feed); Cravens v. Commissioner, 272 F.2d 895, 899 (10th Cir. 1959) (finding business purpose in securing future preferential deliveries of feed when drought endangered supply); Van Raden v. Commissioner, 71 T.C. 1083, 1106 (1979), aff'd, 650 F.2d 1046 (9th Cir. 1981) (concluding that a business purpose existed where taxpayer sought to buy majority of feed during winter months as feed prices had been historically lower at that time of year).

[7] The following constitutes the entire dialogue on this issue in Gragg's deposition:

Gragg's attorney: I'd ask you whether or not in the period from '83 to '87 you had under constant consideration the possibility of acquiring a

(continued...)

Gragg had the financial means to purchase enough cattle to consume the feed, and (iii) evidence that Gragg had negotiated for the delivery of the feed to feedlots near his ranches. Not surprisingly, the parties have a considerable dispute over the amount of cattle necessary to consume the quantities of grain Gragg purchased. Gragg's expert's estimate of 30,000[8])) the most conservative one offered)) represents a significant increase in Gragg's herd, which consisted of approximately 4,500 to 5,000 head at the relevant time.[9] If Gragg had affirmatively stated that he truly intended to purchase the cattle or other circumstances evidenced that he definitively planned to do so, we might well have found a fact issue as to Gragg's intention. Conspicuously absent from Gragg's testimony, however, is any specific design to pursue such an enormous purchase of livestock in a limited period of time (due to the perishable nature of the grain) other than the vague response that he "always did want to get more [cattle]."

(...continued)

significantly greater amount of cattle to add to your herd.

Gragg: I did and I always did want to get more, you know. And as long as I was well and could see about them, I went in that direction.

[8] Specifically, Gragg's expert, Schwertner, averred that approximately 12,000 head of cattle maintained on feedlots at all times throughout the year could consume the feed in one year's time. In the same report, Schwertner also opined that it would take 30,000 head to consume the grain purchased in December 1986 and December 1987. According to Gragg, because cattle typically spend 90 to 150 days on the feedlot, and in light of the fact that there are 2-1/2 to 3 cycles per year of cattle on the feedlot, the maintenance of 12,000 cattle at all times on the feedlot would require the purchase of approximately 30,000 cattle.

[9] We recognize, of course, that the maintenance of a herd of 4,500 to 5,000 cattle during a year actually translates into more cattle sold during the year, considering the fact that cattle are sold in several cycles during a year.

Moreover, the undisputed facts in the record seem to contravene any specific and definite intent to purchase cattle sufficient to exhaust the feed supply. For example, the grain was habitually resold in January within a few weeks after its purchase, and it is hardly conceivable that Gragg would prepare each year for a multi-fold increase in the size of his herd, and then change his mind within a few weeks. Without any evidence of a specific and definite intent to purchase the quantity of cattle in the time period necessary to consume the massive amounts of feed, Gragg could not have convinced a reasonable jury that he had a substantial business purpose for this pattern of buying and selling. Accordingly, we hold that Gragg has failed as a matter of law to carry his summary judgment burden of showing entitlement to a prepaid feed deduction on the facts presented here because he could not have had a reasonable expectation of receiving some business benefit as a result of the prepayments without the requisite intent to purchase numerous, additional cattle.

C. The Negligence Penalty

Gragg contends that even if the trial court correctly denied the refund on the deductions at issue, it should not have imposed a penalty for negligence. Under 26 U.S.C. § 6653(a)(1), a penalty may be added to a taxpayer's liability when any part of underpayment is a result of negligence or intentional disregard of rules and regulations. For purposes of § 6653(a), negligence is defined as a lack of due care or failure to do what a reasonable and ordinarily prudent person would do under the circumstances.

Marcello v. Commissioner, 380 F.2d 499, 506 (5th Cir. 1967), cert. denied, 389 U.S. 1044 (1968). The IRS' determination is presumptively correct, and the taxpayer bears the burden of establishing that the addition to tax under § 6653(a) is erroneous. Sandvall v. Commissioner, 898 F.2d 455, 459 (5th Cir. 1990). The IRS imposed negligence penalties upon Gragg of $356,133 for 1986, and $12,877 for 1987.

When a taxpayer reasonably and in good faith relies upon the opinion of a tax expert, he has done all that ordinary business care and prudence demand. United States v. Boyle, 469 U.S. 241, 251 (1985). "However, to escape the penalty on this ground taxpayers must be able to show that the [expert] reached his decisions independently after being fully apprised of the circumstances of the transaction." Leonhart v. Commissioner, 414 F.2d 749, 750 (4th Cir. 1969). Gragg contends that he acted with reasonable care in taking the deductions and that he relied upon the advice of his tax attorney in doing so.

Although the record is not crystalline on the matter, it appears that this tax advice was received long before the 1986 and 1987 transactions at issue. Gragg was audited in 1983 on his 1981 tax return, and the prepaid feed deduction was allowed. According to Gragg, he consulted with Bird about the 1983 audit and was told that "when the IRS checks your income for two or three or four years and allows you to do things, . . . you can pretty well figure that you can proceed in that manner and they will accept it." Although the deposition is less than clear as to when the

conversation with Bird took place, Gragg admitted that he did not consult with Bird about the 1986 and 1987 transactions before he took the deductions for prepaid feed. We cannot find that the taxpayer could have reasonably relied upon tax advice given in the context of the transactions in the early 1980's to justify the 1986 and 1987 prepaid feed deductions of almost three times the size of his 1983 deduction. Moreover, the 1983 and 1984 purchases approximated the feed expenses actually deducted by Gragg, whereas the 1986 and 1987 purchases were grossly disproportionate to the feed expenses deducted.

Even more telling is the undisputed fact that Gragg's own son and his bookkeeper, Robert Ray Tubbs (Tubbs), alerted him that the size of the transaction)) which is the salient fact that was **not** before Gragg's attorney at the time the prior advice was allegedly given)) might cause a problem. See, e.g., Wicker v. Commissioner, 55 T.C.M. (CCH) 893, 895 (1988) (holding that where lawyer advised taxpayer to obtain independent advice from an accountant, taxpayer was on notice that he could not reasonably rely upon advice of CPA referred to him by salesman of the investment product). The district court correctly recognized that neither Gragg's son nor his bookkeeper was a tax advisor, but their warnings do suggest that a reasonable person would be on notice of the changes in circumstance which would render it unreasonable to rely upon Bird's prior advice. In short, we fail to see how it would be reasonable to rely upon advice rendered by an attorney who did not have all of the relevant facts, including the size of the transactions and the

relationship they bore to the amount of feed expenses deducted. E.g., Bilyeu v. Commissioner, 55 T.C.M. (CCH) 836, 838 n.7 (1988) ("Reliance on the advice of an expert is not a defense to section 6653(a) if that expert is not supplied with all the pertinent facts by the taxpayer."); see also Fielding v. Commissioner, 64 T.C.M. (CCH) 796, 801-802 (1992) (holding that it was not reasonable for investor to rely upon advice of accountant regarding oil and gas investment where accountant had reviewed only placement memorandum). We conclude that these combined factors served to put a reasonable taxpayer on notice that he could not rely upon the tax advice previously given to justify the 1986 and 1987 deductions and thus that Gragg has failed to show reasonable reliance upon the advice of a tax expert. See Boyle, 469 U.S. at 251 (holding that reasonable and good faith reliance upon the advice of an accountant or attorney may be sufficient to avoid the addition of tax for negligence). Accordingly, we find no error in the district court's grant of summary judgment in favor of the government on this issue.[10]

[10] Gragg also contends generally that the district court made improper credibility determinations in granting the IRS' motion for summary judgment. However, taking the evidence proffered by Gragg at face value, he has failed one of the three prongs of the test for entitlement to the deduction under § 162(a) and Revenue Ruling 79-229 and has failed to show reasonable reliance upon a tax expert as a matter of law. No weighing of evidence or comparison of credibility is necessary to reject his claims.

III. Conclusion

For the foregoing reasons, we AFFIRM the district court's summary judgment in favor of the government.