Handling Expenses of Crops with Pre-Productive Periods - The Uniform Capitalization Rules

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Overview

In the Midwest and the Great Plains, we often think of crop production involving the production a crop within a calendar year. From a tax standpoint, that means that the deductions for producing the crop and the income from the crop generally offset in the same tax year (assuming the farmer is on the cash basis of accounting and utilizes a calendar tax year). Of course, expenses can be pre-paid and income deferred, but there is generally an offset. But the singular year comprising the planting and harvesting of a crop is not the case with fruit and vegetable crops. Producers of those crops have a significant time-lag between planting and harvest in marketable quantities.

The tax Code allows farmers that have a long-term crop (which includes a fruit, nut or other crop-bearing tree; ornamental tree; vine; bush; sod; or any other crops or yield of a plant that will have more than one crop or yield) to use a special rule for handling crop production expenses. *I.R.C. §263A.* These rules, known as the "uniform capitalization rules" apply to taxpayers that have a long-term crop with *more than a two-year pre-productive period.* The rules operate to bar deductions for the costs associated with the crop during the pre-productive period. Instead, the taxpayer must add the associated costs to their tax basis in the crop, or the costs must be included in inventory costs. They cannot be claimed as a current deduction.

Note. Production costs can include everything from direct labor and material costs to indirect rents, taxes and other costs. For plants, pre-productive period costs include the costs of items such as irrigation, pruning, frost protection, spraying and harvesting.

Background

Farmers that are not required to use the accrual method of accounting could elect to not have the I.R.C. §263A rules apply with respect to pre-productive period costs. If an election out is made, the plants are treated as I.R.C. §1245 property and the gains rom selling the plants are I.R.C. §1245 gains to the extent of any expenses that would have been required to be capitalized under I.R.C. §263A as if the election had not been made. In addition, alternative depreciation (ADS) then had to be used on all farm property and bonus depreciation was not available (but, expense method depreciation could still be utilized). Under a law passed in 2015, an election was provided to allow bonus depreciation for certain "specified" plants equal to 50 percent of their cost (for 2016) that were planted or grafted after 2015. Eligible plants were trees or vines that produce nuts or fruits and any other plant with a more than two-year pre-productive period.

What is the Pre-Productive Period?

For plants, the pre-productive period begins when the seed is planted, or the plant is first acquired by the taxpayer. The pre-productive period ends when the plant is ready to be produced in marketable quantities or when the plant can reasonably be expected to be sold or otherwise disposed of. The pre-productive period, however, is determined not in light of the taxpayer's personal experience but in light of the weighted average pre-productive period determined on a nationwide basis.

Crops with a Pre-Productive Period Exceeding Two Years

In *Notice 2000-45, I.R.B. 2000-36,* the IRS provided a list of plants that are grown in commercial quantities in the U.S. having a nationwide weighted average pre-productive period in excess of two years. Blackberries, raspberries and papaya plants were on the original list, but were removed in 2013. The current list is as follows:

Almonds	Coffee beans	Kumquats	Oranges	Pomegranates
Apples	Currants	Lemons		Prunes
Apricots	Dates	Limes	Peaches	
Avocados	Figs	Mac. Nuts	Pears	Tangelos
	Grapefruit	Mangoes	Pecans	Tangerines
Blueberries	Grapes	Nectarines	Persimmons	Tangors
Cherries	Guavas	Olives	Pistachio Nuts	Walnuts
Chestnuts	Kiwifruit	Plums		

Application to Grapes

The uniform capitalization rule is particularly problematic for grape growers. If the rule requires that all of the expenses associated with growing grapes be capitalized until the time the wine is sold, that would be a really tough rule for wineries because the wine-making process can take many years. The IRS treats grape growing and winery functions as separate businesses, even though:

1. the grapes are never subject to sale or other disposition as those terms are used in tax law; and
2. the taxpayer does not operate their business as two separate and distinct businesses. *C.A. 200713023 (Nov. 20, 2006).*

In conjunction with that reasoning, the IRS view is that the actual pre-productive period of a grape crop ends no later than the onset of the crushing of the grapes. *Id.* As for the costs incurred between the harvest of the grapes and blossoming of a later crop, IRS requires that a taxpayer must capitalize the direct costs and an allocable portion of the indirect costs of producing the vine. *Treas. Reg. §1.263A-1(e).* Preparatory costs of the vine and the pre-productive period costs of the vine that are incurred during the actual pre-productive period of the vine must be capitalized. The actual pre-productive period of the vine ends when the vine first becomes productive in marketable quantities. After the end of the actual pre-productive period, pre-productive period costs are generally capitalized to a crop during the pre-productive period o the crop and are deducted as a cost of maintaining the vine when incurred between the end of the actual pre-productive period of one crop and the beginning of the actual pre-productive period of the subsequent crop.

Note: Direct and indirect costs include administration costs, depreciation and repairs on farm buildings and farm overhead. *Id.*

Exception for "Field Costs"

A special exception for "field costs" such as irrigating, fertilizing, spraying, and pruning applies to the period between harvesting and the sale of the crop. *Treas. Reg. §1.263A-4(b)(2)(i)(C) (2)(i).* These costs are not required to be capitalized because they do not benefit, and are unrelated to, the harvested crop. They merely maintain and improve the health of the vines, but they do not provide any benefits to the crop which

has already been severed from the vines. This field crop exception, however, ends when the pre-productive period of the crop ends, which is the onset of the crush. Thus, pre-productive period costs incurred between the end of the pre-productive period and the blossoming of the later crop are generally deductible as the cost of maintaining the vine.

The bottom line, therefore, is that costs incurred between the harvest of the crop and the end of the pre-productive period must be capitalized unless they are "field costs" that provide no benefit to the already severed crop. When there is a marketable harvest, the total capitalized costs are depreciated on a straight-line basis over 10 years (for orchards and vineyards). Expense method depreciation or bonus depreciation is also available.

TCJA

Under the Tax Cuts and Jobs Act (TCJA), 100 percent bonus depreciation is available through 2022. In addition, farmers with gross receipts of $25 million or less ($27 million for 2022) can expense all of the direct and indirect costs associated with plantings - including the costs of the plants. This means that the requirement of using I.R.C. §263A is eliminated for these farmers. For those farmers that made the election to expense direct and indirect costs of production, but not have bonus depreciation available, it is not known whether an election can be made to come back into the system. If such an election can be made and the taxpayer' gross revenue is less than the applicable threshold, all costs can be deducted currently under the 100 percent bonus provision. If an election cannot be made, costs must be expensed but bonus is not available on all farm assets. This will be the case even if the taxpayer had not planted any orchards or vineyards for several years.

This raised a question. What if a farmer elected under I.R.C. §263A(d)(3) to expense the direct and indirect costs of production, thereby becoming unable to claim bonus depreciation and being required to use ADS? Many farmers with vineyards and orchards did this to be able to deduct costs as incurred. It was in irrevocable election, but the TCJA raised a question as to whether they could elect to come back into the system. The problem was that these farmers had no way to revoke the election and utilize the TCJA provision eliminated the uniform capitalization rules for a qualified "small business" other than to request (at great expense) an IRS Private Letter Ruling.

Example:

Raymond and Verda, a farm couple, planted an orchard in 2012. Their gross revenues are less than the threshold for utilizing cash accounting. They elected to expense all costs of the orchard. That had the effect of barring them from claiming bonus depreciation on *any* farm assets. In 2018, they bought $1,500,000 of farm equipment. If they cannot elect back into the prior system, they won't be able to claim any bonus depreciation on the new farm equipment and can only take expense method depreciation. If they can elect back into the old rules, that then entire $1,500,000 of farm equipment purchased in 2018 will qualify for bonus depreciation.

In the spring of 2020, the IRS provided a mechanism for taxpayers that had elected out of I.R.C. §263A under prior law to revoke the election. *Rev. Proc. 2020-13, 2020-11 I.R.B.* Under the election, a taxpayer with average annual gross receipts of $25 million or less (adjusted for inflation) over the prior three years (through 2025) are excluded from I.R.C. §263A. For tax years beginning after 2018, the revocation election is to be made on the taxpayer's original return, including extensions, for the tax year for which the taxpayer wants to revoke the election. The election is accomplished by not capitalizing the costs of plants; changing depreciation to GDS unless the property at issue is otherwise required to use ADS (e.g., bonus depreciation is not allowed); and continuing to treat plants that are or have been treated as I.R.C. §1245 property for prior tax years as I.R.C. §1245 property.

Conclusion

For farmers with a crop that has more than a two-year pre-productive period, the tax rules for handling the associated expenses can be confusing.

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