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Selected Tax Issues Arising During the Development Stage of Orchards, Groves, and Vineyards

by

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I. INTRODUCTION

The typical fruit or nut orchard, grove, or vineyard has a "preproductive period" which extends over several years from the time of original planting until yields in commercial quantities are produced. The costs incurred in bringing the crops to this productive state might be considered to be part of the acquisition costs of a *producing* orchard or vineyard and therefore have to be capitalized. Outside the farm industry, costs of constructing or acquiring capital assets are in fact generally capitalized as part of the cost basis of those assets.[1]

However, administrative policy for over sixty-five years has permitted farmers, including fruit and nut growers, to deduct many preproductive period expenditures which, in other industries, would have to be capitalized. Fruit and nut growers have particularly benefitted from this policy because the expenditures necessary to develop an orchard, grove, or vineyard to productivity over several years may be quite substantial.

On the other hand, the availability of these deductions at a time when the crops to which they relate are not yet income producing has proved attractive in recent years to high-bracket taxpayers wanting current deductions to offset nonfarm income. The result has sometimes been that these

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1. *See* I.R.C. § 263 (1982); *see also* Commissioner v. Idaho Power Co., 418 U.S. 1 (1974).

"tax-shelter" investments have threatened to drive up land prices in certain areas and to drive down product prices through overproduction.

As a consequence, Congress has responded with progressive tightenings of formerly liberal rules with respect to preproductive expenses, and these changes have had substantial application to the fruit- and nut-growing industry. To those fruit or nut growers affected by the changes, the result has been, to a large extent, to put the development process during the preproductive stage on a tax footing similar to that of nonagricultural industries.

Once the productive stage is reached, most fruit or nut trees or vines will continue to bear in commercial quantities for several years, even decades. Because of the relative permanency of these kinds of crops, they have generally been considered depreciable assets similar to income-producing assets in other industries. Because of the long productive lives of most of these crops, the typical useful lives for depreciation purposes were usually quite long, resembling those of depreciable buildings in other activities. Unlike most buildings, however, trees and vines have qualified for the investment tax credit.

At the time of the enactment of the Economic Recovery Tax Act of 1981 (ERTA), the trend in recent tax law changes relating to fruit or nut growers had been, as previously mentioned, to curtail some of the liberal preproductive-period deduction rules traditionally available to the agricultural industry. ERTA, on the other hand, introduced the Accelerated Cost Recovery System which, although not being targeted toward agriculture specifically, benefitted agriculture perhaps as much as any other industry. Moreover, fruit and nut growers may have received a greater benefit than the agricultural industry as a whole. Although subsequent legislation, including the Tax Reform Act of 1984, has nibbled away at some of these benefits, most have remained substantially intact.

The fruit- and nut-growing industry has served as somewhat of a microcosm in which tax policy has often veered erratically, at one point providing benefits not available to

those in other industries, and at other points more restrictive to prevent abuses resulting from the attraction of those seeking the unique tax benefits. Recently, orchards, groves, and vineyards have moved back again to a generally more favorable tax status resulting, apparently, not by specific Congressional design.

This article will explore selected tax issues which arise during the development process of fruit and nut orchards, groves, and vineyards. The focus will be on issues arising from initial planting by the fruit or nut growers of seeds or seedlings through the year in which the income-producing stage of the orchard, grove, or vineyard is reached and the investment tax credit and recovery allowances are claimed, if available.

II. TRADITIONAL ADMINISTRATIVE POLICY WITH RESPECT TO PREPRODUCTIVE PERIOD EXPENDITURES

The regulations at section 1.162-12(a) provide that "[a]mounts expended in the development of farms, orchards, and ranches prior to the time when the productive state is reached may, at the election of the taxpayer, be regarded as investments of capital." Substantially identical language first appeared in regulations promulgated under the Revenue Act of 1918.[2]

Since the quoted language provides an option to capitalize certain preproductive period expenditures, the necessary implication is that a farmer also has the option to *deduct* these same expenditures rather than capitalize them. The option to capitalize otherwise deductible expenditures exists only during the preproductive stage.[3]

The regulations do not say precisely what preproductive period expenditures are subject to the option to capitalize and are thus subject by implication to the option to deduct.

2. *See* Article 110, Regulations 45, T.D. 2831 (April 17, 1919); *see also* Wilbur v. Commissioner, 43 T.C. 322, 324 (1964) for a short history of the provision.

3. Treas. Reg. § 1.162-12(a) (1972); *see* Estate of Wilbur v. Commissioner, 43 T.C. 322, 327 (1964); Whitman v. United States, 248 F. Supp. 845, 852 (W.D. La. 1965); I.R.S. Pub. No. 225, FARMER'S TAX GUIDE 15 (1983).

Controversies have usually involved attempts by taxpayers to deduct specific preproductive period expenditures which the Internal Revenue Service (IRS) claims are purely capital in nature and must be capitalized.

A 1919 Solicitor's Law Opinion,[4] in holding orchard trees depreciable, indicated that "all expenditures necessary to bring orchard trees to a producing state should be capitalized and that thereafter a fair and reasonable annual allowance for depreciation should be permitted. . . ." This language seems to suggest that all preproductive period expenditures incurred with respect to orchards (and by analogy, groves and vineyards) are capital in nature and not subject to the option to deduct. This language was next cited by the IRS over 45 years later in Revenue Ruling 65-104[5] dealing with whether citrus trees were "new" or "used section 38 property" for purposes of the investment tax credit. The IRS then quickly "clarified" the ruling to remove any implication that *all* expenditures incurred in the preproductive state with respect to such trees must be capitalized.[6]

It is clear, however, that fruit and nut growers in the 45-year interim did not assume that all their preproductive period expenditures had to be capitalized. In fact, many farmers interpreted the provision in the regulations giving them the option to capitalize certain preproductive period expenditures as also giving them the option to deduct otherwise capital expenditures. A 1923 ruling, I.T. 1610, contributed to, or created, this confusion by stating, without elaboration, that "[i]t is held that under this article the taxpayer has the option of charging such amounts as expense or capitalizing them."[7]

The Board of Tax Appeals in 1934, without mentioning I.T. 1610, specifically rejected the contention that the provision in the regulations gave taxpayers the option to deduct

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4. Op. No. 797, 1 C.B. 130 (1919), *declared obsolete* Rev. Rul. 67-123, 1967-1 C.B. 383.

5. 1965-1 C.B. 28.

6. Rev. Rul. 66-183, 1966-2 C.B. 47.

7. I.T. 1610, II-1 C.B. 85 (1923).

otherwise capital expenditures.[8] However, many taxpayers continued to rely on I.T. 1610 as authority for the deductibility of preproductive period capital expenditures.

The IRS finally issued Mimeograph 6030[9] which revoked I.T. 1610. In this later ruling, the Service made clear its position that the option to deduct or capitalize expenditures applied only to otherwise currently deductible expenses. The Service's interpretation was upheld by the Tax Court.[10]

III. PREPARATORY VERSUS DEVELOPMENTAL EXPENDITURES

Saying that the option to capitalize (and thus the option to deduct) applies only to otherwise deductible preproductive period expenditures leaves open the question of which such expenditures are "otherwise deductible." Consequently, Mimeograph 6030 attempted to give guidance as to which expenses were otherwise currently deductible and thus subject to the option to capitalize. It implied that expenses could be classified into one of three groups: (1) preparatory; (2) development period; or (3) productive period. Under this view, the preproductive period appeared to consist of two distinct stages, the preparatory and the developmental. Preparatory expenses were capital in nature and not subject to the option to deduct. Expenses incurred during the developmental period which were otherwise of a nature to be currently deducted were subject to the option to deduct or capitalize. Deductible expenses incurred during the productive period were no longer subject to the option to capitalize.

This view that there were three distinct chronological stages in a farm or ranch life cycle was more clearly pronounced in the Farmer's Tax Guide. The publication at one time included the following language: "The three definite periods in the life of a farm, ranch, orchard, or grove are

8. August A. Rubel, 3 B.T.A.M. (P-H) ¶ 34,108 (1934).

9. 1946-2 C.B. 45; *see also* Mim. 6030 (Supp. 1), 1948-1 C.B. 42.

10. Thompson & Folger Co. v. Commissioner, 17 T.C. 722, 726-728 (1951); McBride v. Commissioner, 23 T.C. 901, 908-910 (1955), *acq.* 1955-2 C.B. 7.

(1) preparatory, (2) development, and (3) productive."[11] Preparatory period expenditures, except for taxes, interest, and carrying charges, were required to be capitalized.[12]

Under this analysis, the first crucial determination was whether a particular expenditure was incurred in the preparatory or developmental period. If the former, they had to be capitalized. If the latter, they could either be deducted or capitalized if they were otherwise deductible as ordinary and necessary business expenses.

Mimeograph 6030 gave examples of preparatory and developmental expenditures which are very similar to those still listed in current Farmer's Tax Guides.[13] The ruling indicated that preparatory expenditures, which must be capitalized, include:

> the cost of clearing brush, trees, and stumps; leveling and conditioning land; the costs of trees and the planting of trees; drilling and equipping wells; building irrigation canals and ditches; laying irrigation pipes; installing drain tile or ditches to prevent erosion; straightening creek beds to correct erosion; constructing earthen, masonry, or concrete tanks, reservoirs, dams, or ditches; building roads; and the cost of physical equipment having a life in excess of one year.[14]

However, it should be noted that the subsequent enactment of sections 175 and 182 make it possible for some of these expenditures to be deducted as soil and water conservation or land-clearing expenditures.[15]

Developmental expenditures which are deductible and

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11. *See, e.g.*, I.R.S. Pub. No. 225, FARMER'S TAX GUIDE 29-30 (1961), quoted in Whitman v. United States, 248 F. Supp. 845, 851-852, n.11 (W.D. La. 1965).

12. *Id.*

13. *See, e.g.*, I.R.S. Pub. No. 225, FARMER'S TAX GUIDE 15 (1983).

14. Mim. 6030, 1946-2 C.B. 45, 46.

15. Section 175 provides that a taxpayer "engaged in the business of farming" may deduct otherwise capital expenditures incurred with respect to "land used in farming" for the purpose of soil or water conservation or for the prevention of erosion. Covered expenditures may include those for leveling, grading, terracing, and contour furrowing; the construction, control, and protection of diversion channels, drainage ditches, earthen dams, watercourses, outlets, and ponds; the eradication of brush, and the planting of windbreaks. I.R.C. § 175(c)(1) (1982). The provision is elective for the first year in which covered expenditures are incurred. I.R.C. § 175(d)(1) (1982). The maximum deduction under section 175 for a given taxable

thus subject to the option to capitalize were said to include ordinary and necessary expenses such as those for the upkeep of a grove or orchard, taxes, water for irrigation purposes, and cultivating and spraying of trees.[16]

Most of the cases and rulings which have wrestled with the distinction between preparatory and developmental expenditures have involved expenses incurred in connection with development of fruit or nut orchards and groves. This probably resulted from the long preproductive periods typical of those crops as well as from the difficulty of attempting to impose a strict time continuum or chronological tax analysis onto the often peculiar development process of many fruit and nut crops.

In *Estate of Wilbur*[17] the Tax Court considered the deductibility of so-called "cultural practices" expenditures incurred with respect to various fruit and nut trees during some of the several years after planting in permanent orchards but before the trees had reached a producing stage. These cultural practices included irrigation, pruning, fertilizing, cultivating, spraying, and other care.

The taxpayer deducted some of the expenditures but subsequently filed amended returns claiming they were all deductible. The IRS denied the refund on the grounds that the taxpayer had elected to capitalize those expenditures not deducted. The taxpayer then challenged the validity of the provision in the regulations giving an option to capitalize otherwise deductible expenditures. The court noted that these expenditures would clearly be deductible after the trees reached a producing stage, but that deductibility was less

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year cannot exceed 25% of the taxpayer's "gross income derived from farming" during that year. I.R.C. § 175(b) (1982).

Section 182 permits a taxpayer "engaged in the business of farming" to deduct otherwise capital expenditures for clearing land to make it "suitable for use in farming." The maximum deduction for a given taxable year cannot exceed the lesser of 25% of the taxpayer's "taxable income derived from farming" for that year or $5,000. I.R.C. § 182(b) (1982). Covered land-clearing expenditures may include those for the eradication of trees, stumps, and brush, the treatment or moving of earth, and the diversion of streams and watercourses. I.R.C. § 182(c)(1) (1982). The provision is elective on a year-by-year basis. I.R.C. § 182(e) (1982).

16. Mim. 6030, *supra* note 14, at 46.

17. 43 T.C. 322 (1964).

clear before the productive stage was reached: "The expenditures prior to that time may be considered in every real sense as part of and directly related to the cost of acquiring a producing orchard, and as such have the characteristics of capital outlays."[18]

The court compared these expenditures to that of putting a coat of paint on a building. The court noted that if an existing building is painted, the cost is generally deductible, whereas if the building is painted in the course of its construction, the cost of painting is part of the total cost of the building and is a capital expenditure:

> It is thus apparent that expenditures which upon superficial analysis may appear to be merely business expenses actually have strong characteristics of both capital outlays and business expenditures. It is not a choice between black or white. Rather these expenditures fall in a band of gray between black and white and we think that the regulations giving the farmer an election to treat such expenditures either way was well within the authority of the Secretary of the Treasury under the statute.[19]

A 1967 ruling declared Mimeograph 6030 and a number of other rulings obsolete and no longer determinative as to future transactions.[20] The Farmer's Tax Guide was also changed to remove the discussion which had tended to divide the farm or ranch cycle into three distinct chronological stages.[21] The Service appeared to be shifting its focus from the chronological period in which the expenditure was incurred to an analysis of the nature of the preproductive period expenditure itself. However, the Service continued to argue the preparatory/developmental period analysis in cases concerning tax years prior to 1967 during which Mimeograph 6030 was still in force.

The most complete discussion of the distinction between preparatory and developmental expenses incurred in the preproductive period may be found in a 1971 Tax Court

18. *Id.* at 327.

19. *Id.* at 328.

20. Rev. Rul. 67-123, 1967-1 C.B. 383, 386.

21. *See* I.R.S. Pub. No. 225, FARMER'S TAX GUIDE 29-30 (1968).

case, *Robert L. Maple*,[22] which involved the 1961 tax year. A partnership had entered into an agreement with a nursery to purchase citrus seedlings. The nursery agreed to maintain, cultivate, and bud the seedlings at a specified price per tree until they were ready to be transplanted to a permanent orchard on partnership property. Under the agreement, all risk of loss for factors beyond the nursery's control was immediately placed on the partnership.

At the time the nursery sold the seedlings to the partnership they were about two years old and required approximately one year of additional care before transplanting. Prior to transplanting to a permanent orchard, the trees were budded. This involved grafting a bud from an orange tree capable of bearing edible fruit onto the citrus seedling. A seedling would never develop into a tree capable of producing edible oranges unless budded in this manner.

The partnership deducted the amounts paid to the nursery for the care and maintenance of the seedlings prior to their transplanting. This included the same type of "cultural practices" expenditures at issue in *Wilbur*, including irrigation, cultivation, pruning, fertilizer, spraying, etc.

The Commissioner disallowed these deductions on the grounds that all costs of raising the seedlings to the point where they could be transplanted into a permanent orchard were preparatory. The Tax Court held the expenditures to be deductible. The court said that section 1.162-12(a) of the regulations gives farmers an option to deduct "those expenses, which, if incurred while an orchard was in a productive state, would be deductible."[23] Referring to *Wilbur* the court noted that:

> We pointed out that the Treasury Department has recognized that such expenses as these, prior to production, are in the gray area between purely capital expenditures and expenses readily identifiable as a charge against current income. The activities envisaged by the regulations are those which are usually considered to generate current expenses because the amounts expended merely rep-

22. 27 T.C.M. (CCH) 944 (1968), *aff'd*, 440 F.2d 1055 (9th Cir. 1971).
23. 27 T.C.M. (CCH) at 949.

> resent current maintenance of an existing asset and are thus within the category of those expenses generally considered deductible. From another point of view, those expenses are part of the cost of acquiring a producing orchard and because they are a part of that cost, would be in that category of expenses which must be capitalized. Consequently, because of the dual nature of such expenditures, the taxpayer has been given the option to elect the treatment most advantageous to himself. Unless the expenditure is clearly of deductible expense character or falls within the gray area between capital expenditures and deductible expenses, there is no option.[24]

The court compared the costs of caring for and maintaining the seedlings until transplanting into permanent orchards to the costs of feeding livestock to maturity, which are expressly deductible under section 1.162-12(a) of the regulations, and to the costs of shearing and pruning incurred in raising timber, which have been held to be deductible.[25] The court then offered the following guidelines for distinguishing preparatory and developmental expenditures:

> As the above examples show, the term 'preparatory expenditures' has little to do with the uniqueness of an operation performed on a crop or with the value which an operation adds to it. In its historical context, the term 'preparatory expenditures' refers to those expenditures incurred prior to raising agricultural commodities. A 'preparatory expenditure' is incurred so that a farmer may begin the growing process. A 'developmental expenditure' is incurred by the grower so that the growing process may continue in a desired manner.[26]

The Tax Court's decision in *Maple* was affirmed by the Ninth Circuit.[27] The appellate decision made clear the view that a standard analysis of the distinction between capital and currently deductible expenditures would not always suffice with respect to agricultural expenditures:

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24. *Id.*
25. *Id.* at 950.
26. *Id.* at 951.
27. 440 F.2d 1055 (9th Cir. 1971).

> The Commissioner suggests that if a man wishes to produce shoes, he can buy a shoe factory or he can build one. The cost of getting ready to begin the manufacture of shoes, however, must be capitalized whether that cost is embodied in the expense of building a factory or in the price paid for one that is already built. The Commissioner is right about shoemakers. But shoemakers and farmers are not treated in parallel ways by the code and by the regulations. The costs of developing orchards, farms, or ranches, even prior to the time when they are productive, may often be deducted rather than capitalized, even though analogous costs in other industries would have to be capitalized. (*See* Income Tax Regulations § 1.162-12; Estate of Richard R. Wilbur (1964) 43 T.C. 322.) In the field of agriculture the manner in which the expense was incurred will often determine whether it is a capital expenditure or a business expense. If a dairy farmer buys his cows fully mature, he must capitalize their purchase price; if he buys them as calves, he may deduct the cost of raising them to maturity, even though that expense is as much a cost of obtaining an income-producing business as is the purchase of the mature cows. We must analyze the precise path the taxpayer-farmer actually took and we must ask whether the expense in question was purely capital in nature or fell within what the Tax Court has termed the 'band of grey' between capital and business expenses that exists only in agriculture. (Estate of Richard R. Wilbur, *supra* at 328). The band of grey exists because many of the costs of running a producing farm are identical to the costs of creating a producing farm. . . . Expenses of maintaining agricultural items in the preproductive state are deductible if they are sufficiently similar to the expenses that will be required to maintain them once they are productive.[28]

In *Ashworth v. United States*[29] a federal district court rejected the Tax Court's *Maple* decision before the latter had been affirmed on appeal. *Ashworth* involved facts similar to

28. *Id.* at 1056-1057.

29. 28 A.F.T.R.2d (P-H) 71-5976, 71-2 U.S. Tax Cas. (CCH) ¶ 9710 (S.D. Ill. 1971).

those in *Maple*, concerning expenditures for the care of citrus seedlings during 1962 and 1963:

> The court disagrees with the result of the Maple case on the basis that the costs of the tree which must be capitalized includes the cost of raising a seedling to the point where it can be transplanted to the orchard. Only at this point is the tree commercially recognized as a viable orange tree. In making its determination as to when a taxpayer has begun the growing process, the court failed to recognize the distinction between the fruit and the tree. The question is not whether the costs were incurred in order to begin growing orange trees, but whether the costs were incurred in order to begin growing oranges. When the determination is viewed in this manner, the conclusion that the costs of developing a seedling into a transplantable orange tree are preparatory and therefore must be capitalized is clearly consistent with the other farming and timber cases cited by the court. Such costs must therefore be capitalized.[30]

The Tax Court had an opportunity to reconsider its position in *Wagner Mills, Inc. v. Commissioner*.[31] The case again involved expenditures incurred in connection with the care and maintenance by a nursery of citrus tree seedlings purchased by the taxpayer for later transplanting to the taxpayer's orchard. Without discussing *Ashworth*, the Tax Court adhered to its decision in *Maple* that the care and maintenance expenditures could be deducted even before the seedlings became viable as orange trees through budding and transplanting. However, the costs of acquiring the tree seeds, planting the seeds, and grafting the buds onto the seedlings were capital expenditures incurred so that the process of growing orange trees could begin. Although the planting of the seed and the grafting of the bud onto the seedling were separated in time, the court noted that:

> It is a peculiarity of an orange tree that its component parts are planted in two separate operations. We do not believe that the tax treatment of the cost of planting the

30. 28 A.F.T.R.2d (P-H) at 71-5985.

31. 33 T.C.M. (CCH) 1267 (1974), *aff'd without opinion*, 530 F.2d 827 (8th Cir. 1976).

> seed should differ from that of grafting the bud simply because one process was performed before the other.[32]

Maple, *Ashworth*, and *Wagner Mills* all involved taxable years during which the principles of Mimeograph 6030 were in effect. When it was declared obsolete in 1967, it was said not to be determinative for future transactions.[33] The Commissioner's continued insistence in those cases that the preproductive period be further divided into the preparatory and the developmental periods, for purposes of determining which preproductive period expenditures might be deductible, could be seen as merely reflective of the position, now changed, which was in force during the taxable years concerned.

However, after its loss in *Wagner Mills*, the Service proceeded to incorporate its litigation position into Revenue Ruling 75-405.[34] This ruling dealt with a grower of pistachio nuts. The trees were produced by initially planting seeds in small pots, transplanting the young seedlings into larger pots, and eventually transplanting the seedlings at the proper time to permanent orchards. The trees were "budded" after being planted in the permanent orchards by grafting a portion of a producing tree onto the young trees. Commercial variety pistachios would not be produced without this budding process. Relying on *Ashworth*, the ruling held that all expenditures incurred with respect to the growing process through the first budding in the field were preparatory expenditures which must be capitalized since the trees were not commercially viable until that time.[35] The ruling indicated that the Service would not follow *Maple* and *Wagner Mills*.

The Service made its pitch in court again a few years later in another Tax Court case, *Robert J. Vinson*.[36] This case dealt with "cultural practices" expenditures incurred with respect to pecan tree seedlings. The seedlings had been transplanted to the taxpayer's orchard and were allowed to

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32. 33 T.C.M. (CCH) at 1271.

33. Rev. Rul. 67-123, 1967-1 C.B. 383.

34. 1975-2 C.B. 63, *revoked*, Rev. Rul. 83-28, 1983-1 C.B. 47.

35. *Id.* at 64.

36. 38 T.C.M. (CCH) 740 (1979), *aff'd*, 621 F.2d 173 (5th Cir. 1980).

grow there approximately two years prior to budding. The budding determined only the variety of the pecans produced and was not necessary for the trees to produce commercially marketable pecans.

The expenditures at issue were those incurred in caring for and maintaining the seedlings after transplantation in the taxpayer's orchard but before they were budded. The Commissioner again made the argument that all pre-budding expenditures were preparatory and should be capitalized. The Tax Court again rejected this position:

> In making this argument, he attempts to lump together the cultural practices expenditures and budding process and thereby treat them both as preparatory. The difficulty with this approach is that it assumes that the line between preparatory and developmental expenditures is strictly a chronological one and fails to note that we have looked to the nature of the expenditures as well. Thus, from the fact that budding expenditures are preparatory and, therefore, capital in nature, it does not follow that all expenditures that precede budding are capital in nature.[37]

The decision was affirmed by the Fifth Circuit which also specifically rejected a chronological approach:

> The suggested chronological approach would preclude an examination of the crucial factor in this case, the nature of the cultural practices expenditures. Wolfe's cultural practices encompassed services which would be required in the regular care and maintenance of the orchards once they became productive, including spraying, watering, pruning, and irrigating. See *Estate of Wilbur v. Commissioner*, 43 T.C. at 323-24. Expenditures for those services clearly meet the test applied by the Ninth Circuit, which we adopt: "Expenses of maintaining agricultural items in the preproductive state are deductible if they are sufficiently similar to the expenses that will be required to maintain them once they are productive." *Maple v. Commissioner*, 440 F.2d 1055, 1057 (9th Cir. 1971), *aff'g* 27 T.C.M. (CCH) 944 (1968).[38]

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37. 38 T.C.M. (CCH) at 743.

38. 621 F.2d at 175 (5th Cir. 1980).

By this time, the Commissioner's strict chronological approach, at least with respect to the development of fruit and nut trees, had been repeatedly rejected by the Tax Court in decisions which had been affirmed by the Fifth, Eighth, and Ninth Circuits. On its side of the ledger, the Commissioner could cite only the district court decision in *Ashworth*.

Revenue Ruling 83-28[39] bowed to this weight of authority. It involved another producer of pistachio nuts and a growing process like that described in Revenue Ruling 75-405. Revenue Ruling 75-405 was revoked, and the taxpayer was allowed to deduct the costs of transplanting as well as the costs of maintaining the pistachio seedlings both before and after the first budding of the trees in the field. The ruling conceded that these were developmental expenses rather than preparatory expenditures. On the other hand, the costs of initial planting and budding of the trees were said to be preparatory expenditures which must be capitalized.[40] The ruling indicated the Service would follow *Maple*, *Wagner Mills*, and *Vinson*. The ruling was said not to apply to farming syndicates and to taxpayers required to use the accrual method by reason of section 447.

In summary, as things now stand the strict chronological approach urged by the Commissioner for so many years appears to have been firmly rejected by the courts and abandoned by the Service. It no longer appears helpful to view the preproductive period of an orchard, grove, or vineyard in terms of preparatory or developmental periods. Rather, it seems that the analysis of preproductive period expenditures should focus on the nature of the expenditures themselves. As succinctly put by the Ninth Circuit in the *Maple* case, "[e]xpenses of maintaining agricultural items in the preproductive state are deductible if they are sufficiently similar to the expenses that will be required to maintain them once they are productive."[41]

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39. 1983-1 C.B. 47.

40. *Id.* at 48.

41. Maple v. Commissioner, 440 F.2d 1055, 1056-57 (9th Cir. 1971).

IV. WHO CAN DEDUCT PREPRODUCTIVE PERIOD EXPENDITURES?

The preceding discussion focused on *which* preproductive period expenditures were either deductible or subject to the option to capitalize provided in the regulations. It must be noted, however, that the regulation in question is directed toward "farmers" who operate farms for profit.[42] The general issue of when a particular farm activity constitutes an "activity engaged in for profit" has been a matter of frequent litigation, a statutory provision (section 183), and is generally beyond the scope of this article.

However, one aspect of the requirement that a taxpayer be engaged in farming for profit in order to be considered a farmer for purposes of section 1.162-12(a) of the regulations is that the taxpayer bear some risk of loss from the farming operation. This was an issue in several of the orchard cases already discussed because of some of the unusual arrangements whereby taxpayers paid a nursery or some other third party to plant and care for seedlings on the third party's property until such time as the seedlings were ready for transplantation to the taxpayer's grove or orchard.

In *Robert L. Maple*[43] the Tax Court had occasion to consider whether a partnership bore the risk of loss with respect to citrus seedlings while they were being cared for and maintained by a nursery. Under the agreement with the nursery, the partnership bore all risk of loss except for factors under the control of the nursery. The Commissioner contended that, as a practical matter, the partnership bore no risk of loss and thus was not engaged in the business of farming so as to be entitled to deduct any of the expenditures under section 1.162-12(a). The importance of the risk of loss was emphasized by the court: "The major risk in farming is the loss of a crop due to unforeseen circumstances. Without assuming this risk, one cannot be considered in the business of farming nor can his expenditures be

42. Treas. Reg. § 1.162-12(a) (1972).

43. 27 T.C.M. (CCH) 944 (1968), *aff'd*, 440 F.2d 1055 (9th Cir. 1971)

considered farming expenditures."[44] On the basis of the agreement, however, the court concluded that the risk of loss due to such unforeseen circumstances had shifted to the partnership even while the nursery cared for the seedlings. Accordingly, the expenditures for such care and maintenance could be deducted.[45]

Wagner Mills, Inc. v. Commissioner[46] involved a similar arrangement. The Tax Court again found the taxpayers entitled to claim deductions for the maintenance expenditures incurred while the seedlings were under the care of the nursery because title and risk of loss had passed to the taxpayers.[47]

On the other hand, in *Harmston v. Commissioner*[48] the taxpayer purchased newly planted orange groves, but the seller remained in possession and cared for the groves until the trees reached maturity. The court determined that the taxpayer had in effect contracted to purchase mature groves, and all the expenses incurred prior to that time had to be capitalized as part of the cost.

V. MAKING THE ELECTION TO CAPITALIZE PREPRODUCTIVE PERIOD EXPENDITURES

Since the election to capitalize preproductive period expenditures applies only to those expenditures which are otherwise deductible, simply claiming the deductions on the appropriate timely filed tax returns for the years in question is tantamount to an election not to capitalize them. On the other hand, simply failing to claim them in a timely manner constitutes an election to capitalize them.[49] However, taxpayers would probably be well advised to attach a list of expenditures which are to be capitalized in order to avoid

44. 27 T.C.M. (CCH) at 951

45. *Id* at 952.

46. 33 T.C.M. (CCH) 1267 (1974), *aff'd without opinion*, 530 F.2d 827 (8th Cir. 1976).

47. 33 T.C.M. (CCH) at 1270

48. 61 T.C. 216 (1973), *aff'd*, 528 F.2d 55 (9th Cir. 1976).

49. *See* I.R.S. Pub. No. 225, FARMER'S TAX GUIDE 15 (1983).

uncertainty on the later depreciation or disposition of the assets to which the expenditures relate.

A taxpayer can elect in the same year to deduct some expenses while capitalizing others.[50] Once made for a particular year, the election is irrevocable for that year but is not binding as to future years.[51]

The most important single consideration is likely to be whether, by electing to capitalize, the deduction is merely being deferred or is being lost entirely. If the expenses are capitalized as part of the basis of depreciable assets, the deduction is merely being deferred until the productive stage is reached. At that point, the assets would begin to be depreciated.[52]

If the expenses are capitalized as part of the cost or other basis of investment credit property, those capitalized costs would also increase the amount of the investment credit taken when the productive stage is reached and the assets are considered as placed in service.[53] On the other hand, if the capitalized expenses are allocated to the cost of nondepreciable assets such as land, the benefit of the capitalized expenses would be realized only on disposition of the assets.

Assuming the expense will not be added to the basis of a nondepreciable asset if capitalized, a proper determination whether to deduct or capitalize will necessarily involve a comparison, perhaps speculative, of the tax benefits to be derived from claiming the deduction in the current year as opposed to capitalizing the expense and depreciating and possibly claiming a tax credit for it in later years. Even if the orchard, grove, or vineyard produces a net loss after claiming the deductions, the loss can be offset against other income of the taxpayer.[54] Assuming other income is insufficient, a net operating loss can be carried back three

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50. Estate of Wilbur, 43 T.C. 322, 327 (1964), *acq.* 1965-2 C.B. 7.

51. *Id.* at 329-30.

52. *See, e.g.*, Rev. Rul. 80-25, 1980-1 C.B. 65 (capitalized costs of citrus trees).

53. *See, e.g.*, Rev. Rul. 65-104, 1965-1 C.B. 28.

54. Treas. Reg. § 1.165-6(a)(2) (1960).

and carried forward fifteen years.[55]

Another consideration is the nature of the anticipated tax benefit to result. A current deduction may be available to offset ordinary income. On the other hand, an expenditure which is capitalized as part of the basis of the trees, vines, or land may eventually result, on disposition, in the reduction of capital gain only.[56] Assuming a current benefit will result, whether by net operating loss carryback or otherwise, it is probable that only exceptional circumstances would justify capitalizing the expenses as part of the cost of nondepreciable assets.

VI. PREPRODUCTIVE PERIOD EXPENDITURES WHICH MUST BE CAPITALIZED

As previously discussed, longstanding administrative policy has allowed those in the agricultural industry to deduct many preproductive period expenditures which must be capitalized by those in other industries. However, these liberal deduction rules have in some instances led to perceived abuses. Congress has from time to time responded by requiring certain of the preproductive period expenses which would otherwise be deductible under the general administrative policy to be capitalized. Section 278(a) requires that certain expenditures incurred in the development of citrus and almond groves be capitalized. section 278(b) requires "farming syndicates" to capitalize preproductive period expenditures incurred in connection with the development of any fruit or nut grove, orchard, or vineyard. Finally, section 447(b) requires certain farm corporations and partnerships to capitalize preproductive period expenditures incurred in connection with the production of most agricultural products. Outside these statutory developments, the IRS has recently ruled that the costs of certain depreciable equipment used in the development of orchards must be capitalized as part of the cost basis of the trees themselves.

55. I.R.C. § 172(b) (1982).

56. *See* I.R.C. § 1231 (1982).

A. Capitalization of Equipment Depreciation

The Supreme Court held in 1974 in *Commissioner v. Idaho Power Co.*[57] that depreciation on trucks and other transportation equipment used in constructing capital facilities must be capitalized as part of the cost basis of those capital facilities and depreciated over the useful life of those facilities. Although the Service had taken a similar approach in earlier rulings,[58] neither those rulings nor *Idaho Power* were concerned with orchards or vineyards. In fact, Revenue Ruling 80-25[59] had held that the cost of an irrigation system was not subject to the statutory capitalization rule of section 278(a) and could be depreciated when placed in service. *Idaho Power* and the earlier rulings were not mentioned. However, Revenue Ruling 83-67[60] subsequently modified Revenue Ruling 80-25 by holding, on the basis of *Idaho Power*, that depreciation of an irrigation system installed during the preproductive period of a citrus grove must be capitalized as part of the basis of the grove itself.

The position of the IRS, as expressed in Revenue Ruling 83-67, potentially has a very broad application to the orchard and vineyard industry. By the same reasoning, taxpayers could be required to capitalize depreciation of *any* equipment or other depreciable property to the extent allocable to the use of such equipment or property in connection with the development of the orchard, grove, or vineyard before the income-producing stage is reached. For example, depreciation of a tractor and equipment allocable to their use in cultivation of the orchard, grove, or vineyard during the preproductive period would seem subject to the same requirements.

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57. 418 U.S. 1 (1974).

58. *See* Rev. Rul. 55-252, 1955-1 C.B. 319; Rev. Rul. 59-380, 1959-2 C.B. 87.

59. 1980-1 C.B. 65.

60. 1983-1 C.B. 74. It should be noted that the capitalization of the depreciation of the irrigation or similar equipment would not affect the availability of the investment tax credit. It would still be available, if at all, in the year the equipment is placed in service. Treas. Reg. § 1.46-3(d)(4)(i) (1982). If the credit is taken, however, the basis of the trees would *not* include the capitalized depreciation from the equipment for purposes of computing the credit with respect to the trees. Treas. Reg. § 1.48-1(b)(4) (1982). *Cf.* Rev. Rul. 81-1, 1981-1 C.B. 18.

However, requiring capitalization of preproductive period depreciation incurred with respect to orchards, groves, and vineyards seems inconsistent with the generally very liberal policy position of section 1.162-12(a) of the regulations with respect to preproductive period expenditures. As previously discussed, courts have relied on this long-standing policy toward agriculture in allowing *current* deductions of many preproductive period expenditures which are analogous to capital expenditures in other industries.[61] It seems incongruous to allow these current deductions on the one hand while requiring capitalization of otherwise deductible depreciation on the other.

The potential requirement that equipment depreciation be capitalized as part of the basis of trees or vines could limit the benefits of that depreciation in two respects: (1) preproductive period depreciation of the equipment would be deferred and made concurrent with depreciation of the cost of the trees or vines themselves, which would not begin until the trees or vines reached an income-producing stage; (2) the equipment depreciation thus required to be capitalized would be deducted over the useful life of the trees or vines.

Prior to the adoption of the Accelerated Cost Recovery System (ACRS), the second limitation would likely have been the most disadvantageous from the taxpayer's standpoint since the useful life of most citrus trees would have been thirty years or more. For orchards covered by ACRS, however, the recovery period has been shortened to five years,[62] which would generally also be the recovery period for the equipment involved.[63]

To the extent the preproductive period depreciation of equipment must be capitalized, it would seem that depreciation or cost recovery with respect to the equipment should be computed in the regular manner, reducing the basis of the equipment to which it relates and increasing the basis of the

61. *See, e.g., supra* notes 22-28 and accompanying text.

62. *See infra* notes 193-196 and accompanying text.

63. *See* I.R.C. § 168(c)(2) (1982), Rev. Proc 83-35, 1983-1 C.B. 745.

orchard, grove, or vineyard to which it relates.[64] The basis of the equipment should thereby be reduced even though the depreciation deduction was not allowed or allowable.[65]

B. Citrus and Almond Grove Expenditures

Section 278(a) provides a general rule that an otherwise deductible expenditure "which is attributable to the planting, cultivation, maintenance, or development of any citrus or almond grove (or part thereof), and which is incurred before the close of the fourth taxable year beginning with the taxable year in which the trees were planted" must be capitalized. Section 278 was first enacted as part of the Tax Reform Act of 1969, effective for taxable years beginning after December 31, 1969.[66] As originally enacted, however, it applied only to citrus groves, and no mention was made of almond groves or farming syndicates. A 1971 amendment extended the capitalization rule to almond groves.[67]

The Senate Committee Report accompanying the 1971 amendment extending the capitalization rule to almond groves explained that this amendment, as well as the original capitalization rule with respect to citrus groves, was a response to potential abuses of the liberal farm accounting rules. These rules allowed current deductions to be taken in the developmental period when little or no income was being generated by the groves, with the possibility that the mature grove could later be sold and any gain be subject to the favorable capital gains treatment.[68] This favorable tax treatment was thought to attract high-bracket taxpayers into making tax-motivated investments in citrus and almond

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64. *Cf.* Commissioner v. Idaho Power Co., 418 U.S. 1, 14 (1974).

65. *See* Treas. Reg. § 1.1016-6 (1982).

66. Pub. L. No. 91-172, § 216, 83 Stat. 487, 573 (1969). A "citrus grove" is defined for this purpose as "one or more trees of the rue family, often thorny and bearing large fruit with hard, usually thick peel and pulpy flesh, such as the orange, grapefruit, lemon, lime, citron, tangelo, and tangerine." Treas. Reg. § 1.278-1(a)(2)(i) (1982). An "almond grove" is defined as "one or more trees of the species *Prunus amygdalus*." Treas. Reg. § 1.278-1(a)(2)(ii) (1982).

67. Effective with respect to trees planted after January 12, 1971. Pub. L. No. 91-680, § 1, 84 Stat. 2064 (1970).

68. S. REP. No. 1529, 91st Cong., 2d Sess. 2 (1970), 1971-1 C.B. 548, 608.

grove development, which in turn might drive up land prices and drive down product prices through overproduction, both to the detriment of those operators who relied on the income from the groves for their livelihood.[69]

According to section 278(a), otherwise deductible expenditures must be capitalized if "incurred before the close of the fourth taxable year beginning with the taxable year in which the trees were planted." Thus, for example, if a taxpayer plants a citrus grove five weeks before the close of the taxpayer's fiscal year ending in 1971, the taxpayer would be required to capitalize otherwise deductible expenditures incurred with respect to the grove through the end of the taxpayer's 1974 taxable year.[70] The same would be true if the grove were planted earlier in the taxpayer's 1971 taxable year, since the capitalization period is the close of the fourth taxable year beginning with the *year* in which the grove is planted. If different portions of a grove are planted in different taxable years, the capitalization period is computed separately with respect to the portions planted in a particular taxable year.[71]

The regulations provide that a citrus or almond tree will be considered "planted" on the date the tree "is placed in the permanent grove from which production is expected."[72] Since many of the covered trees may be permanently transplanted only after the initial growth process lasting as long as several years,[73] the regulations were interpreted by many taxpayers to mean that expenditures incurred before permanent transplanting were not encompassed by section 278(a). This view seemed justified by language appearing in Revenue Ruling 80-25.[74] The ruling dealt with the separate question of whether section 278(a) had any application to the timing of depreciation on the grove itself and a supporting irrigation system. In discussing this question, the ruling in-

69. *Id.*
70. *See* Treas. Reg. § 1.278-1(a)(1)(ii), Ex. (1) (1982).
71. Treas. Reg. § 1.278-1(a)(1)(ii), Ex. (2) (1982).
72. Treas. Reg. § 1.278-1(a)(2)(iv) (1982).
73. *See, e.g.*, description of process of development of commercially viable orange trees in Robert L. Maple, 27 T.C.M. (CCH) 944 (1968).
74. 1980-1 C.B. 65.

dicated that "Section 278(a) of the Code requires a taxpayer to capitalize for four years the daily out-of-pocket expenses that would otherwise be deductible under section 162." This implied that the capitalization period was limited to the four years beginning with the permanent planting of the trees.

However, this ruling was subsequently "clarified" by Revenue Ruling 83-128.[75] The latter ruling dealt with the precise issue of whether section 278(a) required the capitalization of otherwise deductible expenditures incurred with respect to citrus seedlings for up to three years before being permanently transplanted. The ruling held that such expenditures *were* subject to capitalization since they were incurred *before* the end of the fourth year beginning with the permanent transplanting. In other words, the time the seedlings were permanently transplanted was not the *beginning* of the capitalization period but rather was relevant only to the determination of when the capitalized period *ended.* Thus, for example, if expenditures had been incurred with respect to the seedlings during three taxable years before the taxable year of permanent transplanting and during each taxable year thereafter, the capitalization period would include the expenditures incurred in *seven* taxable years, ending with the close of the fourth year beginning with the year of permanent transplanting.

Section 278(c) provides a statutory exception to the rule requiring capitalization of expenses incurred in connection with almond and citrus grove development. Capitalization is not required for expenditures with respect to a "grove, orchard, or vineyard which was replanted after having been lost or damaged (while in the hands of the taxpayer) by reason of freezing temperatures, disease, drought, pests, or casualty." This statutory exception for lost or damaged groves applies to both the general rule found in section 278(a) and also to the special rule for farming syndicates found in section 278(b).

Section 278(a) is by its terms applicable to otherwise deductible expenditures "attributable to the planting, cultiva-

75. 1983-2 C.B. 57.

tion, maintenance, or development of any citrus or almond grove (or part thereof)" incurred during the appropriate capitalization period. The regulations provide that covered expenditures "include, but shall not be limited to, the following developmental or cultural practices expenditures: irrigation, cultivation, pruning, fertilizing, management fees, frost protection, spraying, and upkeep of the citrus or almond grove."[76] Expenditures subject to the mandatory capitalization requirement include the cost of fertilizer which would otherwise be deductible by reason of section 162 and/or section 180. However, covered expenditures do not include real estate interest and taxes.[77] Moreover, section 278(a) does not apply to soil and water conservation expenditures deductible by reason of section 175 or to land-clearing expenditures deductible by reason of section 182.[78]

Section 278(a) does not apply to expenditures which must be capitalized without regard to its provisions.[79] Therefore, equipment depreciation would not be required to be capitalized by reason of section 278(a).[80] Likewise, section 278 does not affect the time at which the citrus or almond grove itself would begin to be depreciated, which occurs when it first reaches an income-producing stage.[81]

VII. PREPRODUCTIVE EXPENDITURES OF FARMING SYNDICATES

Despite the addition of the capitalization rules of section 278(a) with respect to citrus and almond grove development, there was a substantial increase after 1969 in the number and volume of publicly syndicated investments in almost all areas of agriculture.[82] The ability to deduct

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76. Treas. Reg. § 1.278-1(a)(2)(iii) (1982).

77. *Id.* These would be subject to the *option* to capitalize under Treas. Reg. § 1.162-12(a) (1982). *See* I.R.S. Pub. No. 225, FARMER'S TAX GUIDE 15 (1983).

78. Treas. Reg. § 1.278-1(a)(2)(iii) (1982).

79. Treas. Reg. § 1.278-1(a)(2)(iii) (1982).

80. *See* Rev. Rul. 80-25, 1980-1 C.B. 65, *modified*, Rev. Rul. 83-67, 1983-1 C.B. 74; *but see supra* notes 57-60 and accompanying text.

81. *See* Rev. Rul. 80-25, 1980-1 C.B. 65.

82. *See* Joint Committee Explanation, H.R. REP. No. 10,612, 94th Cong., 2d Sess. 40, 43 (1976) 1976-3 C.B. pt. 2, 52, 55.

preproductive period expenditures with respect to fruit and nut groves, orchards, and vineyards not limited by section 278(a), and other tax advantages continued to attract many whose primary interest was in sheltering nonfarm income.[83]

The Tax Reform Act of 1976 introduced section 464, which places limits on deductions which can be claimed by "farming syndicates."[84] The legislative history of the farming syndicate rules indicates that the primary focus of the special limitations was with respect to enterprises designed to attract passive investors motivated by a desire to shelter nonfarm income.[85] It was noted that these enterprises were usually designed to offer attribution of losses and limited liability to the investors and were therefore generally structured as either limited partnerships or as agency relationships with management contracts, with limited liability generally provided by nonrecourse indebtedness, insurance, stop-loss guarantees, etc.[86]

At the same time, section 278(b) was amended to provide a special limitation on preproductive period expenditures which could be deducted by farming syndicates with respect to the development of fruit or nut orchards, groves, or vineyards. These restrictions are intended to limit the attractiveness of tax-motivated passive investments in agriculture.

Section 278(b) provides a much broader capitalization rule for farming syndicates than is provided by section 278(a) with respect to citrus and almond grove development. A farming syndicate, as defined in section 464(c), which is engaged "in planting, cultivating, maintaining, or developing a grove, orchard, or vineyard in which fruit or nuts are grown"[87] must capitalize otherwise deductible expenditures

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83. Joint Committee Explanation, *supra* note 82, at 45, 1976-3 C.B. pt. 2, at 57.

84. Pub. L. No. 94-455, § 207(c)(2), 90 Stat. 1520, 1538 (1975).

85. Joint Committee Explanation, *supra* note 82, at 45, 1976-3 C.B. pt. 2, at 57

86. *Id.*

87. For purposes of section 278(b), "fruit" is defined as "a fertilized and developed ovary of a plant, including the seeds, or, in the case of a plant that does not bear seeds, the fertile structure of the plant." 48 Fed. Reg. 51,936 (1983) (to be codified at Treas. Reg. § 1.278-2(a)(2)) (proposed November 15, 1983). A "nut" is defined for purposes of section 278(b) as "a hard-shelled fruit." *Id.* Fruits and nuts include, for

incurred "in a taxable year before the first taxable year in which such grove, orchard, or vineyard bears a crop or yield in commercial quantities" to the extent such expenditures are attributable to the "planting, cultivation, maintenance, or development of such grove, orchard or vineyard."[88]

A "farming syndicate" is defined in section 464(c) as: (1) a partnership or any other enterprise (other than a C corporation) engaged in the trade or business of farming, if at any time interests in such partnership or enterprise have been offered for sale in any offering required to be registered with any federal or state agency having authority to regulate the offering of securities for sale,[89] or (2) a partnership or any other enterprise (other than a C corporation) engaged in the trade or business of farming, if more than 35% of the losses[90] during any period are allocable to limited partners

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this purpose, apples, avocados, coffee beans, grapes, jojoba beans or seeds, pecans, pistachios, and walnuts. *Id.*

88. The provisions of section 278(b) generally apply to covered amounts paid or incurred by farming syndicates in taxable years beginning after December 31, 1975. Pub. L. No. 94-455, § 207(c), 90 Stat. 1520, 1538 (1975).

89. The question of whether an offering is required to be registered with a state agency having authority to regulate the offering of securities for sale is a question of state law. 48 Fed. Reg. 51,936 (1983) (to be codified at Treas. Reg. § 1.464-2(a)(7)(i)) (proposed November 15, 1983). It is possible, therefore, that a partnership or enterprise in one state is a farming syndicate for this purpose while a similar enterprise in another state is not. *Id.* However, if interests in a particular enterprise are offered for sale in more than one state and any one of such states requires registration of the offering, *all* the interests in the enterprise will be treated as subject to the requirement of registration for purposes of the definition of farming syndicate in section 464(c). *Id.*

Offerings made through a dealer who is a member of the National Association of Securities Dealers, or through a real estate company, as well as interests in private enterprises which are not sold by a broker-dealer or similar party, are not offerings which will by themselves make the enterprise a farming syndicate if the offerings are not required to be registered with any federal or state agency having authority to regulate offering of securities for sale.

90. "Losses" for this purpose means the excess of the deductions from the trade or business of farming allowable without regard to sections 278(b) and 464 over the amount of income received or accrued by the enterprise during the taxable year from the trade or business of farming. 48 Fed. Reg. 51,936 (1983) (to be codified at Treas. Reg. § 1.464-2(a)(2)(ii)) (proposed November 15, 1983). However, the following are *not* included in the computation of losses for this purpose: gain and losses from the sale of capital assets or section 1231 assets, charitable contributions, and investment income or expenses. *Id.* A farming enterprise becomes a "farming syndicate" for the first taxable year in which more than 35 per cent of the losses are allocable to limited

or limited entrepreneurs.[91]

The restrictions relating to farming syndicates were intended to focus on farming enterprises in which a substantial

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partners and for all subsequent taxable years. 48 Fed. Reg. 51,936 (1983) (to be codified at Treas. Reg. § 1.464-2(a)(2)(i)) (proposed November 15, 1983).

91. A "limited entrepreneur" is one who has an interest in an enterprise other than as a limited partner and who does not actively participate in the management of the enterprise. I.R.C. § 464(e)(2) (1982). Whether one actively participates in the management or operation of a farming enterprise depends on the facts and circumstances of each case. 48 Fed. Reg. 51,936 (1983) (to be codified at Treas. Reg. § 1.464-2(a)(3)) (proposed November 15, 1983). Factors tending to indicate active management include participating in the decisions involving the operation or management of the farm, actually working on the farm, living on the farm, or hiring and discharging employees (as compared to only the farm manager). *Id.* Factors tending to indicate lack of active participation include lack of control of the management and operation of the farm, having authority to discharge only the farm manager, having a farm manager who is an independent contractor rather than an employee, and having limited liability for farm losses. *Id.* However, lack of fee ownership of the farm land is not to be considered a factor indicating a lack of active participation. *Id.*

For purposes of determining whether one has limited liability for farm losses in determining whether such person constitutes a "limited entrepreneur," all the facts and circumstances are to be taken into account. 48 Fed. Reg. 51,936 (1983) (to be codified at Treas. Reg. § 1.464-2(a)(4)(i)) (proposed November 15, 1983). A person will generally be considered to have limited liability for farm losses if that person is protected against losses to any significant degree by nonrecourse financing, stop-loss orders, guarantees, fixed price purchase or repurchase agreements, insurance, or other similar arrangements. 48 Fed. Reg. 51,936 (1983) (to be codified at Treas. Reg. § 1.464-2(a)(4)(ii)) (proposed November 15, 1983). Examples of persons considered to have limited liability could include a general partner who has obtained a guaranty or other protection against loss from another general partner or agent; a principal who has given actual authority to another party to conduct the farm operation, and who utilized nonrecourse financing, stop-loss orders, insurance, or other similar arrangements to limit the risk of loss. *Id.*

Letter Ruling 8346004 gives a good illustration of how these principles are applied in determining whether an enterprise is a farming syndicate. It involved an unregistered offering of "units" of approximately 39 acres each, restricted to a maximum of 16 units to be used for the planting, growing, and cultivation of jojoba. *B* and *C* each acquired one unit and per agreement entered into a "research and development agreement" with *P* providing, basically, that *P* would oversee and conduct the jojoba development. *P* was given the responsibility to supervise farming of the crops, hire employees, supervise harvesting and marketing of the corp, contract for sale of the crops, and supply all small tools needed for operating the farm. The other unit owners entered into similar agreements with *P*.

The ruling concludes that, per the agreement, *P* is to manage the units as an independent contractor with *B* and *C* as mere passive investors. The ruling concluded, therefore, that the enterprise constituted a farming syndicate. Since the jojoba bean is considered to be both a fruit and a nut, the restrictions of section 278(b) were applicable to the perproductive period expenditures of the enterprise with respect to the jojoba development.

portion of the interests in the enterprise are held by taxpayers who are motivated in large part by a desire to shelter other income rather than by a desire to make a profit in the particular farming operation.[92] Consequently, with respect to farming activities other than those conducted by enterprises in which securities have been or were required to be registered, section 464(c)(2) provides five "safe harbor" cases in which interests will not be considered as held by a limited partner or limited entrepreneur. These are designed to exempt passive interests resulting from traditional farm evolutionary processes rather than tax-motivated investments. Under these exemptions the following interests will not be considered as held by limited partners or limited entrepreneurs so as to make the enterprise a farming syndicate:

(1) An interest in a farm business held by an individual which is attributable to his or her active participation for at least five years in the management of the farm business.[93] For purposes of this exemption, where one farm is substituted for or added to another farm, both farms are to be treated as one farm.[94] This first exception is designed to ensure that an enterprise does not become a "farming syndicate" solely because of the passive interest held by one who has actively participated in the management of the enterprise for at least five years.[95] For example, *A*, who has owned and operated a farm for more than five years, retires and forms *AB* limited partnership with *B*, an unrelated individual who takes over active management of the farm. More than 35% of the losses are allocated to *A*, the limited partner. *AB* partnership will not be treated as a farming syndicate because *A*'s interest, under the first exemption, is not treated as a limited partnership interest for this purpose.[96]

(2) The interest of an individual in a farming enterprise engaged in farming the farm on which the individual

92. *See* Joint Committee Explanation, *supra* note 82, at 46, 1976-3 C.B. pt. 2, at 58.

93. I.R.C. § 464(c)(2)(A) (1982).

94. I.R.C. § 464(c)(2) (1982).

95. Joint Committee Explanation, *supra* note 82, at 48, 1976-3 C.B. pt. 2, at 60.

96. 48 Fed. Reg. 51,936 (1983) (to be codified at Treas. Reg. § 1.464-2(a)(6), Ex. (1)) (proposed November 15, 1983).

has his or her principal residence.[97] This exemption is apparently intended to encompass only the activities of the enterprise with respect to the farm on which the individual resides.[98]

(3) The interest of one who is involved in certain livestock-raising operations.[99]

(4) Any interest in a farm business of one whose principal business activity involves active participation in the management of a trade or business of farming, whether or not the individual actively participates in the particular farm enterprise at issue.[100] This would apparently allow one who is a "traditional" farmer with respect to one enterprise to become a passive investor in other farming enterprises without turning the other enterprises into farming syndicates. For example, *H* has owned and operated *LR* apple orchard for 10 years. *H* also holds a limited partnership interest in a partnership which owns and operates another apple orchard. If *H*'s principal business activity is the active management of *LR* apple orchard, the limited partnership interest held by *H* in the other partnership will not be considered as held by a limited partner or limited entrepreneur for purposes of determining whether the partnership is a farming syndicate.[101]

(5) Any interest held by a member of the "family," as defined in section 267(c)(4) (or a spouse of any such member), of a grandparent of an individual described in the first four exemptions where the interest is attributable to the active participation of the latter individual.[102] For example, if *A*, the retired farmer described in the example illustrating the first exemption, above, transfers his or her interest to *C*, *A*'s child, the *BC* partnership would not be a farming syndicate whether the transfer occurs before or after *A*'s retire-

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97. I.R.C. § 464(c)(2)(B) (1982).

98. *See* Joint Committee Explanation, *supra* note 82, at 47, 1976-3 C.B. pt. 2, at 59.

99. I.R.C. § 464(c)(2)(C) (1982).

100. I.R.C. § 464(c)(2)(D) (1982).

101. 48 Fed. Reg. 51,936 (1983) (to be codified at Treas. Reg. § 1.464-2(a)(6), Ex. (2)) (proposed November 15, 1983).

102. I.R.C. § 464(c)(2)(E) (1982).

ment or death.[103] "Farming" for this purpose includes the raising of fruit- or nut-bearing trees.[104]

A farming syndicate may take, but is not limited to, the following forms of organization: general or limited partnership; sole proprietorship involving an agency relationship created by a management contract; a trust; a common trust fund (as defined in section 584(a)); or an S corporation (as defined in section 1361(a)(1)).[105]

In determining whether the expenditures are attributable to the "planting, cultivating, maintaining, or developing a grove, orchard, or vineyard in which fruit or nuts are grown" and are thus subject to the capitalization requirements of section 278(b) if incurred by a farming syndicate, the proposed regulations with respect to section 278(b) make the principles of the section 278(a) regulations applicable.[106] Thus, such expenditures would include, but would not be limited to, the following developmental or cultural practices: "irrigation, cultivation, pruning, fertilizing, management fees, frost protection, spraying, and upkeep" to the fruit or nut grove, orchard or vineyard.[107] Section 278(b), as does section 278(a), would override any deduction otherwise provided by section 180 with respect to expenditures for fertilizer but would not apply to any expenditures attributable to real estate taxes or interest, nor would it override any deductions provided by sections 175 and 182 for soil and water conservation or land-clearing expenditures.[108]

Covered expenditures are required to be capitalized by section 278(b) whether incurred before or after permanent transplanting as long as the capitalization period has not expired.[109] The proposed regulation in effect incorporates the

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103. 48 Fed. Reg. 51,936, *supra* note 96.

104. I.R.C. § 464(e)(1) (1976).

105. 48 Fed. Reg. 51,936 (1983) (to be codified at Treas. Reg. § 1.464-2(a)(1)(ii)) (proposed November 15, 1983).

106. 48 Fed. Reg. 51,936 (1983) (to be codified at Treas. Reg. § 1.278-2(a)(1)) (proposed November 15, 1983).

107 *See* 48 Fed. Reg. 51,936 (1983) (to be codified at Treas. Reg. § 1.278-1(a)(2)(iii)) (proposed November 15, 1983).

108. *Id.*

109. 48 Fed. Reg. 51,936, *supra* note 106.

holding of Revenue Ruling 83-128[110] with respect to section 278(a) that the date of permanent transplanting does not *begin* the capitalization period but only serves as the point of measurement for determining when the capitalization period *ends*. In any event, however, section 278(b) does not compute the capitalization period by reference to the date of permanent planting.

Portions of orchards, groves, or vineyards which are planted in different taxable years are to be treated separately.[111] The proposed regulations also provide that plants that are more than one year older than other plants are to be treated separately.[112]

Once it commences, the capitalization period is unaffected by a sale or other disposition of the grove, orchard, or vineyard to another farming syndicate.[113] Thus, if one farming syndicate plants a fruit orchard and sells it to another farming syndicate before the orchard has first produced fruit in commercial quantities, the capitalization period continues with the new owner through the close of the taxable year before such commercial quantities are produced. The taxable years concerned for purposes of measuring the capitalization period would continue to be those of the owner of the grove, orchard, or vineyard at the time the trees or vines were planted.[114] "Planted" for this purpose means the date on which the tree or vine is placed in the permanent grove, orchard, or vineyard from which production is expected.[115] It would appear, therefore, that if a farming syndicate sells tree seedlings or vines not yet permanently planted, the measuring taxable years will be those of the subsequent owner at the date of the permanent transplanting rather than the original owner.

If a farming syndicate is involved in the development of

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110. 1983-2 C.B. 57.

111. 48 Fed. Reg. 51,936, *supra* note 106.

112. *Id.*

113. 48 Fed. Reg. 51,936 (1983) (to be codified at Treas. Reg. § 1.278-2(a)(4)) (proposed November 15, 1983).

114. *Id.*

115. 48 Fed. Reg. 51,936 (1983) (to be codified at Treas. Reg. § 1.278-2(a)(3)) (proposed November 15, 1983).

citrus or almond groves, both section 278(a) and 278(b) may apply, with the provisions of section 278(a) applied first.[116] To the extent that section 278(b) applies to a farming syndicate, the capitalization period extends through the close of the taxable year before the taxable year in which a grove, orchard, or vineyard bears in commercial quantities.[117] If section 278(a) also applies because citrus or almond development is involved, the capitalization period of section 278(a) will govern if longer.[118]

For example, if a farming syndicate plants an orange grove in 1983 which does not bear fruit in commercial quantities until 1988, section 278(a) would require the capitalization of most otherwise deductible expenditures with respect to the grove through 1986; however, section 278(b) would overlap and require that the capitalization period be extended through 1987, the year before the yield in commercial quantities is produced.[119] On the other hand, if the citrus or almond yield were produced in commercial quantities before the end of the capitalization period specified in section 278(a), the longer period of section 278(a) would then be applicable.[120]

Section 278(c) provides that a farming syndicate is exempted from the capitalization rules of section 278 with respect to expenditures otherwise deductible and attributable to a grove, orchard, or vineyard which was replanted after having been lost or damaged in the taxpayer's hands by reason of freezing temperatures, disease, drought, pests, or casualty.

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116. 48 Fed. Reg. 51,936 (1983) (to be codified at Treas. Reg. § 1.278-2(b)(1)) (proposed November 15, 1983).

117. I.R.C. § 278(b)(3) (1982).

118. 48 Fed. Reg. 51,936 (1983) (to be codified at Treas. Reg. § 1.278-2(b)(2), Ex. (1)) (proposed November 15, 1983).

119. *Id.* at Ex. 2.

120. Treas. Reg. 1.278(b)(2), Ex. (1) (1976).

VIII. PREPRODUCTIVE PERIOD EXPENDITURES OF CERTAIN FARM CORPORATIONS AND PARTNERSHIPS

Section 447(a) provides the general rule that a corporation engaged in the trade or business of farming and a partnership engaged in the trade or business of farming, if a corporation is a partner in such partnership, will be required to use an accrual method of accounting to compute taxable income. Corporations and partnerships thus required to use an accrual method are required to capitalize the preproductive period expenditures specified in section 447(b).

Section 447 was designed to limit the traditional tax advantages of liberal farm tax accounting rules which had developed at a time when most farm operations were relatively unsophisticated operations carried on by individuals.[121] Traditional farming operations were intended to be exempted from these new limitations, and several exemptions are provided.

Although section 447(a) provides the general rule that farm corporations must use an accrual method of accounting and capitalize preproductive period expenditures, the following exemptions are provided:

(1) An S corporation is not subject to this requirement.[122]

(2) A corporation in which at least 50% of the total combined voting power of all classes of stock entitled to vote, and at least 50% of the total number of shares of all other classes of stock of the corporation are actually or constructively owned by members of the same family is also exempted.[123] Section 447(d)(1) defines "family" for this purpose to mean an individual, his or her brothers and sisters, the brothers and sisters of the individual's parents and grandparents, ancestors and lineal descendants of any of the preceding, and a spouse or the estate of any of these individid-

121. *See* H.R. REP. No. 658, 94th Cong., 1st Sess. 93, 94, (1975), 1976-3 C.B. pt. 2 785, 786.

122. I.R.C § 447(c)(1) (1982).

123. I.R.C. § 447(c)(2) (1982).

uals. Individuals related by the half-blood or by legal adoption are treated as if they were related by the whole blood. Section 447(c)(2) and (3) specify the attribution rules to be used in determining whether the ownership requirements are satisfied.

(3) A corporation is exempted if neither it nor any predecessor corporation has had gross receipts exceeding $1,000,000 in any taxable year beginning after December 31, 1975.[124] Once a corporation has gross receipts for a particular taxable year after 1975 which exceed $1,000,000, this exemption is no longer applicable even if receipts in subsequent years do not exceed this limit.[125] The gross receipts of all members of a controlled group of corporations within the meaning of section 1563(a) are aggregated for purposes of determining whether the gross limitations limit is exceeded.

(4) Section 447(h) provides that a corporation is exempted if it were engaged in the business of farming on October 4, 1976, (the date of the enactment of the Tax Reform Act of 1976) and has continued to be so engaged if:

(a) Members of the same "family," as defined previously, own directly or through attribution at least 65% of the total combined voting power of all classes of stock of such corporation entitled to vote, and at least 65% of the total number of shares of all other classes of stock of such corporation; or

(b) Members of three families have owned directly or by attribution at least 50% of the total combined voting power of all classes of stock of such corporation entitled to vote, and at least 50% of the total number of shares of all other classes of stock of such corporation; and substantially all of the stock of the corporation which is not so owned by members of such three families is directly owned by employees of the corporation or members of their families (within the meaning of section 267(c)(4)), or by a trust for the benefit of the employees of such corporation which is

124. I.R.C. § 447(c)(3) (1982).

125. S. Rep. No. 1236, 94th Cong., 2d Sess. 415, 416 (1976), 1976-3 C.B. pt. 3, 819, 820.

described in section 401(a) and which is exempt from taxation under section 501(a).

Section 447(a)(2) requires a partnership which has a corporate partner to use an accrual method of accounting and to capitalize preproductive period expenditures. The application to partnerships is intended to prevent a corporation from escaping the requirements of section 447 by becoming a partner in a partnership which could still use the cash method of accounting.[126] However, a partnership becomes subject to the rules of section 447 by reason of having a corporate partner only if that corporate partner would itself be subject to those rules.[127] Thus, a partnership having only exempted corporations as partners would not be subject to the requirements of section 447.

Section 447(b)(1) defines "preproductive period expenses" as any amount "which is attributable to crops, animals, or any other property having a crop or yield during the preproductive period of such property." The Joint Committee Explanation indicates that only preproductive period expenses which are otherwise allowable as deductions for the taxable year but for the application of section 447 and the farming syndicate rules, if applicable, are subject to the capitalization requirements.[128] Interestingly enough, the explanation indicates that soil and water conservation expenses otherwise deductible under section 175 and land-clearing expenditures otherwise deductible under section 182 may be "preproductive period expenses" required to be capitalized.[129]

The "preproductive period" for purposes of the capitalization rule is defined differently for different kinds of farming activities. In the case of property having a useful life of more than one year which will have more than one crop or yield, the "preproductive period" means "the period before

126. *See* H. REP. No. 658, 94th Cong., 1st Sess., 93, 95 (1975), 1976-3 C.B. pt. 2, 785, 787.

127. *Id.*

128. Joint Committee Explanation, *supra* note 82, at 51, 55, 1976-3 C.B. pt. 2, at 63, 67.

129. 1976-3 C.B. pt. 2, 63, 67, n.29.

the disposition of the first such marketable crop or yield."[130] In the case of other types of property, the preproductive period is the period before such property is disposed of.[131]

Thus, in the case of orchards, groves, and vineyards, the preproductive period for this purpose would be the period before the disposition of the first marketable crop or yield. This would seem to extend the preproductive period until the time of actual disposition. However, the Joint Committee Explanation contains the following illustration: "Thus, costs attributable to the cultivation, maintenance, or development of an orchard or vineyard in a taxable year *before the first year in which a marketable crop or yield is sold* (and which are currently deductible under prior law) are preproductive period expenses."[132] (Emphasis added.) This implies the preproductive period is to extend only through the close of the taxable year preceding the taxable year in which the first marketable crop is disposed of, much like the definition of preproductive period for farming syndicate purposes contained in section 278(b)(3).

The Joint Committee Explanation also indicates that a corporation or partnership which is subject to both the capitalization rules of section 447 and section 278(a) because involved in citrus or almond grove development is bound by the longer preproductive period of the two.[133] The interaction between section 447 and section 278 would thus appear to have the same results as that between the section 278(b) rules with respect to farming syndicates and the section 278(a) rules with respect to those involved in citrus and almond grove development.[134]

The use by the taxpayer in the trade or business of farming of any supply produced in such trade or business shall be treated as a "disposition" for purposes of determining the appropriate preproductive period.[135] This provision

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130. I.R.C. § 447(b)(3)(A) (1982).

131. I.R.C. § 447(b)(3)(B) (1982).

132. Joint Committee Explanation, *supra* note 82, at 51, 1976-3 C.B. pt. 2, at 63.

133. *Id.* at 55, 1976-3 C.B. pt. 2, at 67.

134. *See supra* notes 66-120 and accompanying text.

135. I.R.C. § 447(b) (1982).

was designed to make deductible those expenses incurred in raising feed for a farmer's cattle, chickens, or other animals[136] and seems to have little relevance to orchards, groves, and vineyards unless their produce were used as a major source of feed.

IX. WHEN DOES THE PREPRODUCTIVE PERIOD END?

The ending of the preproductive period has different effects, depending on the crop and/or the taxpayers involved. For purposes of the option to capitalize provided in the regulations at section 1.162-12(a), the end of the preproductive period means that the option to capitalize deductible expenditures is no longer available.[137] For those required by statute to capitalize expenditures relating to almond and citrus grove development, expenditures incurred by farming syndicates, and expenditures incurred by farm corporations and partnerships subject to the capitalization rules of section 447, the end of the statutory capitalization period will usually mean that the taxpayers involved can begin deducting those expenditures which are normally deductible.

As will be seen, the statutory capitalization period for farming syndicates and the farm corporations and partnerships subject to section 447 will usually extend at least as long as the preproductive period for purposes of the option to capitalize provided by section 1.162-12(a). Taxpayers subject to those rules would thus normally never have an *option* to deduct or capitalize expenditures. The issues previously discussed[138] concerning which preproductive period expenditures may be deducted or capitalized and which *must* be capitalized would thus have little relevance. On the other hand, the statutory capitalization period of section 278(a) with respect to almond and citrus grove development may end before the preproductive period has ended. Therefore, during any remaining period between the end of the statutory capitalization period and the end of the preproductive

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136. Joint Committee Explanation, *supra* note 82, at 56, 1976-3 C.B. pt. 2, at 68.

137. *See supra* note 3.

138. *See supra* notes 7-41 and accompanying text.

period, the general rules previously discussed as to the deductibility of preproductive period expenditures would apply.

For those not subject to the statutory capitalization periods, neither the Code nor the regulations describe when the preproductive period ends for purposes of the general option to deduct or capitalize provided by section 1.162-12(a) of the regulations. However, as will be discussed in more detail later,[139] an orchard, grove, or vineyard is considered as "placed in service" for depreciation and investment tax credit purposes when the trees or vines reach an income-producing stage.[140] The income-producing stage occurs in the year in which the trees bear fruit or nuts in sufficient quantity to be harvested and marketed in the ordinary course of the taxpayer's business.[141] The "productive" state is thus presumably reached in the same year the orchard, grove, or vineyard is considered placed in service for depreciation and investment tax credit purposes.[142] Under this rationale, different portions of an orchard, grove, or vineyard may reach a productive state at various times because of differences inherent in the trees or plants and variations in soil, climate, and cultural treatment.[143]

Section 278(b)(3) defines the capitalization period with respect to expenditures incurred by farming syndicates as the taxable years before the taxable year in which the grove, orchard, or vineyard bears a crop or yield in commercial quantities. The capitalization period for this purpose would thus seem to be generally coextensive with the preproductive period for purposes of section 1.162-12(a) of the regulations.

Section 447(b)(3) defines "preproductive period" for purposes of the mandatory capitalization rules relating to certain farm corporations and partnerships as the period before the disposition of the first marketable crop or yield.

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139. *See infra* notes 204-212 and accompanying text.

140. Treas. Reg. § 1.46-3(d)(2) (1979); *see* Rev. Rul. 80-25, 1980-1 C.B. 65, *modified*, Rev. Rul. 83-67, 1983-1 C.B. 74, *clarified*, Rev. Rul. 83-128, 1983-2 C.B. 57.

141. *See* Rev. Rul. 71-488, 1971-2 C.B. 60.

142. *See* Rev. Rul. 65-104, 1965-1 C.B. 28, *clarified* Rev. Rul. 66-183, 1966-2 C.B. 47.

143. *See, e.g.*, Rev. Rul. 71-488, 1971-2 C.B. 60.

As noted previously, the legislative history indicates the preproductive period will end at the close of the taxable year before the crop is sold.[144] Under this rule, it would also seem that the statutory capitalization period would likely be coextensive with the preproductive period under section 1.162-12(a), unless the crop were sold in a year after harvest, in which case the capitalization period would be longer.

Section 278(a) provides that the capitalization period with respect to almond and citrus grove development will extend through the close of the fourth taxable year beginning with the taxable year in which the trees were planted. This capitalization period may end before some trees or vines have reached an income-producing stage. They should then become subject to the general rules of section 1.162-12(a) for the remainder of the preproductive period.[145]

Although the *year* in which the trees or vines become productive for purposes of the option to deduct or capitalize provided by section 1.162-12(a) may be relatively easy to identify, an uncertainty exists as to whether the preproductive period actually extends into that year to the time of harvest, or perhaps even later to the time of actual disposition of the crop. However, since the "income-producing" stage is reached during the year of *harvest*,[146] the time of actual disposition of the crop would not seem determinative.

A private letter ruling[147] indicates that sugar cane, which generally produces more than one crop, would not be considered as placed in service until that point in the year when the first crop is actually harvested. This would presumably coincide with the beginning of the productive period. However, the ruling was concerned with whether the

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144. *See supra* note 132 and accompanying text.

145. *Cf.* I.R.S. Pub. No. 225 FARMER'S TAX GUIDE 15 (1983).

146. Actually, Rev. Rul. 71-488, 1971-2 C.B. 60, said the income-producing stage with respect to a macadamia tree is reached in the year when the trees bear sufficient quantity of nuts to be harvested and *marketed* in the ordinary course of business. However, this would seem to mean merely that the yield must be sufficient to justify harvesting and marketing in the normal course of business, whether both the harvesting and marketing normally take place in the same year or in different years.

147. Letter Rul. 7807047.

cane seed qualified for the tax credit and did not deal with the issue of preproductive period expenditures.

A livestock case, *Sonnabend v. Commissioner*,[148] offers some interesting comments, if not dependable guidance. The case involved section 270 (which was subsequently repealed by the Tax Reform Act of 1969). Under that provision, a taxpayer whose deductions from a trade or business exceeded the gross income from such business for five consecutive years could be required to recompute taxable income by limiting the deductions taken. However, section 270(b) provided that certain "specially treated deductions" could be excluded from the computations in determining whether the taxpayer's deductions exceeded gross income. Among these were expenditures with respect to which taxpayers had been given the option, by law or regulations, to deduct or capitalize.

The taxpayer in question bought a farm in Massachusetts and subsequently bought a herd of cattle in New York which was too large for the farm at that time. The cattle were consequently left in New York while improvements were being made to the farm. The new herd was moved from New York to the farm in the spring of 1954.

The taxpayer contended that the farm operation was not in a productive state during the years 1954 through 1958, and thus that otherwise deductible expenditures incurred during those years were subject to the option to capitalize provided by section 1.162-12(a) of the regulations. If subject to the option to capitalize, they could be excluded from the computations under section 270. However, the Tax Court found that the farm was in the productive state for all of the years 1954 through 1958. The expenditures were thus not subject to the option to capitalize and would be included in the section 270 computations.

On appeal, the First Circuit concluded that the Tax Court's finding that the farm reached the productive state some time during 1954 was not clearly erroneous.[149] How-

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148. 46 T.C. 382 (1966); *vacated and remanded*, 377 F.2d 42 (1st Cir. 1967).
149. 377 F.2d 42, 44 (1st Cir. 1967).

ever, it disagreed with some of the possible implications of the finding that the farm was productive for *all* of 1954:

> However, we think it demonstrated that taxpayer's business was not in production until the date in 1954 when the herd was moved in. The mere ownership of the cattle before then was a holding operation, only, and if the court meant that the farm was in a productive state throughout the 1954 fiscal year, its finding was clearly erroneous. If, on the other hand, the court did not find production throughout 1954, but, rather, ruled as a matter of law that if the farm was in a productive state at any time during the year none of the development expenses could be capitalized, it cites no authority in support of such a proposition, and we are aware of none. We believe such a result not intended by the regulation and, accordingly, hold that those development expenses incurred prior to the date in 1954 when the cattle were moved from New York are to be considered specially treated deductions and excluded from the loss computation for 1954 in determining the applicability of I.R.C. section 270.[150]

The case may be of limited precedential value as to the issue of when the productive period began since the direct issue was the computation of losses for purposes of section 270. However, it seems to suggest that the productive period can begin at some time during the year without including the entire year, and that expenses incurred during that same year up to the moment the productive period is reached are subject to the option to capitalize under section 1.162-12(a). On the other hand, the case can be distinguished as not dealing with a situation similar to that of a developing orchard, grove, or vineyard since the cattle in *Sonnabend* were actually physically moved onto the farm for the first time during the year in issue.

This issue of whether the productive period encompasses the entire year in which the first commercial harvest occurs or begins at the actual date of harvest may be significant in some cases. For example, in the case of a fruit or nut crop which is harvested in the fall, the expenditures incurred

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150. *Id.*

during the year of the first commercial harvest but before the harvest begins may be significant. Since many of these expenditures, if capitalized pursuant to the option in section 1.162-12(a), might be added to the basis of the trees or vines for purposes of the investment tax credit and the first year recovery allowance for that same year,[151] it is conceivable that the availability of the option could be important.

X. TAX CREDITS AND DEPRECIATION OF TREES AND VINES

A. Introduction

As previously discussed,[152] special statutory capitalization rules have been enacted from time to time to require preproductive period expenditures incurred with respect to certain crops and/or incurred by certain taxpayers to be capitalized. These rules were generally designed to limit the attractiveness of fruit or nut growing or other farming activities to high-bracket taxpayers interested primarily in the tax shelter potential of those activities.[153] As will be seen, the required capitalization of the expenditures covered by the statutory rules initially meant that current deductions which might otherwise have been available during the preproductive period, when little income was being produced, were being converted to capital expenditures. The expenditures thus capitalized were deductible, if at all, only when the trees and vines to which they related became income producing, and then only over the typically very long productive lives of the trees and vines involved. Under these circumstances, the required capitalization might serve as a significant deterrent to the nonfarmer seeking a tax shelter.

Subsequent changes in the law, however, have drastically shortened the periods over which the capitalized costs of bringing trees and vines to productivity may be recovered through deductions. These changes, coupled with the availability of the investment tax credit for such costs, have pre-

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151. *See infra* note 225 and accompanying text.

152. *See supra* notes 66-134 and accompanying text.

153. *See supra* notes 69, 85, and 121, and accompanying text.

sumably made the statutory capitalization requirements seem much less onerous. Moreover, these same circumstances have likely made the option provided by section 1.162-12(a) of the regulations to capitalize preproductive period expenditures a much more important planning consideration. The following discussion of the depreciation and investment credit rules with respect to fruit or nut trees and vines is intended to emphasize the changes which have occurred over time and the significance of the current rules in making fruit- and nut-growing operations potentially popular tax-shelter activities despite the statutory capitalization rules.

B. General Depreciation Rules

The Internal Revenue Service has long conceded that fruit and nut trees and vines are depreciable property. A 1919 Solicitor's Law Opinion[154] considered whether an orchard constituted depreciable property. The ruling pointed out that taxpayers were permitted to deduct depreciation with respect to buildings and other tangible property used in the trade or business as a means of allowing the return, tax-free, of the original capital invested. No justification was perceived for treating the trees of a fruit grower differently:

> Just what valid objection there can be in permitting a person who owns an orchard and is in the business of growing fruit to enjoy this same measure of justice does not appear. . . . The life of an orchard may be somewhat indefinite, but it can be as accurately determined as the probable life of a building or other tangible property upon which depreciation charges are allowed. In any event it is certain that there is a gradual and ultimate wearing out of an orchard within a number of years after the productive state has been reached.[155]

The ruling held, therefore, that depreciation deductions were allowable and were to be determined by reference to

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154. Op. No. 797, 1 C.B. 130 (1919), *declared obsolete*, Rev. Rul. 67-123, 1967-1 C.B. 383.

155. *Id.* at 131.

the "average life of the trees from the income-producing state under normal conditions."[156] Depreciation was to begin when the trees reached an income-producing stage, and the basis for purposes of depreciation was to be the initial cost plus capitalized expenditures incurred in bringing them to maturity.

Most of the controversy over depreciation deductions with respect to trees and vines has thus involved peripheral issues rather than the fundamental question of depreciability. Questions concerning the useful life to be used in a given case[157] and which preproductive period expenditures must be capitalized as part of the basis for depreciation purposes[158] have arisen particularly often.

However, *taxpayers* were successful in a few instances in arguing that particular fruit or nut trees were not depreciable. In *Chester B. Knox*[159] the Board of Tax Appeals was confronted with the issue of the taxpayer's appropriate basis for gain purposes on the sale of land with walnut trees. The Commissioner determined the basis of the trees by determining that depreciation should have been allowable based on a productive life of thirty-three years. The taxpayer countered that the productive life was in excess of 200 years. The Board concluded from the evidence that the productive life of the trees could not reasonably be determined, and the taxpayer's basis need not be reduced for purposes of determining gain.

The case of *Thomas Palmer*[160] involved a similarly inverted issue, the basis of orange trees for purposes of gain on sale. This taxpayer was also successful in convincing the

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156. *Id.*

157. *See, e.g.*, C.A. Hawkins, 16 T.C.M. (CCH) 938 (1947) (fig orchard); San Joaquin Fruit & Investment Co., 28 B.T.A. 395 (1933) (orange and walnut trees); F.H. Wilson, 12 B.T.A. 403 (1928) (grape vineyards and peach trees, no evidence as to useful life of plum trees); Ribbon Cliff Fruit Co., 12 B.T.A. 13 (1928) (apple and pear trees); Harry B. Hooper, 8 B.T.A. 397 (1927) (peach orchards, grape vineyard); Kaweah Lemon Co., 5 B.T.A. 992 (1927) (lemon trees); Redlands Security Co., 5 B.T.A. 956 (1926) (orange grove); Loyd H. Wilbur, 5 B.T.A. 597 (1926) (prune orchards, grape vineyards).

158. *See supra* notes 7-41 and accompanying text.

159. 2 B.T.A. 1107 (1925).

160. 23 B.T.A. 296 (1931).

Board that no depreciation had occurred by time of sale, and that the basis for gain purposes should therefore not be adjusted.

Despite these holdings, the IRS listed "average useful lives" for many varieties of trees and vines, including both orange and walnut trees, in Bulletin "F," issued in 1942.[161]

In *Krome v. Commissioner*,[162] taxpayers suffered losses through hurricane damages to avocado, mango, and citrus groves, and the basis for determining such losses was at issue. The taxpayer contended that these groves all had indeterminate useful lives, were not depreciable, and the basis for loss purposes should therefore not reflect any depreciation allowable. The Commissioner did not contest this position with respect to the mango and citrus groves but contended that the basis of the avocado groves should be adjusted for depreciation computed on the basis of an eighty-year life. The Tax Court found on the evidence that the productive life of the avocado groves in question was indeterminate, and they thus were not depreciable.

Revenue Procedure 62-21[163] contained guideline lives replacing those in Bulletin "F". However, no specific guideline lives were provided for fruit and nut trees and vines, the Procedure providing instead that "[d]ue consideration shall be given in each producing region to the geographic, climatic, genetic, economic and other factors which determine depreciable life."[164]

There was apparently never an attempt on the part of the IRS to deny depreciation altogether, although the length of the depreciation period with respect to a particular crop remained a subject for dispute. Revenue Ruling 65-104[165] held that citrus trees were "section 38 property" for purposes of the investment tax credit, and the ruling thus necessarily assumed that the citrus trees constituted depreciable prop-

161. *See* Prentice-Hall Federal Taxes ¶¶ 45,521 to 45,582 (1984).

162. 19 T.C.M. (CCH) 159 (1950).

163. 1962-2 C.B. 418.

164. *Id.* at 421.

165. 1965-1 C.B. 28, *clarified*, Rev. Rul. 66-183, 1966-2 C.B. 47.

erty.[166] The ruling relied on the 1919 Solicitor's Law Opinion discussed earlier.[167] Revenue Ruling 67-51[168] indicated generally that trees of a fruit orchard or grove constituted "section 38 property." A 1981 private letter ruling[169] took the position that avocado trees were depreciable and distinguished *Krome*[170] on the grounds that it had been decided prior to the enactment of the investment tax credit.

C. Accelerated Cost Recovery System

The Economic Recovery Act of 1981[171] introduced the Accelerated Cost Recovery System (ACRS) to do away with many of the complexities associated with the computation of depreciation deductions under section 167. Section 167(a) was amended to provide that deductions with respect to "recovery property" would be computed under section 168 rather than section 167. Section 168(c)(1) defines "recovery property" as tangible property used in the trade or business or held for the production of income which is of a character subject to the allowance for depreciation. This is generally limited to such property which is placed in service after 1980.[172]

The most significant feature of ACRS is its standardization of the "useful life" concept into several "recovery classes." Section 168(c)(2) originally listed the following five recovery classes: 3-year property, 5-year property, 10-year property, 15-year real property, and 15-year public utility property. The Tax Reform Act of 1984 converted 15-year real property into "18-year real property," generally effective with respect to covered property placed in service after March 15, 1984.[173] For the sake of convenience, the term "18-year real property" will be used hereinafter to refer to both.

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166. *See* I.R.C. § 48(a)(1) (1982).
167. *See supra* note 154 and accompanying text.
168. 1967-1 C.B. 68.
169. Letter Rul. 8108007.
170. *See supra* note 162 and accompanying text.
171. Pub. L. No. 97-34, 95 Stat. 172 (1981).
172. I.R.C. § 168(e)(1) (1982).
173. Pub. L. No. 98-369, § 111(a), (g), 98 Stat. 494, — (1984).

The classification procedure under section 168 has its roots in section 167(m), which was added by the Revenue Act of 1971.[174] It authorized the Secretary of the Treasury to develop a system of "class lives" for various classifications of assets. These lives could then be elected for depreciation purposes by taxpayers acquiring covered assets. Section 167(m) also authorized a degree of flexibility in the class life system by providing that the system could permit a variance of 20% shorter or longer than the standard class life established for the particular asset classification.

Proposed, and then final, regulations[175] were issued pursuant to this authorization establishing the Asset Depreciation Range (ADR) System. Revenue Procedure 71-25[176] was published simultaneously with the proposed ADR regulations and actually specified the "class lives" to be used for various asset classifications. Revenue Procedure 71-25 was superseded by subsequent Revenue Procedures, the latest of which is Revenue Procedure 83-35.[177]

Orchards, groves, and vineyards which are recovery property would not qualify as "public utility property"[178] and would thus fit into one of four possible recovery classes: 3-year property, 5-year property, 10-year property, or 18-year real property. A first step in determining the proper classification is to determine whether the trees and vines constitute "section 1245 class property" or "section 1250 class property" since the former will fall into either the 3- or 5-year property class and the latter will fall into either the 10-year property or the 18-year real property class.[179]

"Section 1245 class property" is defined as tangible property described in section 1245(a)(3), other than subparagraphs (C) and (D).[180] "Section 1250 class property" is defined as property described in section 1250(c) and property

174. Pub. L. No. 92-178, § 109(a), 85 Stat. 497, 508 (1971).

175. Treas. Reg. 1.167(a)-(11) (1982).

176. 1971-2 C.B. 553.

177. 1983-1 C.B. 745.

178. *See* I.R.C. § 168(g)(1) (1982).

179. *See* I.R.C. § 168(c)(2) (1982).

180. I.R.C. § 168(g)(3) (1982).

described in section 1245(a)(3)(C).[181] Section 1250(c) includes depreciable real property other than property described in section 1245(a)(3). The key to proper classification of trees and vines, therefore, is in determining whether they are described in section 1245(a)(3)(A), (B), (E), or (F).

Section 1245(a)(3)(A) refers to tangible "personal property." The IRS has ruled that trees of fruit orchards or groves do not constitute tangible personal property for purposes of the additional first-year depreciation allowance under former section 179 since they are considered "part and parcel of the land in which they are rooted."[182] The same ruling contained the implicit finding that the trees also did not constitute "tangible personal property" within the meaning of section 48(a)(1)(A) since it concluded that the trees were "other tangible property" within the meaning of section 48(a)(1)(B). Since the regulations under section 1245 provide that "tangible personal property," for purposes of section 1245(a)(3)(A), is to have the same meaning as under section 48,[183] trees and vines should clearly not constitute tangible personal property for purposes of section 1245(a)(3)(A).

The only other property description under section 1245(a)(3) which could have application to fruit or nut trees and vines is contained in subparagraph (B): "other property (not including a building or its structural components) but only if such property is tangible and . . . was used as an integral part of manufacturing, production, or extraction." No case or ruling has yet specifically held that trees and vines are encompassed by this definition. However, the description is substantially identical to that in section 48(a)(1)(B), which contains one of the descriptions of "section 38 property" qualifying for the investment tax credit. Moreover, the regulations under section 1245 provide that the "other property" described in section 1245(a)(3)(B) is to have the same meaning as the similar "other property" de-

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181. I.R.C. § 168(g)(4) (1982).

182. Rev. Rul. 67-51, 1967-1 C.B. 68.

183. Treas. Reg. § 1.1245-3(b)(1) (1976).

scribed in section 48(a)(1)(B).[184]

The regulations under section 48 provide that "manufacturing," "production," and "extraction" include the cultivation of the soil.[185] The regulations go on to provide that "other property . . . used as an integral part of manufacturing, production or extraction" includes property used as an integral part of "the cultivation of orchards."[186]

Revenue Ruling 65-104[187] concluded that citrus trees were "other property . . . used as an integral part of manufacturing, production or extraction" so as to constitute "section 38 property" for purposes of the investment tax credit. Revenue Ruling 67-51[188] reached a similar conclusion for fruit orchards and groves generally. A private letter ruling also held that avocado trees qualified as such "other property."[189]

It should be clear, therefore, that fruit or nut trees and vines are "other property . . . used as an integral part of manufacturing, production, or extraction" within the meaning of section 1245(a)(3)(B) and, if recovery property, thus constitute "section 1245 class property." As such, they will necessarily fall into either the 3-year or 5-year property recovery class.[190]

The 3-year property class is defined as "section 1245 class property" with a "present class life" of 4 years or less.[191] The 5-year property class is in effect defined as "section 1245 class property" which does not fit into any of the other recovery classes.[192] Since the only other recovery class containing "section 1245 class property" is the 3-year property class, "section 1245 class property" will be 3-year property if it has a class life of 4 years or less, and it will

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184. Treas. Reg. § 1.1245-3(c)(2) (1971).

185. Treas. Reg. § 1.48-1(d)(2) (1983).

186. *Id.*

187. 1965-1 C.B. 28, *clarified*, Rev. Rul. 66-183, 1966-2 C.B. 47; *see also* Rev. Rul. 69-249, 1969-1 C.B. 31.

188. 1967-1 C.B. 68.

189. Letter Rul. 8108007.

190. *See* I.R.C. § 168(c)(2) (1982).

191. I.R.C. § 168(c)(2)(A) (1982).

192. I.R.C. § 168(c)(2)(B) (1982).

necessarily be 5-year property if it has a class life in excess of 4 years or does not have a class life at all.

The "class life" for this purpose is defined as the class life, if any, which would be applicable with respect to such property on January 1, 1981, the effective date of ACRS.[193] As previously noted, the applicable class lives have most recently been specified in Revenue Procedure 83-35.[194] The class life is the "midpoint" life between the upper and lower 20% variance limits.[195]

None of the revenue procedures issued with respect to the Asset Depreciation Range System have provided class lives expressly applicable to orchards or vineyards. Moreover, it is clear that the trees and vines would not fit into any of the very few available asset classes having class lives of four years or less. Consequently, the trees and vines would necessarily fall into the 5-year property classification. This classification constitutes an extraordinary shortening of the 30-40 year depreciation periods traditionally common before ACRS.

The annual "recovery allowance" for 5-year property is computed by reference to a statutory table[196] which incorporates a 150% declining balance method initially, switching subsequently to a straight-line method, and which uses a "half-year convention" for the year the assets are placed in service.[197] This means that the first year "recovery percentage" is determined on the assumption that the property is placed in service at mid-year (regardless of the actual date placed in service) using a rate 150% of the applicable straight line percentage. The first-year recovery percentage for 5-year property is thus 15%. Recovery rates of 22%, 21%, 21% and 21% apply, respectively, to the next four recovery years.[198]

Taxpayers may elect to use optional 5-, 12-, or 25-year

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193. I.R.C. § 168(g)(2) (1982).

194. 1983-1 C.B. 745.

195. *See* S. REP. NO. 176, 97th Cong., 1st Sess. 206-207 (1981).

196. I.R.C. § 168(b)(1) (1982).

197. *See* S. REP. NO. 144, 97th Cong., 1st Sess. 50 (1981).

198. I.R.C. § 168(b)(1) (1982).

recovery periods with respect to 5-year property.[199] However, recovery allowances under any of these optional periods are computed by use of the straight-line method.[200] Optional recovery tables have been provided in proposed regulations.[201]

All recovery property except for 18-year real property receives the same recovery percentage for the first year regardless of the actual point during the year when it is placed in service.[202] It is necessary, therefore, to determine only the taxable *year* in which fruit or nut trees are deemed placed in service in order to determine the first-year recovery percentage.

The regulations under section 167 provide that "depreciation of an asset shall begin when the asset is placed in service" but does not define what "placed in service" means.[203] However, the proposed regulations under section 168 define "placed in service" for purposes of the first-year recovery allowance as meaning "the time that property is first placed by the taxpayer in a condition or state of readiness and availability for a specifically assigned function."[204] This definition coincides with that in the regulations relating to the investment tax credit, which provides that an asset is "placed in service" for purposes of the tax credit in the *earlier* of the taxable year in which the taxpayer properly begins to depreciate the property or the taxable year "in which the property is placed in a condition or state of readiness and availability for a specifically assigned function."[205] These latter regulations go on to provide, however, that "fruit bearing trees and vines shall not be considered in a condition or state of readiness and availability for a specifically assigned

199. I.R.C. § 168(b)(3) (1982).

200. *Id.*

201. 48 Fed. Reg. 51,936 (1983) (to be codified at Treas. Reg. § 1.168-2(c)(4)) (proposed November 15, 1983).

202. *See* I.R.C. § 168(b)(1), (2) (1982).

203. Treas. Reg. § 1.167(a)-11(e)(1) (1982) provides a definition for property subject to the ADR system. The definition is the same as that in the proposed regulations under I.R.C. § 168. *See infra* note 204 and accompanying text.

204. 48 Fed. Reg. 51,936 (1983) (to be codified at Treas. Reg. § 1.168-2(1)(2)) (proposed November 15, 1983).

205. Treas. Reg. § 1.46-3(d)(1) (1982).

function until they have reached an income-producing stage."[206] In other words, trees and vines would not be considered placed in service for purposes of the investment tax credit before the taxable year in which the income-producing stage is reached.

The same rule has long been applied with respect to the year in which depreciation of trees and vines is to begin. A 1919 ruling[207] held that depreciation begins when an orchard reaches "the income-producing stage."[208] Of course, if a taxpayer acquires a producing orchard, it is placed in service as to the acquiring taxpayer in the year acquired.[209]

Since "placed in service" has been defined similarly with respect to trees and vines for purposes of depreciation and the investment tax credit, they should be considered as reaching an "income-producing stage" at the same time for both purposes. Revenue Ruling 71-488[210] concluded that a macadamia tree reaches an "income-producing stage" for purposes of the investment tax credit "in the year when it first bears nuts in sufficient quantity to be harvested and marketed in the ordinary course of the taxpayer's business." The ruling indicated that the yield must be more than *de minimus* but may be less than expected at maximum bearing capacity.[211] It also pointed out that the income-producing stage may be reached at different ages for different portions of a grove, "depending upon factors inherent in the trees, as well as variations in soil, climate, and cultural treatment."[212]

The usual stage at which particular fruit and nut crops bear yields in commercial quantities in a given geographical area will likely be well recognized. However, it is the taxpayer's actual experience rather than industry norms which

206. Treas. Reg. § 1.46-3(d)(2) (1982).

207. Op. No. 797, 1 C.B. 130 (1919), *declared obsolete*, Rev. Rul. 67-123, 1967-1 C.B. 383.

208. *See also* Rev. Rul. 80-25, 1980-1 C.B. 65, *modified*, Rev. Rul. 83-67, 1983-1 C.B. 74, *clarified*, Rev. Rul. 83-128, 1983-2 C.B. 57.

209. *See* Rev. Rul. 65-104, 1965-1 C.B. 28, *clarified*, Rev. Rul. 66-183, 1966-2 C.B. 47 (producing orchard placed in service for purposes of investment tax credit when purchased).

210. Rev. Rul. 71-488, 1971-2 C.B. 60.

211. *Id.* at 61.

212. *Id.*

establish when the income-producing stage is considered reached.[213]

D. Coordination with Preproductive Expenses

It should be noted that the date the trees and vines are placed in service for depreciation or cost recovery purposes is not affected by the special statutory rules requiring certain preproductive expenses to be capitalized. For example, section 278(a) requires otherwise deductible preproductive period expenditures incurred with respect to citrus and almond groves to be capitalized if incurred prior to the close of the fourth taxable year beginning with the taxable year in which the trees are planted. Since only *otherwise currently deductible* expenditures are subject to the rule, the timing of the commencement of depreciation is unaffected and begins when the income-producing stage is reached.[214]

Likewise, the capitalization rule of section 278(b) with respect to preproductive expenditures of farming syndicates is limited by its terms to amounts "which would be allowable as a deduction but for the provisions of this section"[215] and should thus likewise not affect the commencement of depreciation or cost recovery. Moreover, the preproductive period is defined for purposes of section 278(b) as ending with the close of the taxable year before the year in which the grove, orchard, or vineyard "bears a crop or yield in commercial quantities."[216] Thus, the capitalization period for purposes of section 278(b) would generally end before the income-producing stage is reached and normal depreciation or cost recovery begins.

On the other hand, section 447(b), requiring capitalization of "preproductive period expenses" of certain farm corporations and partnerships, defines "preproductive period

213. *See* Rev. Rul. 71-488, 1971-2 C.B. 60, 61; *see also* Redlands Security Co., 5 B.T.A. 956, 958 (1926) (normal maturity date of orange trees retarded two years by heavy frost or freeze).

214. Rev. Rul. 80-25, 1980-1 C.B. 65, *modified*, Rev. Rul. 83-67, 1983-1 C.B. 74, *clarified*, Rev. Rul. 83-128, 1983-2 C.B. 57.

215. I.R.C. § 278(b)(1) (1982).

216. I.R.C. § 278(b)(3) (1982).

expenses" for this purpose as "any amount which is attributable to crops, animals, or any other property having a crop or yield during the preproductive period of such property."[217] The definition thus does not by its terms limit the capitalization requirement to otherwise deductible expenditures. However, the Joint Committee Explanation of the provision indicates that the "preproductive period expenditures" intended to be subject to the capitalization rule were only those "which are allowable as deductions for the taxable year but for the application of this provision."[218] Regulations will presumably take the same approach. The issue will probably be moot in most instances since the "preproductive period" for purposes of section 447(b) is defined as "the period before the disposition of the first such marketable crop or yield."[219] The ending of the preproductive period would therefore normally coincide with the beginning of depreciation or cost recovery if the first commercial harvest and sale take place during the same taxable year.

E. Basis for Cost Recovery Purposes

If a taxpayer develops the orchard, grove, or vineyard from planting to maturity, the basis of the trees or vines for depreciation or cost recovery purposes is generally the initial cost of the trees or vines plus capitalized expenditures incurred in bringing them to an income-producing stage.[220] The initial cost would include the cost of purchasing and initial planting of the seeds or seedlings.[221]

Since the underlying land is not depreciable,[222] it is important to determine which capitalized expenditures are associated with the development of the trees or vines to maturity and which are properly to be capitalized as additions to the basis of the land itself. For example, if the elec-

217. I.R.C. § 447(b)(1) (1982).

218. Joint Committee Explanation, *supra* note 82, at 55, 1976-3 C.B. pt. 2, at 67.

219. I.R.C. § 447(b)(3)(A) (1982).

220. Op. No. 797, 1 C.B. 130 (1919), *declared obsolete*, Rev. Rul. 67-123, 1967-1 C.B. 383; Rev. Rul. 65-104, 1965-1 C.B. 28, *clarified*, Rev. Rul. 66-183, 1966-2 C.B. 47.

221. *See* Rev. Rul. 83-28, 1983-1 C.B. 47.

222. Treas. Reg. § 1.167(a)2 (1960).

tion is made to capitalize soil and water conservation expenditures, it seems clear that they must be capitalized as part of the basis of the land to which they relate.[223] Such costs would therefore not form part of the cost basis of trees and vines on such land and would not be subject to depreciation or cost recovery. The same would be true for land-clearing expenditures not deducted pursuant to section 182.[224]

On the other hand, most preproductive development costs capitalized at the taxpayer's option under section 1.162-12(a) would be properly capitalized as part of the cost of bringing the trees or vines to maturity. These should include, if capitalized, the otherwise deductible "cultural practices" costs such as for fertilizer, cultivation, pruning, spraying, and transplanting growing plants.[225] Likewise, most of the expenditures required to be capitalized by reason of section 278(a) (citrus and almond grove development) and section 278(b) (preproductive expenditures of farming syndicates with respect to orchards, groves, and vineyards) should form part of the basis of the trees or vines since the expenditures required to be capitalized are only those which would otherwise be deductible and which are attributable to planting, cultivating, maintaining, or developing the orchard, grove, or vineyard.[226] The same should be true of most of the costs capitalized pursuant to section 447(b) (preproductive period expenses of certain farm corporations and partnerships).[227]

If a taxpayer purchases a producing orchard, grove, or vineyard, the purchase price would have to be allocated between the nondepreciable land and the depreciable trees or vines in proportion to their respective values.[228] If a grove, orchard, or vineyard is purchased after planting but before

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223. *See* Treas. Reg. § 1.175-1 (1960).

224. I.R.C. § 182 (1982).

225. *See* Rev. Rul. 69-249, 1969-1 C.B. 31; *see also* Rev. Rul. 83-28, 1983-1 C.B. 47.

226. *See* I.R.C. § 278(a), (b)(2) (1982).

227. *See* I.R.S. Pub. No. 225, FARMER'S TAX GUIDE 16 (1983).

228. *See* Treas. Reg. § 1.167(a)-5 (1960); *see also* Rev. Rul. 65-104, 1965-1 C.B. 28, *clarified*, Rev. Rul. 66-183, 1966-2 C.B. 47.

reaching the productive stage, the basis for depreciation would be the initial purchase price allocated to the trees or vines plus additional capitalized costs incurred to bring the trees or vines to the productive stage.[229]

F. First-Year Expense Election

Prior to the Economic Recovery Tax Act of 1981 (ERTA), section 179 provided an additional 20% first-year depreciation allowance with respect to "section 179 property."[230] "Section 179 property" was defined for this purpose as depreciable, "tangible personal property."[231] Revenue Ruling 67-51[232] held that trees of fruit orchards and groves were a part of the land in which they are rooted and thus did not constitute "tangible personal property" for purposes of the additional first-year depreciation allowance. The few decisions on point held similarly with respect to citrus trees and grapevines.[233]

ERTA amended section 179 to provide an option to deduct the entire cost, within prescribed maximums, of "section 179 property" for the year it is placed in service.[234] Moreover, the definition of "section 179 property" was changed to mean "any recovery property which is section 38 property and which is acquired by purchase for use in a trade or business."[235] Since it is well established that trees and vines can constitute "section 38 property,"[236] they should also qualify for the deduction under section 179 if they constitute recovery property and are acquired by "purchase" for use in a trade or business.[237]

"Purchase" is defined for this purpose as "any acquisi-

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229. *See* Rev. Rul. 65-104, 1965-1 C.B. 28, *clarified*, Rev. Rul. 66-183, 1966-2 C.B. 47.

230. *See* former I.R.C. § 179(a) (1976).

231. Former I.R.C. § 179(d)(1) (1976).

232. 1967-1 C.B. 68.

233. Kimmelman v. Commissioner, 72 T.C. 294, 309 (1979) (grapevines); La Croix v. Commissioner, 61 T.C. 471, 485 (1974) (citrus trees); Powars v. United States, 285 F. Supp. 72 (C.D. Cal. 1968).

234. Pub. L. No. 97-34, § 202(a), 95 Stat. 172, 219 (1981).

235. I.R.C. § 179(d)(1) (1982).

236. *See infra* note 250 and accompanying text.

237. *See* H.R. REP. No. 201, 97th Cong., 1st Sess. 75 (1981).

tion" except for acquisitions from certain related persons, members of a controlled group, and acquisitions where the property acquired has a carryover basis or a basis determined under section 1014 (relating to property acquired from a decedent).[238] This is the same definition used for purposes of the first-year depreciation allowance prior to the ERTA changes.[239] Regulations under the prior provision make it clear that construction or erection of section 179 property by the taxpayer constitutes a "purchase."[240] Therefore, the growth of trees or vines to the income-producing stage should qualify as a "purchase" for this purpose, as well as an actual purchase of already productive trees or vines.

The deduction is taken for the year in which section 179 property is placed in service.[241] "Placed in service," although not specifically defined for this purpose, should have the same meaning as for the regular first-year recovery allowance and the investment tax credit.[242]

As originally enacted by ERTA, a maximum deduction of $5,000 was to be available for qualifying property placed in service during 1982, increasing to $7,500 in 1984 and $10,000 in 1986 and thereafter. The Tax Reform Act of 1984 deferred the increased maximums, providing that the $5,000 maximum would be retained through 1987, the $7,500 maximum would be effective for 1988 and 1989, and the $10,000 maximum would be available for 1990 and thereafter.[243] The applicable maximum deduction for a given taxable year is the maximum *aggregate* deduction under section 179 that a taxpayer can claim with respect to all "section 179 property" placed in service that year by the taxpayer.[244]

The basis for both the investment tax credit and the regular recovery allowance must be reduced for any amount deducted with respect to the property under section 179.[245]

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238. I.R.C. § 179(d)(2) (1982).
239. *See* S. REP. No. 144, 97th Cong., 1st Sess. 60 (1981).
240. Treas. Reg. § 1.179-3(c)(2) (1972).
241. I.R.C. § 179(a) (1982).
242. *See* S. REP. No. 144, *supra* note 239.
243. Pub. L. No. 98-369, § 13, 98 Stat. 494, — (1984).
244. I.R.C. § 179(b)(1) (1982).
245. I.R.C. §§ 179(d)(9), 168(d)(1)(A)(ii)(II) (1982).

XI. QUALIFICATION FOR INVESTMENT TAX CREDIT

Section 38 authorizes an investment tax credit and section 46 describes how it is to be computed. The amount of the credit is computed as a percentage of the "qualified investment,"[246] which is in turn defined as the "applicable percentage" of the "basis of each new section 38 property" and the "cost of each used section 38 property."[247] To qualify for the credit, therefore, property must constitute "section 38 property."

"Section 38 property" is defined in section 48(a), with the primary definitions contained in section 48(a)(1). Section 48(a)(1)(A) includes depreciable "tangible personal property," but trees and vines do not qualify as "tangible personal property" since they are considered "part and parcel of the land in which they are rooted."[248]

Section 48(a)(1)(B) includes "other tangible property (not including a building and its structural components) but only if such property . . . is used as an integral part of manufacturing, production, or extraction. . . ." The regulations provide that the terms "manufacturing, production, or extraction" include "cultivation of the soil" and that "section 38 property" would include property used as "an integral part of . . . the cultivation of orchards, gardens, or nurseries."[249] Several rulings make it clear that fruit or nut trees and vines can constitute "section 38 property" under the "other tangible property" category of section 48(a)(1)(B) and thus qualify for the tax credit.[250]

The amount of the investment credit is determined by applying the "regular percentage" to the "qualified investment."[251] The "regular percentage" is 10%.[252] The qualified

246. I.R.C. § 46(a)(2) (1982).

247. I.R.C. § 46(c) (1982).

248. *See* Rev. Rul. 67-51, 1967-1 C.B. 68.

249. Treas. Reg. § 1.48-1(d)(2) (1972).

250. Rev. Rul. 65-104, 1967-1 C.B. 28 (citrus groves), *clarified*, Rev. Rul. 66-183, 1966-2 C.B. 47; Rev. Rul. 67-51, 1967-1 C.B. 68 (trees of fruit orchards or groves); Rev. Rul. 69-249, 1969-1 C.B. 31 (citrus trees); Letter Rul. 8108007 (avocado trees). In Kimmelman v. Commissioner, the Commissioner conceded that grapevines constituted section 38 property. 72 T.C. 294, 309, n.5 (1979).

251. I.R.C. § 46(a)(2)(A)(i) (1982).

investment in depreciable trees and vines which are not recovery property would be 100% of the basis or cost (depending on whether they are new or used section 38 property) if they have a useful life of seven years or more.[253] The "qualified investment" in recovery property which is 5-year property, as the trees and vines would be,[254] is also 100% of the basis of "new section 38 property" or 100% of the cost of "used section 38 property."[255] Thus, for example, if an orchard, grove, or vineyard is recovery property and qualifies as "new section 38 property," the investment credit would be 10% of the taxpayer's basis in the trees or vines.

The credit is available only for the year during which the section 38 property is "placed in service" by the taxpayer.[256] Property is placed in service for purposes of the tax credit in the *earlier* of (1) the taxable year in which the taxpayer begins to depreciate the property or (2) the taxable year "in which the property is placed in a condition or state of readiness and availability for a specifically assigned function."[257] The alternative was intended to require the credit be taken when the property meets the condition in (2) although depreciation might start in a succeeding taxable year under one of the available "averaging conventions" for depreciating property.[258] Recovery property is also placed in service for purposes of the recovery allowance when the property "is first placed by the taxpayer in a condition or state of readiness and availability for a specifically assigned function."[259]

The tax credit regulations provide that fruitbearing trees and vines are not considered in a "condition or state of readiness and availability for a specifically assigned function

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252. I.R.C. § 46(a)(2)(B) (1982).

253. I.R.C. § 46(c)(1), (2) (1982).

254. *See supra* notes 190-95 and accompanying text.

255. I.R.C. § 46(c)(7) (1982).

256. Treas. Reg. § 1.46-3(d)(4)(i) (1979).

257. Treas. Reg. § 1.46-3(d)(1) (1979).

258. *See id.*

259. 49 Fed. Reg. 5943 (1984) (to be codified at Treas. Reg. § 1.168-2(*l*)(2)) (proposed February 16, 1984).

until they have reached an income-producing stage."[260] Consequently, fruit or nut trees or vines will be considered as placed in service for purposes of the tax credit during the year they reach an income-producing stage.[261] The IRS has ruled that a macadamia tree reaches an "income-producing stage" in the year "when it first bears nuts in sufficient quantity to be harvested and marketed in the ordinary course of the taxpayer's business."[262] This stage may be reached at different times for different portions of a grove "depending upon factors inherent in the trees, as well as variations in soil, climate, and cultural treatment."[263] This view of when the income-producing stage is reached should apply generally to fruit or nut trees and vines.[264]

The credit with respect to fruit or nut trees and vines will generally be 10% of their "basis," if they are "new section 38 property," or 10% of their "cost" if they are "used section 38 property."[265] Trees or vines will constitute "new section 38 property" as to a taxpayer if the "original use of such property commences with the taxpayer."[266] The original use of fruitbearing trees and vines begins when the income-producing stage is reached.[267] The trees and vines would thus constitute new section 38 property with respect to a taxpayer who owns them at the time the income-producing stage is reached whether the taxpayer developed them from seeds or seedlings or purchased established orchards, groves, or vineyards before the income-producing stage was reached.[268]

On the other hand, "used section 38 property" means section 38 property "acquired by purchase" which is not

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260. Treas. Reg. § 1.46-3(d)(2) (1979).

261. *See* Rev. Rul. 65-104, 1965-1 C.B. 28, *clarified*, Rev. Rul. 66-183, 1966-2 C.B. 47; Rev. Rul. 69-249, 1969-1 C.B. 31.

262. Rev. Rul. 71-488, 1971-2 C.B. 60.

263. *Id.*

264. *Id.* This seems to be the only ruling which has attempted to define when the income-producing stage is reached with respect to fruit or nut trees and vines. Nothing in the ruling suggests its analysis is limited to macadamia trees.

265. I.R.C. § 46(c)(1) (1982).

266. I.R.C. § 48(b) (1982).

267. Rev. Rul. 65-104, 1965-1 C.B. 28, *clarified*, Rev. Rul. 66-183, 1966-2 C.B. 47.

268. *See id.*

"new section 38 property."[269] That would include all orchards, groves, and vineyards acquired after the income-producing stage is reached.[270] "Acquired by purchase" has the same meaning as under section 179,[271] which excludes acquisitions from many related parties.[272] However, an orchard, grove, or vineyard acquired after the income-producing stage has been reached would *not* be used section 38 property if it continues to be farmed by a person who farmed it before acquisition by the taxpayer, or if it is farmed after the acquisition by a person who is related to someone (within the meaning of section 179(d)(2)(A) or (B)) who farmed it before the acquisition. The latter limitation was designed to prevent transfers between related parties to qualify for the credit.[273] Thus, if a son were to acquire an orchard from his father after the income-producing stage had been reached, the property would not be used section 38 property in the hands of the son since the acquisition would not be considered a "purchase."[274] Since the first use of the orchard would not have commenced with the son, it would also not constitute new section 38 property as to the son.[275] The result would be that the son would not be entitled to an investment credit with respect to the orchard. Similarly, if *A* sells an income-producing orchard to *B* and leases it back in a sale and leaseback arrangement, *B* would not be entitled to a credit since the property would continue to be used by a person (*A*) who used it before the sale.[276] The result would be the same if the leaseback were to *A*'s son, since the son is related (within the meaning of section 179(d)(2)(A)) to someone (*A*) who farmed it before the sale to *B*.

The "cost" of used section 38 property is generally the

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269. I.R.C. § 48(c)(1) (1982).

270. *See* Rev. Rul. 65-104, *supra* note 267.

271. Treas. Reg. § 1.48-3(a)(1) (1982); *see supra* notes 238-240 and accompanying text.

272. *See* I.R.C. § 179(d)(2) (1982).

273. *See* H.R. REP. No. 1447, 87th Cong., 2nd Sess. — (1962), 1962-3 C.B. 414-415.

274. *See* I.R.C. § 179(d)(2)(A) (1982).

275. I.R.C. § 48(b)(2) (1982).

276. *See* Treas. Reg. § 1.48-3(a)(2)(i) (1982).

basis of such property but excludes so much of the basis as is determined by reference to the adjusted basis of other property.[277] For example, if a farmer acquires a productive orchard in an exchange qualifying for nonrecognition treatment under section 1031, the "cost" of the acquired orchard would not include so much of the basis as is determined by reference to the basis of the property exchanged.[278] On the other hand, if the acquired orchard had not yet reached a productive stage, it would constitute new section 38 property when the productive stage is reached, and its entire basis would be part of the "qualified investment" on which the tax credit would be computed.[279]

The basis of new or used section 38 property must be reduced for any amount deducted with respect to the prop-

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277. Treas. Reg. § 1.48-3(b)(1) (1982).

278. *See* I.R.C. § 1031(d) (1982); Treas. Reg. § 1.48-3(b)(4), Ex. (1) (1982).

279. Section 48(c)(2) places limitations on how much of the cost of used section 38 property can enter into the tax credit computations for a given taxable year. Immediately prior to the ERTA changes, there was a basic $100,000 limitation ($50,000 each for married individuals filing separately). The ERTA raised the basic limitation to $125,000 for taxable years beginning in 1981 through 1984, with a scheduled increase to $150,000 thereafter. Pub. L. No. 97-34, § 213(a), 95 Stat. 172, 240 (1981). Married individuals filing separately would each be limited to one-half the basic amount. However, the Tax Reform Act of 1984 deferred the scheduled increase to $150,000 until taxable years beginning after 1987. Pub. L. No. 98-369, § 11(a)(1), (2), 98 Stat. 494, — (1984).

This cost limitation with respect to used section 38 property applies not only to the cost of such property placed in service by that person but also to the cost of used section 38 property apportioned or allocated to such person by a trust, estate, S corporation or partnership for a taxable year ending with or within the person's taxable year. Treas. Reg. § 1.48-3(c)(1) (1982). In the case of a partnership, the limitation applies *both* at the partnership and at the partner level. I.R.C. § 48(c)(2)(D) (1982). The same is now true of an S corporation and its shareholders as a result of the Subchapter S Revision Act of 1982. I.R.C. § 48(c)(2)(D) (1982) as amended by Pub. L. No. 97-354, § 3(d), 96 Stat. 1669, 1689 (1982).

If the limitation is exceeded, the taxpayer must select the property, within the limitations, which will be considered in computing the credit for the particular year. Treas. Reg. § 1.48-3(c) (1982). The portion of the cost which exceeds the limitations is lost for tax credit purposes and cannot be considered in other years.

After applying the used section 38 property limitations, if any, the maximum aggregate credit which can be claimed by a taxpayer for a particular year cannot exceed so much of the taxpayer's tax liability for the particular year as does not exceed $25,000 plus 85% of so much of the tax liability for the year as does exceed $25,000. I.R.C. § 46(a)(3) (1982). Excess unused credits can be carried back three years and forward fifteen years. I.R.C. § 46(b)(1) (1982).

erty under section 179.[280] The Tax Equity and Fiscal Responsibility Act of 1982 added subsection (q) to section 48. Section 48(q) generally requires that the basis of section 38 property must be reduced by 50% of the credit taken with respect to such property.[281] This lowers the basis, for example, on which the recovery allowance under section 168 is computed. However, taxpayers are given an option, in lieu of the basis adjustment, to reduce the applicable regular percentage by two percentage points.[282] For example, the 10% regular percentage applicable to groves, orchards, and vineyards could be reduced to 8% and the basis adjustment avoided.[283]

A major limitation on the availability of the investment tax credit was added by the Economic Recovery Tax Act of 1981. Section 48(c)(8) limits the credit to amounts with respect to which the taxpayer is "at risk." The manner of determining the amount at risk was revised by the Tax Reform Act of 1984, which is generally effective for property placed in service after July 18, 1984.[284] The provision generally

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280. *See* I.R.C. § 179(d)(9) (1982).

281. Pub. L. No. 97-248, § 205(a), 96 Stat. 324, 427 (1982).

282. I.R.C. § 48(q)(4) (1982).

283. Focusing solely on relative tax benefits, it appears that this reduction in the credit percentage usually cannot be justified if the taxpayer's marginal tax rate is 40% or lower. For example, if a taxpayer has a basis of $100,000 in the trees of an orchard which has just reached an income-producing stage, a credit of 10% of that basis will produce a tax credit of $10,000 while a credit of 8% will produce a tax credit of $8,000. Reducing the credit percentage thus results in a reduction in the tax credit by $2,000. If the 10% credit is taken, the basis of the orchard would have to be reduced for cost recovery purposes to $95,000 (representing a reduction of one-half of the $10,000 credit taken). Assuming the taxpayer has a 40% marginal rate, the reduction of the basis by $5,000 for recovery purposes will result in $2,000 more in tax payable because of the basis reduction (40% maringal rate × $5,000 in lost recovery allowances). However, that would be exactly offset by the $2,000 additional tax credit taken by using the full 10% rather than the lower 8% credit percentage. These are actually not equal benefits since the trade-off is of a current $2,000 additional tax credit in exchange for an additional $2,000 in tax savings from additional recovery allowances over the recovery life if the basis is not reduced. If the taxpayer's marginal rate is less than 40%, the additional recovery deductions which will result if the basis is not reduced will not save as much in taxes as would be lost by the required reduction in the credit percentage from 10% to 8%. Thus, unless the benefit of the full tax credit is not otherwise available to the taxpayer, the taxpayer will probably want to use the full 10% credit percentage.

284. Pub. L. No. 98-369, § 431, 98 Stat. 494, — (1984).

forces a taxpayer to reduce the basis of "new section 38 property" and the cost of "used section 38 property" for purposes of determining the credit by the amount of "nonqualified nonrecourse financing" with respect to the property.[285] The basis or cost does not have to be reduced by the amount of the "qualified commercial financing."[286] "Qualified commercial financing" includes financing:

(1) with respect to property which is not acquired from a related party as defined in section 168(e)(4);[287]

(2) the amount of the nonrecourse financing with respect to the property does not exceed 80% of the credit base of the property;[288] and

(3) such financing is borrowed from a "qualified person" or represents a loan from any federal, state, or local government or instrumentality, or is guaranteed by any federal, state, or local government.[289]

CONCLUSION

It is ironic that the fruit- and nut-growing industry, which has been the target of much restrictive tax legislation over the past 15 years, should be such an apparent major beneficiary of the new cost recovery rules. These inconsistent developments perhaps aptly illustrate one of the likely consequences of the tremendous dynamism of the tax laws in recent years. Changes have occurred at such a rapid rate that taxpayers and their advisors (and law professors) scramble to keep pace. Legislators, on the other hand, often seem to be scrambling to keep one step ahead. It is little wonder

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285. I.R.C. § 46(c)(8)(A) (1982).

286. I.R.C. § 46(c)(8)(D)(i) (1982).

287. I.R.C. § 46(c)(8)(D)(ii)(I), (V) (1982).

288. I.R.C. § 46(c)(8)(D)(ii)(II) (1982). The "credit base" is the basis of new section 38 property and the cost of used section 38 property. I.R.C. § 46(c)(8)(C) (1982).

289. I.R.C. § 46(c)(8)(D)(ii)(III) (1982). A "qualified person" is defined generally as any party in the business of lending money who is not a related person with respect to the taxpayer, a person from whom the taxpayer acquired the property (or a person related to such person), or a person who receives a fee with respect to the taxpayer's investment in the property (or a related person to such person). I.R.C. § 46(c)(8)(D)(iv) (1982).

that some of these changes may produce unexpected and inconsistent results.

In any event, most of the statutory restrictions with respect to preproductive period expenditures in the fruit- and nut-growing industry seem to be much less limiting now since the capitalized costs can be recovered over a five-year span beginning when the income-producing stage is reached rather than over the thirty to forty years or longer previously common. Whether the industry will now again attract those nonfarm taxpayers the restrictions were designed to discourage remains to be seen. If perceived abuses do occur, responsive new laws may become part of the seemingly endless cycle.

The one clear beneficiary of all of this is the grower who is not subject to the statutory capitalization restrictions at all, the "true" farmer. The liberal preproductive period rules still apply, *and* the option to capitalize may present new planning considerations in light of the shortened recovery periods.