INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM
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Chief, Appeals Office

Taxpayers' Name:
Taxpayers' Address:

Taxpayer Identification No:
Years Involved:
Date of Conference:

LEGEND:

Region X =
State Y =
Variety Z =

Year 1 =
Year 2 =
Year 3 =
Year 4 =
Year 5 =
Year 6 =
Year 7 =
Year 8 =
Year 9 =
Year 10 =

A =
B =
C =
D =
E =
F =
G =
H =
J =
K =

L =
M =
N =
P =
Q =
R =
S =
T =
U =
V =
W =
AA =

$A =
$B =
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$H =
$J =
$K =

ISSUES:

1. For purposes of determining whether the production of wine grape vines may be exempted from § 263A of the Internal Revenue Code under § 263A(d)(1), is the nationwide weighted average preproductive period of wine grape vines greater than two years?

2. For purposes of determining the actual preproductive period for cost capitalization under § 263A, did the taxpayers produce a marketable quantity of wine grapes in Year 4, Year 5, or Year 6?

3. Does the actual preproductive period for cost capitalization under § 263A end when the first marketable quantity of wine grapes is harvested or at the beginning of the annual growing cycle that produces such a harvest?

4. Did the taxpayers make an effective election under § 263A(d)(3)(D) such that § 263A does not apply to their production of wine grape vines?

CONCLUSIONS:

1. The nationwide weighted average preproductive period of wine grape vines is greater than two years.

2. The taxpayers produced a marketable quantity of wine grapes in Year 6.

3. The actual preproductive period of wine grape vines ends with the harvest of a marketable quantity of wine grapes.

4. The taxpayers did not make an effective election under § 263A(d)(3)(D).

FACTS:

The taxpayers are married individuals reporting income on a calendar year basis. They filed joint returns for Year 4, Year 5 and Year 6, the taxable years at issue.

The taxpayers purchased land in Region X of State Y in Year 1. They constructed a residence on the property in Year 2, and began preparing land for a vineyard in October of that year. In early Year 3, the taxpayers planted A acres of Variety Z wine grape vines, using one-year old green grafted vines. In October of that year, the vines produced an insignificant crop, which was not harvested. The grapes were allowed to fall from the vines, or were trimmed off with the winter pruning and training.

In October of Year 4, the taxpayers harvested B tons of wine grapes from their vineyard, a yield of C tons per acre. A winery paid $A for the Year 4 crop and absorbed all costs of harvesting the crop. The taxpayers assert that the Year 4 crop was below their expectations because of damage caused by deer in Year 4. The deer uprooted or otherwise killed D (9.3%) of the E vines originally planted, and stripped or chewed many other vines.

In October of Year 5, the taxpayers harvested F tons of wine grapes from their vineyard, a yield of G tons per acre. A winery paid $B for the crop, and the taxpayers paid the costs of harvesting. The taxpayers estimate that an additional H to J tons were produced but were lost to birds. The taxpayers further assert that the Year 5 wine grape crop was significantly below normal throughout Region X.

In October of Year 6, the taxpayers harvested K tons of wine grapes from their vineyard, a yield of L tons per acre. A winery paid $C for the crop, and the taxpayers paid the costs of harvesting. They estimate that an additional M to N tons were produced but were lost to mildew. The taxpayers further assert that the Year 6 wine grape crop was significantly below normal throughout Region X.

In October of Year 7, the taxpayers harvested P tons of wine grapes from their vineyard, a yield of Q tons per acre. The taxpayers assert that Year 7 saw an unusually bountiful harvest of wine grapes in Region X.

The taxpayers were not required under § 447 to use an accrual method of accounting with respect to their vineyard trade or business. The taxpayers were not precluded by § 448 from using a cash method of accounting with respect to their vineyard trade or business.

LAW AND ANALYSIS:

ISSUE 1: For purposes of determining whether the production of wine grape vines may be exempted from § 263A under § 263A(d)(1), is the nationwide weighted average preproductive period of wine grape vines greater than two years?

Section 263A(a) generally requires that the direct costs and all indirect costs that directly benefit, or are incurred by reason of, the production of tangible personal property be capitalized.

Section 263A(d)(1)(A)(ii) provides that § 263A shall not apply to any plant that has a preproductive period of two years or less and is produced by a taxpayer in a farming business. Section 263A(d)(1)(B) provides that the exemptions in § 263A(d)(1)(A) do not apply to any corporation, partnership, or tax shelter required to use an accrual method of accounting under §§ 447 or 448(a)(3).

Section 263A(e)(4)(A) provides that, for purposes of § 263A, the term "farming business" means the trade or business of farming.

Section 263A(e)(3)(A)(i) provides that, for purposes of § 263A, the term "preproductive period" means, in the case of a plant which will have more than one crop or yield, the period before the first marketable crop or yield from such plant.

Section 263A(e)(3)(B) provides that, in the case of a plant grown in commercial quantities in the United States, the preproductive period for such plant, if grown in the United States, shall be based on the nationwide weighted average preproductive period for such plant.

Section 1.263A-4T of the Temporary Income Tax Regulations was in effect for the tax years at issue. Section 1.263A-4T(c)(4)(ii)(A) provided that the preproductive period of property produced in a farming business means, in the case of a plant or animal which will have more than one crop or yield, the period before the first marketable crop or yield from such plant or animal.

Section 1.263A-4T(c)(4)(ii)(B) provided that the preproductive period of a plant begins when the plant or seed is first planted or acquired by the taxpayer. The preproductive period ends when the plant becomes productive in marketable quantities or when the plant is reasonably expected to be sold or otherwise disposed of.

Section 1.263A-4T(c)(4)(ii)(D) provided that the preproductive period of plants grown in commercial quantities in the United States is based on the nationwide weighted average preproductive period for such plant.

Growing plants is the production of property within the meaning of § 263A. A taxpayer growing plants is thus generally required by § 263A(a) to capitalize both the direct costs of the plants and the indirect costs that directly benefit, or are incurred by reason of, the production of the plants. A limited exemption from this capitalization requirement is provided for taxpayers that are not required to use an accrual method of accounting under §§ 447 or 448(a)(3) ("permitted cash method taxpayers") when they produce plants with a preproductive period of two years or less. § 263A(d)(1)(A)(ii).

A plant that bears more than one crop or yield is a completed item of property when it has the productive capacity to bear marketable crops or yields. The production of such a plant is completed when its first marketable crop or yield is harvested.

The production period of a plant corresponds generally to the preproductive period of the plant. However, § 263A and the regulations thereunder embody two separate but related conceptions of the preproductive period: the nationwide weighted average preproductive period and the actual preproductive period. These conceptions serve different purposes in the application of § 263A to farming businesses.

First, the nationwide weighted average preproductive period determines whether a plant has a preproductive period of two years or less for purposes of the exemption provision in § 263A(d)(1)(A)(ii). Under such provision, a plant is exempt from § 263A if it has a preproductive period of two years or less and is produced in a farming business by a permitted cash method taxpayer. § 263A(d)(1)(B). If the plant is produced in commercial quantities in the United States, this exemption is applied using the nationwide weighted average preproductive period for that plant. § 263A(e)(3)(B); § 1.263A-4T(c)(4)(ii)(A), (D).

The nationwide weighted average preproductive period of a plant reflects the cumulative experience of all taxpayers that cultivate such plants in the United States, and, consequently, is determined by the life cycle of the plant itself rather than the experience of any particular taxpayer. For purposes of computing the nationwide weighted average, the preproductive period of a plant begins when the plant starts to grow. The preproductive period of grafted varietal grape vines, for example, begins no later than when the varietal grape stock is grafted to the root stock to create the final plant.

Second, if a plant is subject to § 263A, the actual preproductive period of each plant determines how long the taxpayer must capitalize costs with respect to such plant. Growing plants constitutes the production of property for purposes of § 263A, and thus a taxpayer growing plants subject to 263A is required by § 263A(a) to capitalize specified costs with respect to these plants while they are being produced, *i.e.*, during the preproductive period of the plants.

The actual preproductive period is the period during which a specific taxpayer produces a specific plant, and, consequently, is determined by the taxpayer's actual experience rather than nationwide averages. The actual preproductive period begins when the taxpayer first plants or acquires the plant or seed, and ends when the plant becomes productive in marketable quantities or when the plant is reasonably expected to be disposed of. § 1.263A-4T(c)(4)(ii)(B).

The nationwide weighted average preproductive period of a plant and the actual preproductive periods of that plant as cultivated by various taxpayers are distinct. Thus, if the nationwide weighted average preproductive period for grape vines exceeded two years, all grape growers would be subject to § 263A, including those growers, if any, whose grape vines had actual preproductive periods of two years or less and were otherwise eligible for the exemption in § 263A(d)(1)(A)(ii). Conversely, if the nationwide weighted average preproductive period for grape vines were two years or less, all grape growers eligible for the exemption in § 263A(d)(1)(A)(ii) would be exempted from § 263A, including those producers whose grape vines had actual preproductive periods in excess of two years.

The nationwide weighted average preproductive period and the actual preproductive period are each appropriate for the functions they perform. Moreover, both concepts are necessary because neither concept could appropriately perform the function served by the other.

First, if the actual preproductive period, rather than the nationwide weighted average preproductive period, were used to determine whether the § 263A(d)(1)(A)(i) exemption applied, the exemption would not apply uniformly among permitted cash method taxpayers that produce the same plant. Some of these taxpayers might be required to capitalize costs under § 263A because their actual preproductive periods exceeded two years, while other taxpayers producing the identical plant might be entirely exempt from capitalizing costs under § 263A because their actual preproductive periods were two years or less.

Congress rejected this result and chose instead to apply the § 263A(d)(1)(A)(i) exemption on a national, rather than regional or individual, basis. The express specification of a nationwide weighted average in § 263A(e)(3)(B) clearly reflects the intent of Congress that all producers of a particular plant throughout the entire country should be treated uniformly with respect to whether cost capitalization under § 263A is required.

Second, if the nationwide weighted average preproductive period, rather than the actual preproductive period, were used to determine how long a taxpayer must capitalize costs under § 263A, most taxpayers would either overcapitalize or undercapitalize their expenditures. Some taxpayers would have actual preproductive periods that were shorter than the nationwide weighted average preproductive period. These taxpayers would overcapitalize because they would continue to capitalize costs after their plants had become productive but before the nationwide weighted average preproductive period ended. Conversely, some taxpayers would have actual preproductive periods that were longer than the nationwide weighted average preproductive period. These taxpayers would undercapitalize because they would stop capitalizing costs after the nationwide weighted average preproductive period ended but before their plants had become productive.

This result would be contrary to basic tax accounting principles, which generally attempt to match the income of a period against the expenses of that period. By contrast, using the actual preproductive period as the capitalization period achieves proper matching of income and expenses of each taxpayer by ensuring that the capitalization period corresponds to the actual production experience of the individual taxpayer.

In sum, the combined use of the nationwide weighted average preproductive period and the actual preproductive period strikes the proper balance between promoting a desirable uniformity in capitalization regulations and achieving an accurate matching of the revenues and expenses of each taxpayer.

Growing wine grape vines is the production of property, and thus is generally subject to cost capitalization under § 263A(a). The production of wine grape vines, however, is exempt from § 263A if (i) the taxpayer is a permitted cash method taxpayer, and (ii) wine grape vines have a preproductive period of two years or less. § 263A(d)(1)(A)(ii), (B). Wine grape vines are a plant with more than one crop or yield, and they are grown in commercial quantities in the United States. Accordingly, for purposes of the exemption in § 263A(d)(1)(A)(ii), the preproductive period of wine grape vines is the nationwide weighted average preproductive period for wine grape vines. § 263A(e)(3)(B).

According to the information submitted, the taxpayers are permitted cash method taxpayers. But the taxpayers are still subject to § 263A with respect to their production of wine grape vines unless the nationwide weighted average preproductive period of wine grape vines is two years or less.

The taxpayers assert that the preproductive period for wine grape vines in Region X is less than two years, and have submitted evidence to support this assertion. This evidence, however, is restricted to Region X, and has limited value in determining the *nationwide* weighted average preproductive period of wine grape vines. As discussed above, the use of a nationwide weighted average preproductive period in applying the exemption in § 263A(d)(1)(A)(ii) is expressly required by § 263A(e)(3)(B).

Moreover, the evidence produced by the taxpayers does not support the conclusion that the preproductive period of wine grape vines in Region X is two years or less for purposes of determining the nationwide weighted average preproductive period of wine grape vines. The taxpayers misconstrue their evidence in two respects.

First, the taxpayers calculate the preproductive period by counting the number of annual growing cycles completed rather than the calendar time elapsed. For example, the taxpayers produce evidence of a winery in Region X that planted grapes in 1980 and achieved a first “small harvest” in 1982. Assuming *arguendo* that the 1982 harvest constituted a marketable crop that ended the preproductive period, the period from the 1980 spring planting and the 1982 autumn harvest constitutes two complete annual growing cycles (1980 - 1981 and 1981 - 1982), but is greater than two calendar years. Similarly, the taxpayers produce evidence of another vineyard that planted grape vines in 1997 and achieved a first harvest in 1999. Again, assuming *arguendo* that the Year 9 harvest constituted a marketable crop that ended the preproductive period, the period between planting and the first harvest is two complete annual growing cycles, but is in excess of two calendar years.

Second, the taxpayers apparently fail to include in the preproductive period the time elapsed between the grafting of the varietal grape onto the rootstock and the planting of the resulting plant in the field. If the vineyards in the preceding paragraph were planted with one year old grafted vines, as is common, the preproductive period of each vineyard would be increased by an additional calendar year or by an additional growing season. Thus, the preproductive periods of these vineyards would be at least three years, even if the first harvest constituted a marketable crop or yield, and even when computed under the taxpayers’ method of counting completed growing seasons.

The taxpayers submit a contract between themselves and a winery. Under this contract, the taxpayers agree to plant a specified acreage of a particular variety of grape in Year 7 (not Year 8 as the taxpayers state in their argument), and the winery agrees to purchase the entire output of such acreage beginning with the harvest in Year 10, estimated to be approximately R tons from S acres of vines, or approximately T tons per acre. Assuming *arguendo* that the projected Year 10 harvest would be a marketable crop, the period from planting in the spring of Year 7 until the harvest in the fall of Year 10 constitutes three complete growing cycles (Year 7-Year 8, Year 8-Year 9, Year 9-Year 10) and is in excess of two calendar years, even without considering any time elapsed between the grafting of the vine and the planting of the vine in the field.

The United States Department of Agriculture has furnished the Internal Revenue Service with information indicating that grapes vines do not begin to produce in commercially significant quantities until the fourth year after planting.

Based upon the supplied information, it is appropriate to conclude that the nationwide weighted average preproductive period for wine grape vines is in excess of two years. Accordingly, the taxpayers' production of wine grape vines is not exempt under § 263A(d)(1)(A)(ii) from § 263A.

ISSUE 2: For purposes of determining the actual preproductive period for cost capitalization under § 263A, did the taxpayers produce a marketable quantity of wine grapes in Year 4, Year 5, or Year 6?

Section 263A(e)(3)(A)(i) provides that, for purposes of § 263A, the preproductive period of a plant having more than one crop or yield is the period before the first marketable crop or yield from such plant.

Section § 1.263A-4T(c)(4)(ii)(A)(1) provided that the preproductive period of a plant having more than one crop or yield is the period before the first marketable crop or yield from such plant.

Section § 1.263A-4T(c)(4)(ii)(B) provided that the preproductive period of a plant begins when the plant or seed is first planted or acquired by the taxpayer. The preproductive period ends when the plant become productive in marketable quantities or when the plant is reasonably expected to be sold or otherwise disposed of.

No authorities have been located that directly discuss when a plant becomes productive in marketable quantities for purposes of § 1.263A-4T(c)(4)(ii)(B). However, several rulings have considered the similar issue of when plants are sufficiently productive to be considered as being placed in service for purposes of depreciation. Although not directly on point, these rulings are somewhat helpful in determining when plants become productive in marketable quantities under § 1.263A-4T(c)(4)(ii)(B).

Section 1.46-3(d)(2) provides that fruit-bearing trees and vines shall not be considered in a condition or state of readiness and availability for a specifically assigned function until they have reached an income-producing stage. For purposes of § 1.46-3(d)(2), 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. This 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. The yield of nuts must be more than de minimis, but may be less than expected at the age of maximum bearing capacity. Rev. Rul. 71-488, 1971-2 C.B. 60.

Trees comprising a timber producer's seed orchard that are used to produce genetically superior seedlings for the producer's timber growing operation are placed in service when they bear cones in a quantity sufficient to warrant harvesting for seed. Rev. Rul. 78-264, 1978-2 C.B. 9.

In Ribbon Cliff Fruit Company v. Commissioner, 12 B.T.A. 13, 15 (1928), the apple trees in the taxpayer's locality began to bear fruit in the fourth year after planting, produced a commercial crop in the twelfth year after planting, reached their maximum bearing capacity in the eighteenth year after planting, and maintained this maximum capacity through their twenty-eighth year, after which they were no longer economically viable as producers. The Board of Tax Appeals concluded that the useful life of the apple trees began in their twelfth year, when they first bore a commercial crop, and ended in their twenty-eighth year, when they were no longer commercially viable.

Taken together, the foregoing authorities establish that a plant becomes productive in marketable quantities under § 1.263A-4T(c)(4)(ii)(B) when a crop or yield is harvested that is more than de minimis, although it may be less than expected for the plant at maximum bearing stage. Determining whether a crop or yield is de minimis requires consideration of all relevant factors, including the physical quantity produced, the revenues resulting from the crop relative to the costs of production, and the time elapsed since permanent planting.

A marketable quantity under § 1.263A-4T(c)(4)(ii)(B) must be more than a de minimis physical quantity. This determination is generally made by comparing the annual productivity of a plant in the year in question with the expected annual productivity of the plant at its full maturity. If the annual production of a plant is de minimis in relation to the annual production expected at maturity, the plant is still in its preproductive period.

"Marketable quantity" cannot be interpreted to mean *any* physical quantity so long as it can be sold. This construction would have the anomalous result of closing the preproductive period with the production of one item if that item could be sold. The production of a de minimis amount should not close the preproductive period simply because the amount can be sold. Accordingly, the fact that a crop or yield was sold does not, in itself, establish that a marketable quantity was produced under § 1.263A-4T(c)(4)(ii)(B).

The fact that the revenues from selling a crop or yield exceed the direct costs of harvesting that crop or yield does not, in itself, establish that a marketable quantity was produced under § 1.263A-4T(c)(4)(ii)(B). A trade or businesses must do more than cover selected direct costs of production; it must generate sufficient revenue to pay all of its direct and indirect costs and, if possible, return a profit. Accordingly, simply producing enough harvest revenues to cover direct harvest expenses does not establish that an operation has entered its productive phase.

A marketable quantity under § 1.263A-4T(c)(4)(ii)(B) must generate sufficient revenues both to cover the direct costs of its harvest and to contribute more than a de minimis amount towards recovering the direct and indirect costs of producing the plants and the crop or yield. Generation of such revenue demonstrates that the plants have become sufficiently productive to constitute a potentially sustainable farming business.

The taxpayers claim that regulations and case law state that a crop is marketable under § 1.263A-4T(c)(4)(ii)(B) when the income from that crop exceeds the direct costs of harvest, but they have not furnished such authorities. The taxpayers also rely upon the IRS Market Segment Specialization Program ("MSSP") Paper for the Wine Industry. They point to an excerpt from page 3, which states: "It takes a period of two to three years from the time of planting to produce a 'commercially harvestable crop.' This term generally means when the crop is substantial enough where sales proceeds will exceed the cost of harvest. This is an important factor in that it determines when the vines are 'placed in service.'"

Initially, we note that any MSSP Paper, as part of the Internal Revenue Manual, is not promulgated pursuant to any mandate or delegation of authority by Congress and lacks the force and effect of law. The Service is not bound by contents of the IRM. First Federal Savings and Loan Association of Pittsburgh v. Goldman, 644 F. Supp. 101 (D.C. Pa. 1986); M.R. Notaro, 93-1 USTC ¶ 50,030; Thompson Electric, Inc. v. Commissioner, T. C. Memo. 1995-292.

By its own terms, moreover, the MSSP Paper excerpt does not purport to define when cost capitalization under § 263A should end; rather, it defines when a crop is "harvestable" for commercial purposes. Determining when it is profitable to harvest a crop from plants involves different considerations from those used in determining when the plants have become sufficiently productive that their costs need no longer be capitalized under § 263A. The decision whether to harvest focuses primarily on the incremental revenues and costs of performing or omitting the harvest. The decision whether to close the preproductive period focuses on whether the plants are sufficiently mature and productive that further expenditures should be considered period costs or costs of a future crop or yield, rather than a capital investment in the plants.

The determinations whether to harvest and whether to capitalize can occur quite independently of each other. A plant with highly-valued fruit, for example, may produce a very minor crop that is worth harvesting because the harvest revenues, although not large, are greater than the harvest costs. Nonetheless, the plant may still be so immature that the production costs for that period should be capitalized and depreciated over the future productive life of the plant. Conversely, a plant can be sufficiently mature that its preproductive period is closed, but may produce so poor a crop or yield that it is not commercially "harvestable" in that year.

According to a study by the University of State Y, the expected annual yield from a mature Variety Z vineyard in Region X, where the taxpayers farm, is approximately U tons per acre. This is a relatively conservative standard for comparison because it is based upon a vineyard planted with V vines per acre, whereas the taxpayers planted their vineyard with approximately W vines per acre, approximately a 25% greater density. The taxpayers have A acres of grapes, and the expected annual yield of their vineyard at maturity would be AA tons, if planted at V vines per acre as in the University of State Y study.

In Year 4, the taxpayers harvested B tons of grapes, which is approximately 3.3% of the expected yield of the vineyard at maturity when planted at V vines per acre. In Year 5, the taxpayers harvested F tons of grapes, which is approximately 3.9% of the expected yield of the vineyard at maturity when planted at V vines per acre. In Year 6, the taxpayers harvested K tons, which is approximately 31.7% of the expected yield of the vineyard at maturity when planted at V vines per acre. The Year 4 and Year 5 amounts are clearly de minimis in relation to the expected mature yield; the Year 6 amount is more than de minimis in relation to the expected mature yield.

The grape vines did not produce sufficient revenues in Year 4 or Year 5 to make more than a de minimis contribution towards recovering the direct and indirect costs of their production. In Year 4, harvest revenues were $A, depreciation was $D, and other expenses were $E. In Year 5, harvest revenues were $B, depreciation was $F, and other expenses were $G. In Year 6, harvest revenues were $C, depreciation was $H, and other expenses were $J. The purchaser absorbed the costs of harvesting (approximately $K) in Year 4, while the taxpayers paid the costs of harvesting in Year 5 and Year 6.

After adjusting for the different treatment of harvest costs, the Year 4 harvest revenue was 6.8% of total period expenses and 3.8% of total period expenses exclusive of depreciation. The Year 5 harvest revenue was 2.3% of total period expenses and 3.8% of total period expenses exclusive of depreciation. The Year 6 harvest revenue was 12.2% of total period expenses and 19% of total period expenses exclusive of depreciation. The grape vines clearly did not make more than a de minimis contribution toward the total costs of the farming business of the taxpayers in Year 4 or Year 5. The grape vines did make more than a de minimis contribution in Year 6, even though the overall farming business was still unprofitable in that year.

In sum, the production of the vineyard was de minimis in Year 4 and Year 5, whether measured in terms of physical production or revenue generation. Accordingly, the vineyard did not achieve a marketable crop until the Year 6 harvest, when the actual preproductive period of the vines ended.

ISSUE 3: Does the actual preproductive period for cost capitalization under § 263A end at the harvest of the first marketable quantity of wine grapes or at the beginning of the annual growing cycle that produces such a harvest?

Section 263A(e)(3) provides that, in the case of a plant which will have more than one crop or yield, the term “preproductive period” means the period before the first marketable crop or yield from such plant.

Section 1.263A-4T(c)(4)(ii)(A)(1) provided that, in the case of a plant or animal which will have more than one crop or yield, the preproductive period of property produced in a farming business means the period before the first marketable crop or yield from such plant.

Section 1.263A-4T(c)(4)(ii)(B) provided that the preproductive period of a plant ends when the plant becomes productive in marketable quantities or when the plant is reasonably expected to be sold or otherwise disposed of.

Section § 1.263A-4T(c)(4)(ii)(C) provided that the preproductive period of an animal ends at the time the animal is ready to perform the primary function intended to be performed by that animal (e.g., when the animal becomes productive in marketable quantities), or when the animal is reasonably expected to be sold or otherwise disposed of. For example, in the case of a cow used for breeding purposes, the preproductive period with respect to the cow ends on the date the first calf is dropped.

The taxpayers argue that the actual preproductive period should not end with the harvest of the first marketable crop; rather, it should end at the beginning of the annual growing cycle that produces such crop. In effect, the taxpayers suggest that the actual preproductive period should be delimited and applied in terms of crop production cycles rather than calendar days.

Under the taxpayers’ theory, if their vineyard produced its first marketable crop in October of Year 6, the preproductive period of the vineyard would end with the October Year 5 harvest, which, the taxpayers assert, marks the beginning of the production cycle for the Year 6 crop. Production costs incurred after the Year 5 harvest would be deducted as period costs or capitalized into the Year 6 crop, as appropriate. If, however, the vineyard did not produce a marketable crop in October of Year 6, the preproductive period would not end with the October of Year 5 harvest, and all production costs in Year 5 would be capitalized into the vines.

The theory suggested by the taxpayers is not consistent with the language of the applicable statute and regulations. Section 263A(e)(3) and § 1.263A-4T(c)(4)(ii)(A)(1) both define the actual preproductive period as the period before the first marketable crop or yield, rather than the period before the first productive growing cycle. Section 1.263A-4T(c)(4)(ii)(B) states that the actual preproductive period of a plant ends when the plant “becomes productive” in marketable quantities, which indicates that the plant must have completed production of the marketable quantity before the actual preproductive period closes. The most natural reading of these authorities is that the first marketable crop or yield is an event occurring at some point in time, and this point in time is the end of the preproductive period.

This reading is further supported by the analogous provisions of § 1.263A-4T(c)(4)(ii)(C) regarding the preproductive period of animals. This regulation specifically states that the preproductive period of a cow used for breeding purposes ends when the first calf is dropped, which corresponds to the actual harvesting of a marketable quantity from a plant, and not when gestation of the calf commences, which would correspond to the beginning of the production cycle of a marketable quantity.

The taxpayers' theory also creates considerable practical difficulties where the crop production cycle of a plant with multiple crops or yields spans two or more taxable years. A farmer preparing a return for a given year (1998, for example) often will not know whether the growing cycle commenced in that year will ultimately produce a marketable crop in the subsequent year (1999), yet such knowledge is required under the taxpayers' theory to determine the proper tax treatment of costs incurred for the production cycle within 1998. In such situations, the farmer would simply be required to guess regarding the events of 1999 in order to prepare the return for 1998.

This anomalus result is not required if the first productive harvest is treated as the end of the preproductive period of a plant. Under such treatment, the events of a taxable year are always sufficient in themselves to determine the correct tax treatment of production costs incurred within such year, and the farmer is never required to guess regarding events in subsequent tax years.

The taxpayers' theory is also inconsistent with the annual accounting concept that is a fundamental and longstanding principle of federal income taxation. Under this concept, taxes are calculated and assessed on the basis of annual tax accounting periods rather than completed transactions or production cycles. An event that spans multiple tax accounting periods is taken into account in one or more of those periods according to the tax accounting methods of the taxpayer. The items taken into account in each such period are generally determined by events occurring within that period, without regard to events occurring in other periods. Burnet v. Sanford & Brooks Co., 282 U.S. 359 (1931).

Under the theory advanced by the taxpayers, the tax treatment of production costs in each accounting period is not determined solely by events within such period. Rather, the characterization of costs in a given year would be determined not by events in that year, but by the outcome of the harvest in the subsequent year. In effect, the taxpayers' theory would account for costs on the basis of production cycles rather than tax accounting periods, which does not comport with the annual accounting concept. By contrast, treating the harvest of the first marketable crop or yield as the end of the preproductive period of a plant with multiple crops or yields is perfectly consistent with the annual accounting concept. Under such treatment, the correct tax characterization of production costs incurred during the year is always determinable by reference to the events of the year.

For the foregoing reasons, we conclude that the actual preproductive period of wine grape vines under § 263A ends at the harvest of the first marketable crop, rather than the beginning of the annual growing cycle that produced such harvest.

ISSUE 4: Did the taxpayers make an effective election under § 263A(d)(3)(D) such that § 263A does not apply to their production of wine grape vines?

Section 263A(d)(3)(A) provides that if a taxpayer makes an election under § 263A(d)(3), § 263A shall not apply to any plant produced in any farming business carried on by such taxpayer.

Sections 263A(d)(3)(B) and (C) provide that certain taxpayers and activities are not eligible for the election under § 263A(d)(3).

Section 263A(d)(3)(D) provides that, unless the Secretary otherwise consents, an election under § 263A(d)(3) may be made only for the taxpayer's first taxable year which begins after December 31, 1986, and during which the taxpayer engages in a farming business.

Section 263A(e)(2)(A) provides that if a taxpayer makes an election under § 263A(d)(3), the provisions of § 168(g)(2), relating to alternative depreciation, shall apply to all property of the taxpayer and any related person under § 263A(e)(2)(B) used predominantly in the farming business and placed in service in any taxable year during which such election is in effect.

Section 1.263A-4T(c)(6)(i) permitted certain taxpayers to make an election not to have the rules of § 1.263A-4T(c)(6) apply to any plant or animal produced in a farming business conducted by the electing taxpayer.

Section 1.263A-4T(c)(6)(iii) provided that unless consent is obtained from the Commissioner of Internal Revenue, the election described in § 1.263A-4T(c)(6) may only be made for the taxpayer’s first taxable year that begins after December 31, 1986, and during which the taxpayer engages in a farming business.

Section 1.263A-4T(c)(6)(iv) provided that a taxpayer eligible to make the election under § 1.263A-4T(c)(6) shall be treated as having made the election if such taxpayer does not capitalize the costs of producing property in a farming business as the provisions of § 1.263A-4T would otherwise require.

Section 1.263A-4T(c)(6)(iv)(B) provided that if the taxpayer makes the election under § 1.263A-4T(c)(6), the alternative depreciation system (as defined in § 168(g)(2))

("ADS") shall be applied to all property used predominantly in any farming business of the taxpayer or related person and placed in service in any taxable year during which the election is in effect.

Notice 87-76, 1987-2 C.B. 384, provides that the consent of the Commissioner is granted to any otherwise eligible taxpayer to make an election under § 263A(d)(3) for the first taxable year during which the taxpayer produces property to which the provisions of § 263A apply, although such year may be subsequent to the general effective date of § 263A.

Notice 87-76 further provides that in order for a taxpayer to be treated as having made an election under § 263A(d)(3) by reporting income and expenses in accordance with the rules under the election, it is necessary to report both income and expenses in accordance with the rules contained in § 1.263A-1T(c) (subsequently redesignated as § 1.263A-4T(c)), including use of ADS under § 168(g)(2). Notice 87-76 specifically states that a farmer who continues to expense production costs otherwise required to be capitalized under § 263A but fails to use ADS for applicable property placed into service has not made an election under § 263A(d)(3) and thus is not in compliance with the provisions of § 263A.

Determining whether the taxpayers made an effective election under § 263A(d)(3) raises two distinct issues: first, when were the taxpayers required to make the election; and, second, did the taxpayers comply with the requirements for an effective election at such time.

With respect to the first issue of when the election must be made, § 1.263A-4T(c)(6)(iii) provided that a taxpayer must make an election under § 263A(d)(3) in the first taxable year during which the taxpayer engages in a farming business. Notice 87-76, however, provides the automatic consent of the Commissioner to make an election under § 263A(d)(3) in the first taxable year during which the taxpayer produces property to which § 263A applies, even if the taxpayer had previously engaged in a farming business without being subject to § 263A.

The taxpayers began their farming business in Year 2, when they started preparing their land for the installation of the vineyard. The taxpayers first incurred costs subject to § 263A when the preproductive period of the vines commenced, which occurred when the vines were first acquired or planted. § 1.263A-4T(c)(4)(ii)(2)(B). The vines were purchased in Year 2 or Year 3 (the submitted information is unclear on this point), and were planted in Year 3.

Under § 1.263A-4T(c)(6)(iii) and Notice 87-76, the first taxable year in which the taxpayers could make the election under § 263A(d)(3) was the year in which the taxpayers acquired the vines, either Year 2 or Year 3.

With respect to the second issue of how an election under § 263A(d)(3) is made, § 1.263A-4T(c)(6)(iii) provides that a taxpayer may make the election by including an express statement to that effect on the return for the tax year of the election. Alternately, a taxpayer may make an implicit election by failing to capitalize the costs of producing property in a farming business as the provisions of § 263A would otherwise require. § 1.263A-4T(c)(6)(iv). In either case, the electing taxpayer is required to abide by the requirements of § 263A(e), including the use of ADS with respect to all depreciable property placed in service in the farming business during an election year. § 1.263A-4T(c)(6)(vi).

In Year 2, the taxpayers prepared the soil for the installation of the vineyard, and they may have purchased the vines. The taxpayers did not claim any deductions for their farming business for Year 2 and did not include a Schedule F in their return for that year. Accordingly, the taxpayers did not make an implicit election under § 263A(d)(3) in Year 2. The taxpayers either incurred no costs subject to capitalization under § 263A or they incurred costs subject to § 263A and failed to deduct them.

In Year 3, the taxpayers planted the vines and began the normal activities necessary to cultivate them. The taxpayers did not claim any deductions related to their farming business in Year 3 and did not include a Schedule F in their return for that year. Accordingly, the taxpayers did not make an implicit election under § 263A(d)(3) in Year 3 because they failed to deduct numerous costs, such as vine pruning and maintenance, that were subject to capitalization under § 263A.

In Year 4, the taxpayers filed a Schedule F with their return. They deducted costs incurred in association with the vineyard during Year 4. The grape vines and other vineyard assets were placed in service. The taxpayers depreciated the vines over a 20-year recovery period as required by ADS (§ 168(e)(3)(D)(ii), (g)(3)(B)), but utilized the 150% declining balance method rather than the straight-line method required by ADS (§ 168(g)(2)(A)). Most of the other vineyard assets were depreciated using the 150% or 200% declining balance methods rather than the straight-line method required by ADS.

The deduction of § 263A costs in Year 4 did not constitute a valid election under § 263A(d)(3). Section 1.263A-1T(c)(6)(iii) and Notice 87-76 provide that the election under § 263A(d)(3) must be made in the first year in which it can be made. The first year in which the taxpayers could have made the election was either Year 2 or Year 3, depending upon when the taxpayers first incurred preproductive costs, and the taxpayers did not make an explicit or implicit election in either year. Accordingly, the taxpayers were no longer eligible to make an election under § 263A(d)(3) in Year 4 or thereafter.

Having failed to make a timely election under § 263A(d)(3)(D) in Year 2 or Year 3, the taxpayers have lost their right to make this election without the consent of the

Commissioner. The § 263A(d)(3) election is a method of accounting under § 446. Accordingly, in order to obtain the consent of the Commissioner to make an election under § 263A(d)(3), a taxpayer must file a Form 3115, Application for Change in Accounting Method, to request the Commissioner's consent to change its method to the § 263A(d)(3) election. No Form 3115 was filed by the taxpayers.

Further, the failure of the taxpayers to use ADS in depreciating their vineyard assets is sufficient in itself to preclude an effective § 263A(d)(3) election. Section 263A(e)(2) mandates that taxpayers maintaining an election under § 263A(d)(3) must use ADS for property that is predominantly used in the farming business and is placed in service in an election year. *See also* General Explanation of the Tax Reform Act of 1986, 515. Notice 87-76 clarifies that the use of ADS mandated by § 263A(e)(2) is a continuing condition for a valid election under § 263A(d)(3) election.

The taxpayers failed to comply with the requirement to use ADS as required by § 263A(e)(2), and thus did not make an effective election under § 263A(d)(2). Accordingly, even if the taxpayers had otherwise complied with the requirements for a timely § 263A(d)(3) election in Year 2 or Year 3 by deducting preproductive period costs, they would still not have made an effective election because they failed to use ADS as required by § 263A(e)(2).

In sum, the taxpayers did not make an effective election out of § 263A under § 263A(d)(3).

A copy of this technical advice memorandum is to be given to the taxpayers. Section 6110(k)(3) provides that it may not be used as precedent.