INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

April 6, 1999

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CASE MIS No.: TAM-121607-98
CC:DOM:IT&A:B7

Number: **199929001**
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District Director

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No:
Years Involved:
Date of Conference:

LEGEND:

Variety 1 =
Variety 2 =
Variety 3 =
Variety 4 =

Region X =
State Y =

Year 1 =
Year 2 =
Year 3 =
Year 4 =
Year 5 =

a =
b =
c =
d =
e =
f =
g =
h = _____
j =

k =
m =

$A =
$B =
$C =
$D =
$E =
$F =
$G =

ISSUE(S):

1. For purposes of determining whether the costs of producing fig trees must be capitalized under § 263A, is the nationwide weighted average preproductive period of fig trees greater than 2 years?

2. For purposes of ending the actual preproductive period for cost capitalization under § 263A, did the taxpayer produce a marketable quantity of figs in Year 3?

CONCLUSION:

1. The nationwide weighted average preproductive period for fig trees is more than 2 years.

2. The taxpayer did not produce a marketable crop of Variety 1, Variety 2, or Variety 3 figs in Year 3. Sufficient information was not provided to determine whether the taxpayer produced a marketable crop of Variety 4 figs in Year 3.

FACTS:

The taxpayer, a partnership, operates a fig orchard in Region X of State Y. The orchard was planted in December of Year 1 and January of Year 2. It consisted of a acres of Variety 1 fig trees, b acres of Variety 2 fig trees, c acres of Variety 4 fig trees , and d acres of Variety 3 fig trees. The trees were planted approximately 155 trees per acre.

The Variety 3 fig trees were first harvested in August of Year 3. They produced e pounds of merchantable dried fruit, a yield of f pounds per acre. The fruit was sold for $A. The direct costs of harvesting the fruit were $B.

The Variety 4 fig trees were also first harvested in August of Year 3. They produced g half-baskets of fruits. A half-basket of fruit weighs approximately 6 pounds, resulting in a harvest weight of h pounds and a yield rate of j pounds per acre. The fruit

was sold for $C to an independent harvester that absorbed all of the harvesting costs.

The Year 3 Schedule F Gross Income for the entire orchard was $D, and total expenses were $E, with depreciation of $F.

The Variety 2 and Variety 1 fig trees were not harvested in Year 2 or Year 3.

LAW AND ANALYSIS:

ISSUE 1: For purposes of determining whether the costs of producing fig trees must be capitalized under § 263A, is the nationwide weighted average preproductive period of fig trees more than 2 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 that is produced by a taxpayer in a farming business.

Section 263A(e)(4)(B)(ii) provides that, for purposes of § 263A, the term “farming business” includes the trade or business of raising or harvesting of trees bearing fruit, nuts, or other crops.

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 1 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.

Temporary Regulation § 1.263A-4T(c)(4)(ii)(D) provides that, for purposes of determining whether a plant has a preproductive period in excess of two years, 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. The nationwide weighted average preproductive period is used only for purposes of determining whether the preproductive period of a plant is greater than 2 years.

Growing fig trees is the production of property. As such, it is subject to cost capitalization under § 263A(a), unless it is exempt from § 263A under § 263A(d)(1)(A)(ii) as the production of a plant with a preproductive period of two years or

less. Figs trees 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 fig trees is the nationwide weighted average preproductive period for fig trees. § 263A(e)(3)(B). Taxpayer is thus subject to § 263A with respect to its production of fig trees unless the nationwide weighted average preproductive period of fig trees is two years or less.

Inherent in the notion of a nationwide average is the expectation that some producers will be above the average and some producers will be below the average. By expressly specifying the use of a nationwide average in § 263A(d)(1)(A)(ii), Congress determined that all producers of a particular plant should be treated uniformly with respect to whether cost capitalization under § 263A is required.

Thus, if the nationwide weighted average preproductive period for fig trees were in excess of two years, all fig growers would be subject to § 263A, including those producers, if any, whose fig trees had preproductive periods of two years or less. Conversely, if the nationwide weighted average preproductive period for fig trees were two years or less, all fig growers would be exempted from § 263A, including those producers, if any, whose fig trees had preproductive periods in excess of two years.

The taxpayer and the agent have produced and discussed various items of evidence regarding the preproductive period of fig trees. This evidence, however, relates predominantly to the production of Variety 3 fig trees in Region X of State Y, the immediate locality of the taxpayer. As such, it has limited value in determining the weighted average preproductive period for all types of fig trees on a nationwide basis.

Further, the evidence produced generally lacks the detail necessary to determine the exact beginning and end of the preproductive periods of the fig trees described. The preproductive period of a fig tree begins when the plant is propagated. Thus, the time between propagation and planting of fig trees must be included in their preproductive period, but the evidence often does not specify the age of the fig trees planted. Similarly, the preproductive period of a fig tree ends when the first marketable crop or yield is produced. The evidence often states only that a crop was produced in a particular year after planting.

In two examples, the taxpayer improperly measures the preproductive period. Instead of using calendar days, the taxpayer measures by indivisible tax years, in which the events that begin and end the preproductive period are deemed to occur on the first day of the year.

First, the taxpayer produces evidence that an orchard of nine month old, hot house cultured Variety 3 fig trees was planted in March of Year 3, and a marketable crop was first harvested in the fall of Year 5. The preproductive period of this orchard is two years or less only if (1) the years are treated as indivisible units, such that Year 5 would

be entirely a productive year, and Year 3 and Year 4 would thus be preproductive years; and (2) the nine month cultivation period in the hot house is disregarded. Neither condition is appropriate. The period between March of Year 3 and the fall of Year 5 should be measured in terms of calendar length; by such measure, it exceeds two years. Further, the nine month cultivation period in the hot house preceding the March, Year 3 planting in the permanent grove must be included in the preproductive period.

Second, the taxpayer relies upon a University of State Y study of fig production in Region X, which states that fig trees generally begin bearing an "economic crop" in the third year after planting. Taxpayer equates "economic crop" in the study with a marketable crop or yield for purposes of § 1.263A-4T(e)(3)(A)(I), and argues that the preproductive period of fig trees is two years because their third year is productive. However, the harvesting of the marketable crop occurs within the third year, and thus the study describes a preproductive period that exceeds two years as measured in calendar length.

When measured under the correct calendar days method, the preproductive periods in both of these examples exceed two years. Accordingly, they are not evidence that the nationwide weighted average preproductive period of fig trees is two years or less.

The Department of Agriculture has furnished the Service with information indicating that fig trees do not begin to produce in commercially significant quantities until the sixth year after planting.

Based on the supplied information, it is appropriate to conclude that the nationwide weighted average preproductive period for all varieties of fig trees is in excess of two years. Accordingly, the taxpayer's production of fig trees is not exempt under § 263A(d)(1)(A)(ii) from the cost capitalization provisions of § 263A.

ISSUE 2: For purposes of ending the actual preproductive period for cost capitalization under § 263A, did the taxpayer produce a marketable quantity of figs in Year 3?

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.

Temporary Regulation § 1.263A-4T(c)(4)(ii)(A)(1) provides 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.

Temporary Regulation § 1.263A-4T(c)(4)(ii)(B) provides 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 into 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).

Regulation § 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 minimus, 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.

A marketable quantity under § 1.263A-4T(c)(4)(ii)(B) means something more than a de minimus crop or yield. Generally, the annual productivity of a plant is compared with the expected annual productivity of the plant at its full maturity. If the annual production is of a plant is de minimus in relation to the annual production expected at maturity, the plant is still in its preproductive period.

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). "Marketable quantity" cannot be interpreted to mean any 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 minimus amount should not close the preproductive period simply because it could be sold.

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). This interpretation would also result in closing the preproductive period if the taxpayer harvested and sold a single item at a price greater than the direct cost of harvesting the item. Further, a productive trade or business 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.

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

The fact that production of a plant is not profitable, on a financial accounting or tax accounting basis, during a particular tax year does not, in itself, preclude the production of a "marketable crop" from that plant during that year. Profitability is affected by many variables unrelated to the productive capacity of the plants, such as weather, commodity prices and plant diseases and pests.

The taxpayer planted 4 varieties of fig trees. The Variety 1 and Variety 2 fig trees apparently produced no harvested fruit at all during Year 3, so they were clearly still within their respective preproductive periods in that year. The Variety 4 trees did produce a harvest in Year 3. However, no information has been supplied regarding the productive capacity of these trees, so no opinion can be expressed whether the yield of these trees in Year 3 represents a marketable quantity.

The Variety 3 fig trees produced a Year 3 crop of e pounds of fruit, representing f pounds per acre. This is less than one-third of what the University of State Y considered an "economic crop" yield of k pounds per acre, which typically does not occur until the third year after planting. Further, it is approximately 2.4% of the mature yield of m pounds per acre. Two percent of a mature yield must be considered a de minimus amount rather than a marketable quantity, and it is insufficient to establish that the fig trees ended their preproductive period in Year 3.

The Year 3 Variety 3 crop generated revenues of $A, against $B of direct harvesting costs. The fact that the crop was sold does not, in itself, establish that a marketable quantity was produced. The fact the sales revenue from the crop exceeded its direct harvesting costs by a modest $G does not, in itself, establish that a marketable quantity was produced.

More significantly, the Year 3 Variety 3 crop made only a de minimus contribution towards recovering the expenses incurred in establishing the Variety 3 orchard, and as such was not characteristic of a potentially sustainable farming business. This conclusion is evident from the results of the overall business for Year 3. The combined revenues from the Variety 3 and Variety 4 fig harvests in Year 3 are only 2.6% of the total Schedule F expenses for Year 3, and 3.4% of total Schedule F expenses exclusive of depreciation for Year 3.

In sum, the Variety 3 harvest produced during Year 3 was de minimus both as a fraction of the mature productive capacity of the Variety 3 fig trees and as a contribution towards recovery of the costs of producing the Variety 3 fig trees and the Year 3 Variety 3 crop. Accordingly, the Variety 3 fig trees were still in their preproductive period during Year 3.

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