## Section 263A.—Capitalization and Inclusion in Inventory Costs of Certain Expenses

*26 CFR 1.263A–4T: Rules for property produced in a farming business (temporary).*

# T.D. 8729

## DEPARTMENT OF THE TREASURY
## Internal Revenue Service
## 26 CFR Part 1

## Rules for Property Produced in a Farming Business

AGENCY: Internal Revenue Service (IRS), Treasury

ACTION: Final and temporary regulations.

SUMMARY: This document contains final and temporary regulations relating to the application of section 263A of the Internal Revenue Code to property produced in a farming business. These regulations affect certain taxpayers engaged in the trade or business of farming. These regulations are necessary to provide guidance with respect to section 263A(d).

The text of the temporary regulations also serves as the text of REG–208151–91 on page 21 of this Bulletin.

DATES: These regulations are effective August 22, 1997. For dates of applicability, see §1.263A–4T(f) of these regulations.

FOR FURTHER INFORMATION CONTACT: Jan Skelton, (202) 622-4970 (not a toll-free call).

SUPPLEMENTARY INFORMATION:

*Background*

Prior to the enactment of section 263A, the rules that governed the deduction or capitalization of costs incurred with respect to property produced in the trade or business of farming were set forth in several different statutory and regulatory provisions. Costs regarded as preparatory expenditures were required to be capitalized under section 263. Preparatory expenditures are expenditures incurred prior to raising agricultural or horticultural commodities or that otherwise enable a farmer to begin the farming process. See, e.g., Rev. Rul. 83–28, 1983–1 C.B. 47. Preparatory expenditures include the costs of clearing land, leveling and grading land, drilling and equipping wells, acquiring irrigation systems, acquiring seeds or seedlings, budding trees, and acquiring animals.

Costs regarded as developmental expenditures (sometimes referred to as cultural practices expenditures) were generally permitted to be deducted, or, at a taxpayer's election, could be capitalized. See, e.g., *Wilbur v. Commissioner,* 43 T.C. 322 (1964), acq., 1965–2 C.B. 7. Developmental expenditures are those expenditures incurred by a taxpayer so that the growing process may continue in the desired manner. Developmental expenditures are expenditures that, if incurred while the plant or animal was in a productive state, would be deductible. See, *Maple v. Commissioner,* 27 T.C.M. 944 (1968), *aff'd,* 440 F.2d 1055 (9th Cir. 1971). Developmental expenditures include the costs of irrigating, fertilizing, spraying, cultivating, pruning, feeding, providing veterinary services, rent on land, and depreciation allowances on irrigation systems or structures.

Former sections 278 and 447 provided special rules requiring the capitalization of certain developmental expenditures. Former section 278(a) provided special rules for citrus and almond groves. Under former section 278(a), all otherwise deductible costs of developing citrus or almond groves incurred before the end of the fourth taxable year after permanent planting were required to be capitalized. Rev. Rul. 83–128, 1983–2 C.B. 57, clarified that the costs incurred prior to permanent planting were also required to be capitalized.

Former sections 278(b) and 447(b) provided special rules for farming syndicates, corporations, and partnerships with a corporate partner. Section 447 requires certain corporations and partnerships with a corporate partner to use an accrual method of accounting (accrual method). Former section 447(b) required these taxpayers to capitalize preproductive period expenses. Preproductive period expenses were defined as any expenses attributable to crops, animals, trees, or other property having a crop or yield and that are incurred during the preproductive period of such property. Soil and water conservation expenditures, as defined in section 175, and land-clearing expenditures as defined in former section 182, are preproductive period expenses if they are incurred in a preproductive period of an agricultural or horticultural activity and if the taxpayer elects to deduct these expenses rather than capitalize them. House Comm. on Ways and Means, Tax Reform Act of 1975, H.R. Rep. No. 94–658, 94th Cong., 1st Sess. 93 (1975).

In the case of a farming syndicate engaged in planting, cultivating, maintaining, or developing an orchard, vineyard, or grove, former section 278(b) required the capitalization of all otherwise deductible expenditures incurred with respect to the orchard, vineyard, or grove, if incurred prior to the first taxable year in which there was a crop or yield in commercial quantities.

Former section 278(c) provided a relief provision. Under this provision, sections 278(a) or (b) would not require the capitalization of developmental expenditures attributable to an orchard, vineyard, or grove that was replanted after having been lost or damaged by reason of freezing temperatures, disease, drought, pests, or casualty.

Section 263A, enacted in the Tax Reform Act of 1986, Pub. L. 99–514, 100 Stat. 2085, 1986–3 C.B. Vol. 1 (the 1986 Act), provides uniform capitalization rules that govern the treatment of costs incurred in the production of property or the acquisition of property for resale. Section 263A was enacted, in part, to prevent the inappropriate mismatching of income and expense that results from the current deduction of the costs of producing property. Section 263A generally incorporates and expands upon the rules set forth in several code and regulatory sections, including section 263, and former sections 278 and 447.

Section 263A(b) generally provides that the uniform capitalization rules apply to the taxpayer's production of real or tangible personal property. Section 1.263A–2(a)(1)(i) clarifies that for purposes of section 263A, produce includes the following: construct, build, install, manufacture, develop, improve, create, raise, or grow. Sections 263A(d) and (e) provide special rules for property produced in a farming business.

Section 263A, as enacted in 1986, generally required taxpayers to capitalize the costs of producing plants and animals. Taxpayers not required by section 447 or 448(a)(3) to use an accrual method were excepted from capitalizing the preproductive period costs of plants and animals (except animals held for slaughter) that had a preproductive period of 2 years or less. Section 263A was amended as part of the Omnibus Budget Reconciliation Act of 1987, Pub. L. 100–203, 101 Stat. 1330, 1987–3 C.B. Vol. 1 (the 1987 Act), the Technical and Miscellaneous Revenue Act of 1988, Pub. L. 100–647, 102 Stat. 3342, 1988–3 C.B. Vol. 1 (the 1988 Act), and the Omnibus Budget Reconciliation Act of 1989, Pub. L. 101–239, 103 Stat. 2106 (the 1989 Act). Under the 1988 Act, the scope of the exception for these taxpayers is expanded to include all animals irrespective of the length of the preproductive period.

In addition, taxpayers not required by section 447 or 448(a)(3) to use an accrual method may elect not to capitalize the costs of plants (other than certain costs of producing citrus and almond trees) with a preproductive period in excess of 2 years. If a taxpayer makes this election, the taxpayer must treat such plants as section 1245 property and upon disposition of these plants any amount allowable as a deduction that would, but for the election, have been capitalized must be recaptured and treated as a deduction allowed for depreciation with respect to such property. See section 263A(e)(1). Also, if the taxpayer makes the election, the taxpayer and related persons must apply the alternative depreciation system provided in section 168(g)(2) to all property used by the taxpayer or related person predominantly in a farming business and placed in service in any taxable year in which the election out of section 263A is in effect. See section 263A(e)(2).

On March 30, 1987, the IRS published in the **Federal Register** a notice of proposed rulemaking (52 FR 10118) by cross reference to temporary regulations published the same day (T.D. 8131, 52 FR 10052). Amendments to the notice of proposed rulemaking and temporary regulations were published in the **Federal Register** on August 7, 1987, by a notice of proposed rulemaking (52 FR 29391) that cross referenced to temporary regulations published the same day (T.D. 8148, 52 FR 29375). Notice 88–24, 1988–1 C.B. 491, provided that forthcoming regulations would modify the temporary regulations and the regulations under §1.471–6. Notice 88–86, 1988–2 C.B. 401, provided that forthcoming regulations would clarify the definition of a related person for purposes of the election out of section 263A. In addition, Notice 88–86 provided that forthcoming regulations would provide that certain taxpayers could elect to use the simplified production method for property used in the trade or business of farming. On August 5, 1994, the temporary regulations relating to property produced in a farming business were reissued and published in the **Federal Register** (T.D. 8559, 59 FR 39958). Because substantial changes are being made from the 1994 temporary regulations, the IRS and Treasury Department have decided to issue, in part, new proposed and temporary, rather than final, regulations.

*Explanation of Provisions*

*Property Produced In The Trade Or Business Of Farming*

The temporary regulations clarify that the special rules of section 263A(d) apply only to property produced in a farming business. The temporary regulations provide that for purposes of section 263A, the term farming means the cultivation of land or the raising or harvesting of any agricultural or horticultural commodity. Examples include the trade or business of operating a nursery or sod farm; the raising or harvesting of trees bearing fruit, nuts, or other crops; the raising of ornamental trees (other than evergreen trees that are more than six years old at the time they are severed from their roots); and the raising, shearing, feeding, caring for, training, and management of animals. The regulations clarify that for this purpose harvesting does not include contract harvesting of an agricultural or horticultural commodity grown or raised by another taxpayer. Accordingly, while a taxpayer that grows a plant may apply the special rules of section 263A(d) to the costs of growing and harvesting the plant, the special rules of section 263A(d) do not apply to a taxpayer that merely contract harvests agricultural or horticultural commodities grown or raised by another taxpayer. Similarly, the temporary regulations clarify that the special rules of section 263A(d) do not apply to a taxpayer that merely buys and resells plants or animals grown or raised by another. In evaluating whether a taxpayer is engaged in the production, or merely the resale, of plants or animals, it is anticipated that consideration will be given to factors including: the length of time between the taxpayer's acquisition of a plant or animal and the time the plant or animal is made available for sale to the taxpayer's customers, and, in the case of plants, whether plants acquired by the taxpayer are planted in the ground or kept in temporary containers.

The temporary regulations provide that a farming business does not include the processing of commodities or products beyond those activities that are incident to the growing, raising, or harvesting of such products.

*Preparatory And Developmental Costs*

The IRS and Treasury Department believe that, in general, section 263A does not change the rules regarding capitalization of costs during the preparatory period. Thus, the temporary regulations clarify that, as under prior law, taxpayers generally must capitalize preparatory expenditures, including the cost of seeds, seedlings, and animals; clearing, leveling and grading land; drilling and equipping wells; irrigation systems; and budding trees. However, because section 263A requires the capitalization of certain indirect costs as well as direct costs, the amount of preparatory expenditures capitalized may be greater under section 263A than under prior law.

Section 263A expands the circumstances under which costs that were once termed developmental expenditures must be capitalized. The temporary regulations clarify that costs that were, in years prior to the enactment of section 263A, regarded as developmental are included in the category of preproductive period costs. Section 263A generally requires the capitalization of preproductive period costs including the costs of irrigating, fertilizing, spraying, cultivating, pruning, feeding, providing veterinary services, rent on land, and depreciation allowances on irrigation systems or structures. Preproductive period costs also include real estate taxes, interest, and soil and water conservation expenditures incurred during the preproductive period of a plant.

Taxpayers that are required by section 447 or 448(a)(3) to use an accrual method must capitalize all preproductive period costs of plants (without regard to the length of the preproductive period) and animals. Taxpayers that are not required by section 447 or 448(a)(3) to use an accrual method qualify for an exception to this general rule. Under this exception, taxpayers are not required to capitalize preproductive period costs incurred with respect to animals, or with respect to plants that have a preproductive period of 2 years or less. Thus, under this exception, taxpayers are required to capitalize only those preproductive period costs incurred with respect to plants that have a preproductive period in excess of 2 years. The temporary regulations clarify that, for purposes of determining whether a plant has a preproductive period in excess of 2 years, in the case of a plant grown in commercial quantities in the United States, the nationwide weighted average preproductive period of such plant is used.

The IRS and Treasury Department are considering the publication of guidance with respect to the length of the preproductive period of certain plants that will have more than one crop or yield. At the present time, the IRS and Treasury Department anticipate that such guidance would provide that plants producing the following crops or yields have a nationwide weighted average preproductive period in excess of 2 years: almonds, apples, apricots, avocados, blueberries, blackberries, cherries, chestnuts, coffee beans, currants, dates, figs, grapefruit, grapes, guavas, kiwifruit, kumquats, lemons, limes, macadamia nuts, mangoes, nectarines, olives, oranges, peaches, pears, pecans, persimmons, pistachio nuts, plums, pomegranates, prunes, raspberries, tangelos, tangerines, tangors, and walnuts. The IRS and Treasury Department invite comments on this issue.

*Capitalization Period*

Preproductive period costs (e.g., irrigating, fertilizing, real estate taxes, etc.) are capitalized during the preproductive period of a plant or animal. A taxpayer that grows a plant that will have more than one crop or yield is engaged in the production of two types of property, the plant and the crop or yield of the plant (e.g., the orange tree and the orange). The temporary regulations clarify the capitalization period for plants that will have more than one crop or yield, for crops or yields of plants that will have more than one crop or yield, and for other plants.

The temporary regulations clarify that the preproductive period of a plant generally begins when a taxpayer first incurs costs with respect to the plant, e.g., when the plant is acquired or the seed is planted. In the case of the crop or yield of a plant that has become productive in marketable quantities, the preproductive period of the crop or yield begins when the crop or yield first appears, whether in the form of a sprout, bloom, blossom, bud, etc.

In the case of a plant that will have more than one crop or yield, the preproductive period of the plant ends when the plant becomes productive in marketable quantities (i.e., when the plant is placed in service for purposes of depreciation). In the case of the crop or yield of a plant that has become productive in marketable quantities, the preproductive period of the crop or yield ends when the crop or yield is disposed of. Finally, in the case of other plants, the preproductive period ends when the plant is disposed of.

The temporary regulations provide that the preproductive period of an animal begins at the time of acquisition, breeding, or embryo implantation. The temporary regulations clarify that, in the case of an animal that will be used in the trade or business of farming, the preproductive period generally ends when the animal is placed in service for purposes of depreciation. However, in the case of an animal that will have more than one yield, the preproductive period ends when the animal produces (e.g., gives birth to) its first yield. In the case of any other animal, the preproductive period ends when the animal is sold or otherwise disposed of. The temporary regulations additionally clarify that, in the case of an animal that will have more than one yield, the costs incurred after the beginning of the preproductive period of the first yield but before the end of the preproductive period of the animal must be allocated between the animal and the yield on a reasonable and consistent basis. Any depreciation allowance on the animal may be allocated entirely to the yield.

*Method Of Capitalizing Costs*

The temporary regulations provide that the costs required to be capitalized with respect to farming property may, if the taxpayer chooses, be determined using any reasonable inventory valuation method, such as the farm-price method of accounting (farm-price method) or the unit-livestock-price method of accounting (unit-livestock-price method). The use of these inventory valuation methods avoids the necessity of accounting for the costs of raising plants or animals by tracing costs to each separate plant or animal. In addition, under the temporary regulations, these inventory methods may be used by a taxpayer regardless of whether the farming property being produced is otherwise treated as inventory by the taxpayer, and regardless of whether the taxpayer is otherwise using the cash method or an accrual method.

The temporary regulations clarify that notwithstanding a taxpayer's use of the farm-price method with respect to farming property to which the provisions of section 263A apply, the taxpayer is not required, solely by such use, to use the same method of accounting with respect to farming property to which the provisions of section 263A do not apply.

Under the unit-livestock-price method, the taxpayer adopts a standard unit price for each animal within a particular class. This standard unit price is used by the taxpayer in lieu of specifically identifying and tracing the costs of raising each animal in the taxpayer's farming business. Taxpayers using the unit-livestock-price method must adopt a reasonable method of classifying animals with respect to their age and kind so that the unit prices assigned by the taxpayer to animals in each class are reasonable. Thus, taxpayers using the unit-livestock-price method typically classify livestock based on their age (for example, a separate class will typically be established for calves, yearlings, and 2-year olds).

The temporary regulations under section 263A modify the rule set forth in §1.471–6 providing that no increase in unit cost is required under the unit-livestock-price method with respect to the taxable year in which certain animals are purchased, if the purchases occur in the last 6 months of the taxable year. The temporary regulations provide that any taxpayer required to use an accrual method under section 448(a)(3) must include in inventory the annual standard unit price for all animals purchased during the taxable year, regardless of when in the taxable year the purchases are made. The temporary regulations further amend this rule and provide that all taxpayers using the unit-livestock-price method must modify the annual standard price to reasonably reflect the particular period in the taxable year in which purchases of livestock are made, if such modification is necessary in order to avoid significant distortions in income that would otherwise occur through operation of the unit-livestock-price method. The temporary regulations do not specify the particular modification that must be made to the annual standard price for any particular taxpayer, but rather allow any reasonable modification made by the taxpayer to the annual standard price to avoid significant distortions in income. For example, assume a taxpayer purchases and raises cattle for slaughter. Assume further that the taxpayer is required to use an accrual method under section 447 so that section 263A applies to the taxpayer's costs of raising the cattle. The temporary regulations provide that the taxpayer may not expense the costs of raising cattle that are purchased in the latter half of the taxpayer's taxable year. Instead, the taxpayer must modify the annual standard price so as to reasonably capitalize the costs of raising the cattle, based on the date of their purchase.

In Notice 88–86, the IRS noted that commentators had inquired as to the availability of the simplified production method of accounting (simplified production method) for farmers using the unit-livestock-price method for the costs of raising livestock. The temporary regulations clarify that farmers using the unit-livestock-price method are permitted to elect the simplified production method, as well as the simplified service cost method of accounting, under section 263A. In such a situation, section 471 costs are the costs taken into account by the taxpayer under the unit-livestock-price method using the taxpayer's standard unit price determined under these temporary and final regulations. The term additional section 263A costs includes all additional costs required to be capitalized under section 263A including costs that are required to be capitalized under section 263A that are not reflected in the standard unit prices (e.g., general and administrative costs and depreciation, including depreciation on a calf's mother).

In light of the additional costs required to be capitalized under section 263A, taxpayers should not adopt unit prices utilized under pre-section 263A unit-livestock-price rules without carefully analyzing whether these unit prices reflect all of the costs required to be capitalized under section 263A.

*Election Not To Capitalize Costs*

Certain taxpayers, other than those required to use an accrual method by section 447 or 448(a)(3), may elect not to capitalize the preproductive period costs of certain plants even though such plants have a preproductive period in excess of 2 years and would otherwise be subject to the capitalization requirements of section 263A. Taxpayers making this election may continue to deduct (subject to other limitations of the Code) the preproductive period costs that were deductible under the rules in effect before the enactment of section 263A. The temporary regulations clarify that although a taxpayer producing a citrus or almond grove may make this election, the election does not apply to the preproductive period costs of a citrus or almond grove that are incurred before the close of the fourth taxable year beginning with the taxable year in which the trees were planted.

If a taxpayer makes this election with respect to any plant, the taxpayer must treat the plant as section 1245 property. In addition, the taxpayer, and any person related to the taxpayer, must use the alternative depreciation system of section 168(g)(2) for any property used predominantly in a farming business that is placed in service in a taxable year for which the election is in effect.

*Casualty Loss Exception*

Section 263A(d) provides an exception from capitalization for preproductive period costs incurred with respect to plants that are replacing certain plants that were lost by reason of certain casualties. The temporary regulations clarify that this exception for preproductive period costs does not apply to preparatory expenditures or the costs of capital assets. In addition, the temporary regulations clarify that the casualty loss exception applies whether the plants are replanted on the same parcel of land as the plants destroyed by casualty or a parcel of land of the same acreage in the United States. The temporary regulations additionally clarify that the exception applies to all plants replanted on such acreage, even if the plants are replanted in greater density than the plants destroyed by the casualty.

*Final Regulations*

In final regulations, cross references to §1.263A–4T are provided in §§1.61–4, 1.162–12, 1.263A–1, and 1.471–6.

Under §1.471–6(f), taxpayers using the unit livestock method may not subsequently change the classification or unit costs they initially adopted without obtaining the approval of the Commissioner. As provided in Notice 88–24, the final regulations modify the rule in §1.471–6(f) and require that taxpayers adjust the unit prices upward from time to time, to reflect increases in costs taxpayers experience in raising livestock. Any other changes in the classification or unit prices used in the unit- livestock-price method will continue to be allowed only with the consent of the Commissioner.

*Effective Date And Transitional Rule*

The temporary regulations provide that, in the case of property that is not inventory in the hands of the taxpayer, the regulations are generally effective for costs incurred on or after August 22, 1997, in taxable years ending after such date. In the case of inventory property, the temporary regulations are generally effective for taxable years beginning after August 22, 1997. However, taxpayers in compliance with §1.263A–4T in effect prior to August 22, 1997 (See 26 CFR part 1 edition revised as of April 1, 1997.), as modified by other administrative guidance, that continue to comply with §1.263A–4T in effect prior to August 22, 1997 (See 26 CFR part 1 edition revised as of April 1, 1997.), as modified by other administrative guidance, will not be required to apply these new temporary rules until the notice of proposed rulemaking that cross-references these temporary regulations is finalized. The amendment to §1.471–6(f) is effective for taxable years beginning after August 22, 1997.

*Effect on Other Documents*

The following publications will be obsolete when the notice of proposed rulemaking that cross-references these temporary regulations is finalized: Notice 87–76, 1987–2 C.B. 384; Notice 88–24, 1988–1 C.B. 491; and section V of Notice 88–86, 1988–2 C.B. 401.

*Special Analyses*

It has been determined that this Treasury decision is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, the temporary regulations will be submitted, and the notice of proposed rulemaking that preceded the final regulations were submitted, to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

*Drafting Information*

The principal author of these temporary regulations is Jan Skelton of the Office of Assistant Chief Counsel (Income Tax and Accounting). However, other personnel from the IRS and Treasury Department participated in their development.

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*Adoption of Amendments to the Regulations*

Accordingly, 26 CFR Part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

**§1.61–4 [Amended]**

Par. 2. Section 1.61–4 is amended by:

1. Adding a new sentence “See section 263A for rules regarding costs that are required to be capitalized.” at the end of the concluding text of paragraph (a).

2. Adding a new sentence “See section 263A for rules regarding costs that are required to be capitalized.” after the fourth sentence of the concluding text of paragraph (b).

**§1.162–12 [Amended]**

Par. 3. Section 1.162-12(a) is amended by:

1. Removing the eighth sentence, and adding the sentence “For rules regarding the capitalization of expenses of producing property in the trade or business of farming, see section 263A and §1.263A–4T.” in its place.

2. Adding a new sentence “For rules regarding the capitalization of expenses of producing property in the trade or business of farming, see section 263A and the regulations thereunder.” after the third sentence.

Par. 4. Section 1.263A-0T is added to read as follows:

*§1.263A–0T Outline of regulations under section 263A (temporary).*

This section lists the paragraphs in §1.263A–4T.

*§1.263A–4T Rules for property produced in a farming business (temporary).*

(a) Introduction.
(1) In general.
(2) Exception.
(i) In general.
(ii) Tax shelter.
(iii) Presumption.
(iv) Costs required to be capitalized or inventoried under another provision.
(v) Examples.
(3) Farming business.
(i) In general.
(A) Plant.
(B) Animal.
(ii) Incidental activities.
(A) In general.
(B) Activities that are not incidental.
(*1*) In general.
(*2*) Examples.
(b) Application of section 263A to property produced in a farming business.
(1) In general.
(i) Plants.
(ii) Animals.
(2) Preproductive period.
(i) Plant.
(A) In general.
(B) Applicability of section 263A.
(C) Actual preproductive period.
(*1*) Beginning of the preproductive period.
(*2*) End of the preproductive period.
(*i*) In general.
(*ii*) Marketable quantities.
(D) Examples.
(ii) Animal.
(A) Beginning of the preproductive period.
(B) End of the preproductive period.
(C) Allocation of costs between animal and first yield.
(c) Inventory methods.
(1) In general.
(2) Available for property used in a trade or business.
(3) Exclusion of property to which section 263A does not apply.
(d) Election not to have section 263A apply.
(1) Introduction.
(2) Availability of the election.
(3) Time and manner of making the election.
(4) Special rules.
(i) Section 1245 treatment.
(ii) Required use of alternative depreciation system.
(iii) Related person.
(A) In general.
(B) Members of family.
(5) Examples.
(e) Exception for certain costs resulting from casualty losses.
(1) In general.
(2) Ownership.
(3) Examples.

(4) Special rule for citrus and almond groves.

(i) In general.

(ii) Example.

(f) Effective date and transition rule.

**§1.263A–1 [Amended]**

Par. 5. Section 1.263A–1 is amended by:

1. Removing the last sentence of paragraph (b)(3) and adding the sentence "See §1.263A–4T for specific rules relating to taxpayers engaged in the trade or business of farming." in its place.

2. Removing the last sentence of paragraph (b)(4) and adding the sentence "See §1.263A–4T, however, for rules relating to taxpayers producing certain trees to which section 263A applies." in its place.

Par. 6. Section 1.263A–4T is revised to read as follows:

*§1.263A–4T Rules for property produced in a farming business (temporary).*

(a) *Introduction*—(1) *In general.* The regulations under this section provide guidance with respect to the application of section 263A to property produced in a farming business as defined in paragraph (a)(3) of this section. Except as otherwise provided by the rules of this section, the general rules of §§1.263A–1 through 1.263A–3 and 1.263A–7 through 1.263A–15 apply to property produced in a farming business. A taxpayer that engages in the raising or growing of any agricultural or horticultural commodity, including both plants and animals, is engaged in the production of property. Section 263A generally requires the capitalization of the direct costs and an allocable portion of the indirect costs that benefit or are incurred by reason of the production of this property. Taxpayers that do not qualify for the exception described in paragraph (a)(2) of this section must capitalize these costs of producing all plants and animals unless the election described in paragraph (d) of this section is made.

(2) *Exception*—(i) *In general.* A taxpayer is not required to capitalize the preproductive period costs of producing plants with a preproductive period of 2 years or less or the costs of producing animals, if the taxpayer is not—

(A) A corporation or partnership required to use an accrual method of accounting (accrual method) under section 447 in computing its taxable income from farming; or

(B) A tax shelter required to use an accrual method under section 448(a)(3).

(ii) *Tax shelter.* A farming business is considered a tax shelter, and thus a taxpayer required to use an accrual method under section 448(a)(3), if the farming business is—

(A) A farming syndicate as defined in section 464(c); or

(B) A tax shelter, within the meaning of section 6662(d)(2)(C)(iii).

(iii) *Presumption.* Marketed arrangements in which persons carry on farming activities using the services of a common managerial or administrative service will be presumed to have the principal purpose of tax avoidance, within the meaning of section 6662(d)(2)(C)(iii), if such persons prepay a substantial portion of their farming expenses with borrowed funds.

(iv) *Costs required to be capitalized or inventoried under another provision.* The exception from capitalization provided in this paragraph (a)(2) does not apply to any cost that is required to be capitalized or inventoried under another Code or regulatory provision, such as section 263 or section 471.

(v) *Examples.* The following examples illustrate the provisions of this paragraph (a)(2):

*Example 1.* Farmer A grows trees that have a preproductive period in excess of 2 years, and that produce an annual crop. Farmer A is not required by section 447 or 448(a)(3) to use an accrual method. Accordingly, Farmer A qualifies for the exception described in this paragraph (a)(2). Since the trees have a preproductive period in excess of 2 years, Farmer A must capitalize the direct costs and an allocable portion of the indirect costs that benefit or are incurred by reason of the production of the trees. Since the annual crop has a preproductive period of 2 years or less, Farmer A is not required to capitalize the costs of the crops.

*Example 2.* Assume the same facts as *Example 1*, except that Farmer A is required by section 447 or 448(a)(3) to use an accrual method. Farmer A does not qualify for the exception described in this paragraph (a)(2). Farmer A is required to capitalize the direct costs and an allocable portion of the indirect costs that benefit or are incurred by reason of the production of the trees and crops, including all preproductive period costs.

(3) *Farming business*—(i) *In general.* A farming business means a trade or business involving the cultivation of land or the raising or harvesting of any agricultural or horticultural commodity. Examples include the trade or business of operating a nursery or sod farm; the raising or harvesting of trees bearing fruit, nuts, or other crops; the raising of ornamental trees (other than evergreen trees that are more than 6 years old at the time they are severed from their roots); and the raising, shearing, feeding, caring for, training, and management of animals. For purposes of this section, the term harvesting does not include contract harvesting of an agricultural or horticultural commodity grown or raised by another. Similarly, the trade or business of merely buying and reselling plants or animals grown or raised by another is not a farming business.

(A) *Plant.* A plant produced in a farming business includes, but is not limited to, a fruit, nut, or other crop bearing tree, an ornamental tree, a vine, a bush, sod, and the crop or yield of a plant that will have more than one crop or yield. Sea plants are produced in a farming business if they are tended and cultivated as opposed to merely harvested.

(B) *Animal.* An animal produced in a farming business includes, but is not limited to, any stock, poultry or other bird, and fish or other sea life raised by the taxpayer. Thus, for example, the term animal may include a cow, chicken, emu, or salmon raised by the taxpayer. Fish and other sea life are produced in a farming business if they are raised on a fish farm. A fish farm is an area where fish or other sea life are grown or raised as opposed to merely caught or harvested.

(ii) *Incidental activities*—(A) *In general.* Farming business includes processing activities that are normally incident to the growing, raising, or harvesting of agricultural products. For example, a taxpayer in the trade or business of growing fruits and vegetables may harvest, wash, inspect, and package the fruits and vegetables for sale. Such activities are normally incident to the raising of these crops by farmers. The taxpayer will be considered to be in the trade or business of farming with respect to the growing of fruits and vegetables and the processing activities incident to their harvest.

(B) *Activities that are not incidental*—(*1*) *In general.* Farming business does not include the processing of commodities or products beyond those activities that are normally incident to the growing, raising, or harvesting of such products.

(*2*) *Examples.* The following examples illustrate the provisions of this paragraph (a)(3)(ii):

*Example 1.* Individual A is in the business of growing and harvesting wheat and other grains. Individual A also processes grain that Individual A has harvested in order to produce breads, cereals, and other similar food products, which Individual A then sells to customers in the course of its business. Although Individual A is in the farming business with respect to the growing and harvesting of grain, Individual A is not in the farming business with respect to the processing of such grain to produce the food products.

*Example 2.* Individual B is in the business of raising poultry and other livestock. Individual B also operates a meat processing operation in which the poultry and other livestock are slaughtered, processed, and packaged or canned. The packaged or canned meat is sold to Individual B's customers. Although Individual B is in the farming business with respect to the raising of poultry and other livestock, Individual B is not in the farming business with respect to the slaughtering, processing, packaging, and canning of such animals to produce the food products.

(b) *Application of section 263A to property produced in a farming business*—(1) *In general.* Unless otherwise provided in this section, section 263A requires the capitalization of the direct costs and an allocable portion of the indirect costs that benefit or are incurred by reason of the production of any property in a farming business (including animals and plants without regard to the length of their preproductive period).

(i) *Plants.* Costs typically required to be capitalized under section 263A include the acquisition costs of the seed, seedling, or plant, and the costs of planting, cultivating, maintaining, or developing such plant during the preproductive period. These costs include, but are not limited to, management, irrigation, pruning, fertilizing (including costs that the taxpayer has elected to deduct under section 180), soil and water conservation (including costs that the taxpayer has elected to deduct under section 175), frost protection, spraying, upkeep, electricity, tax depreciation and repairs on buildings and equipment used in raising the plants, farm overhead, taxes (except state and federal income taxes), and interest required to be capitalized under section 263A(f).

(ii) *Animals.* Costs typically required to be capitalized under section 263A include the acquisition cost of the animal, and the costs of raising or caring for such animal during the preproductive period. Preproductive period costs include, but are not limited to, the costs of management, feed (such as grain, silage, concentrates, supplements, haylage, hay, pasture and other forages), maintaining pasture or pen areas (including costs that the taxpayer has elected to deduct under sections 175 or 180), breeding, artificial insemination, veterinary services and medicine, livestock hauling, bedding, fuel, electricity, hired labor, tax depreciation and repairs on buildings and equipment used in raising the animals (for example, barns, trucks, and trailers), farm overhead, taxes (except state and federal income taxes), and interest required to be capitalized under section 263A(f).

(2) *Preproductive period*—(i) *Plant*—(A) *In general.* The preproductive period of property produced in a farming business means —

(*1*) In the case of a plant that will have more than one crop or yield, the period before the first marketable crop or yield from such plant;

(*2*) In the case of the crop or yield of a plant that will have more than one crop or yield, the period before such crop or yield is disposed of; or

(*3*) In the case of any other plant, the period before such plant is disposed of.

(B) *Applicability of section 263A.* For purposes of determining whether a plant has a preproductive period in excess of 2 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. For all other plants, the taxpayer is required, at or before the time the seed or plant is acquired or planted, to reasonably estimate the preproductive period of the plant. If the taxpayer estimates a preproductive period in excess of 2 years, the taxpayer must capitalize preproductive period costs. If the estimate is reasonable, based on the facts in existence at the time it is made, the determination of whether section 263A applies is not modified at a later time even if the actual length of the preproductive period differs from the estimate. The actual length of the preproductive period will, however, be considered in evaluating the reasonableness of the taxpayer's future estimates. Thus, the nationwide weighted average preproductive period or the estimated preproductive period are only used for purposes of determining whether the preproductive period of a plant is greater than 2 years.

(C) *Actual preproductive period.* The plant's actual preproductive period is used for purposes of determining the period during which a taxpayer must capitalize preproductive period costs with respect to a particular plant.

(*1*) *Beginning of the preproductive period.* The actual preproductive period of a plant begins when the taxpayer first incurs costs that directly benefit or are incurred by reason of the plant. Generally, this occurs when the taxpayer plants the seed or plant. In the case of a taxpayer that acquires plants that have already been planted, or plants that are tended, by the taxpayer or another, prior to permanent planting, the actual preproductive period of the plant begins upon acquisition of the plant by the taxpayer. In the case of the crop or yield of a plant that will have more than one crop or yield and that has become productive in marketable quantities, the actual preproductive period begins when the crop or yield first appears, for example, in the form of a sprout, bloom, blossom, or bud.

(*2*) *End of the preproductive period*—(*i*) *In general.* In the case of a plant that will have more than one crop or yield, the actual preproductive period ends when the plant first becomes productive in marketable quantities. In the case of any other plant (including the crop or yield of a plant that will have more than one crop or yield), the actual preproductive period ends when the plant, crop, or yield is sold or otherwise disposed of.

(*ii*) *Marketable quantities.* A plant that will have more than one crop or yield becomes productive in marketable quantities when it is (or would be considered) placed in service for purposes of section 168 (without regard to the applicable convention).

(D) *Examples.* The following examples illustrate the provisions of this paragraph (b)(2)(i):

*Example 1.* (i) Farmer A, a taxpayer that qualifies for the exception in paragraph (a)(2) of this section, grows plants that will have more than one crop or yield. The plants are grown in commercial quantities in the United States. Farmer A acquires the plants by purchasing them from an unrelated party, Corporation B, and plants them immediately. The nationwide weighted average preproductive period of the plant is 4 years. The particular plants grown by Farmer A do not begin to produce in marketable quantities until 4 years and 6 months after they are planted by Farmer A.

(ii) Since the plants are deemed to have a preproductive period in excess of 2 years, Farmer A is required to capitalize the preproductive period costs of the plants. See paragraphs (a)(2) and (b)(2)(i)(B) of this section. In accordance with paragraph (b)(2)(i)(C)(*1*) of this section, Farmer A must begin to capitalize such costs when the plants are planted. In accordance with paragraph (b)(2)(i)(C)(*2*) of this section, Farmer A must continue to capitalize costs to the plants until the plants begin to produce in marketable quantities. Thus, Farmer A must capitalize the preproductive period costs of the plants for a period of 4 years and 6 months, notwithstanding the fact that the plants, in general, have a nationwide weighted average preproductive period of 4 years.

*Example 2*. (i) Farmer B, a taxpayer that qualifies for the exception in paragraph (a)(2) of this section, grows plants that will have more than one crop or yield. The plants are grown in commercial quantities in the United States. The nationwide weighted average preproductive period of the plant is 2 years and 5 months. Farmer B acquires the plants by purchasing them from an unrelated party, Corporation B. Farmer B enters into a contract with Corporation B under which Corporation B will retain and tend the plants for 7 months following the sale. At the end of 7 months, Farmer B takes possession of the plants and plants them in the permanent orchard. The plants become productive in marketable quantities 1 years and 11 months after they are planted by Farmer B.

(ii) Since the plants are deemed to have a preproductive period in excess of 2 years, Farmer B is required to capitalize the preproductive period costs of the plants. See paragraphs (a)(2) and (b)(2)(i)(B) of this section. In accordance with paragraph (b)(2)(i)(C)(*1*) of this section, Farmer B must begin to capitalize such costs when the purchase occurs. In accordance with paragraph (b)(2)(i)(C)(*2*) of this section, Farmer B must continue to capitalize costs to the plants until the plants begin to produce in marketable quantities. Thus, Farmer B must capitalize the preproductive period costs of the plants for a period of 2 years and 6 months (the 7 months the plants are tended by Corporation B and the 1 year and 11 months after the plants are planted by Farmer B), notwithstanding the fact that the plants, in general, have a nationwide weighted average preproductive period of 2 years and 5 months.

*Example 3*. (i) Assume the same facts as in *Example 2*, except that Farmer B acquires the plants by purchasing them from Corporation B when the plants are 7 months old and that the plants are planted by Farmer B upon acquisition.

(ii) Since the plants are deemed to have a preproductive period in excess of 2 years, Farmer B is required to capitalize the preproductive period costs of the plants. See paragraphs (a)(2) and (b)(2)(i)(B) of this section. In accordance with paragraph (b)(2)(i)(C)(*1*) of this section, Farmer B must begin to capitalize such costs when the plants are planted. In accordance with paragraph (b)(2)(i)(C)(*2*) of this section, Farmer B must continue to capitalize costs to the plants until the plants begin to produce in marketable quantities. Thus, Farmer B must capitalize the preproductive period costs of the plants for a period of 1 year and 11 months.

*Example 4*. (i) Farmer C, a taxpayer that qualifies for the exception in paragraph (a)(2) of this section, grows plants that will have more than one crop or yield. The plants are grown in commercial quantities in the United States. Farmer C acquires the plants from an unrelated party and plants them immediately. The nationwide weighted average preproductive period of the plant is 2 years and 3 months. The particular plants grown by Farmer C begin to produce in marketable quantities 1 year and 10 months after they are planted by Farmer C.

(ii) Since the plants are deemed to have a nationwide weighted average preproductive period in excess of 2 years, Farmer C is required to capitalize the preproductive period costs of the plants, notwithstanding the fact that the particular plants grown by Farmer C become productive in less than 2 years. See paragraph (b)(2)(i)(B) of this section. In accordance with paragraph (b)(2)(i)(C)(*1*) of this section, Farmer C must begin to capitalize such costs when it plants the plants. In accordance with paragraph (b)(2)(i)(C)(*2*) of this section, Farmer C properly ceases capitalization of preproductive period costs when the plants become productive in marketable quantities (i.e., after 1 year and 10 months).

*Example 5*. (i) Farmer D, a taxpayer that qualifies for the exception in paragraph (a)(2) of this section, grows plants that will have more than one crop or yield. The plants are not grown in commercial quantities in the United States. At the time the plants are planted Farmer D reasonably estimates that the plants will have a preproductive period of 4 years. The actual plants grown by Farmer D do not begin to produce in marketable quantities until 4 years and 6 months after they are planted by Farmer D.

(ii) Since the plants have an estimated preproductive period in excess of 2 years, Farmer D is required to capitalize the preproductive period costs of the plants. See paragraph (b)(2)(i)(B) of this section. In accordance with paragraph (b)(2)(i)(C)(*1*) of this section, Farmer D must begin to capitalize such costs when it plants the plants. In accordance with paragraph (b)(2)(i)(C)(*2*) of this section, Farmer D must continue to capitalize costs until the plants begin to produce in marketable quantities. Thus, Farmer D must capitalize the preproductive period costs of the plants for a period of 4 years and 6 months, notwithstanding the fact that Farmer D estimated that the plants would become productive after 4 years.

*Example 6*. (i) Farmer E, a taxpayer that qualifies for the exception in paragraph (a)(2) of this section grows plants that are not grown in commercial quantities in the United States. The plants do not have more than 1 crop or yield. At the time the plants are planted Farmer E reasonably estimates that the plants will have a preproductive period of 1 year and 10 months. The actual plants grown by Farmer E are not ready for harvesting and disposal until 2 years and 2 months after the seeds are planted by Farmer E.

(ii) Because Farmer E's estimate of the preproductive period (which was 2 years or less) was reasonable at the time made based on the facts, Farmer E will not be required to capitalize the preproductive period costs of the plants notwithstanding the fact that the actual preproductive period of the plants exceeded 2 years. See paragraph (b)(2)(i)(B) of this section. However, Farmer E must take the actual preproductive period of the plants into consideration when making future estimates of the preproductive period of such plants.

*Example 7*. Farmer F, a calendar year taxpayer that does not qualify for the exception in paragraph (a)(2) of this section, grows trees that will have more than one crop. Farmer F acquires and plants the trees in April, 1998. On October 1, 2003, the trees are placed in service within the meaning of section 168. Under paragraph (b)(2)(i)(C)(2)(*ii*) of this section, the trees become productive in marketable quantities on October 1, 2003. The preproductive period costs incurred by Farmer F on or before October 1, 2003, are capitalized to the trees. Preproductive period costs incurred after October 1, 2003, are capitalized to a crop when incurred during the preproductive period of the crop and expensed when incurred between the disposal of one crop and the appearance of the next crop. *See* paragraphs (b)(2)(i)(A), (b)(2)(i)(C)(*1*) and (b)(2)(i)(C)(*2*) of this section.

(ii) *Animal*. An animal's actual preproductive period is used to determine the period that the taxpayer must capitalize preproductive period expenses with respect to a particular animal.

(A) *Beginning of the preproductive period*. The preproductive period of an animal begins at the time of acquisition, breeding, or embryo implantation.

(B) *End of the preproductive period*. In the case of an animal that will be used in the trade or business of farming (e.g., a dairy cow), the preproductive period generally ends when the animal is (or would be considered) placed in service for purposes of section 168 (without regard to the applicable convention). However, in the case of an animal that will have more than one yield (e.g., a breeding cow), the preproductive period ends when the animal produces (e.g., gives birth to) its first yield. In the case of any other animal, the preproductive period ends when the animal is sold or otherwise disposed of.

(C) *Allocation of costs between animal and first yield*. In the case of an animal that will have more than one yield, the costs incurred after the beginning of the preproductive period of the first yield but before the end of the preproductive period of the animal must be allocated between the animal and the yield on a reasonable basis. Any depreciation allowance on the animal may be allocated entirely to the yield. The allocation method used by a taxpayer is a method of accounting that must be used consistently and is subject to the rules of section 446 and the regulations thereunder.

(c) *Inventory methods*—(1) *In general*. Except as otherwise provided, the costs required to be allocated to any plant or animal under this section may be determined using reasonable inventory valuation methods such as the farm-price method or the unit-livestock-price method. See §1.471–6. Under the unit-livestock-price method, unit prices must include all costs required to be capitalized under section 263A. A taxpayer using the unit-livestock-price method may elect to use the cost allocation methods in §1.263A–1(f) or 1.263A–2(b) to allocate its direct and indirect costs to the property produced in the business of farming. In such a situation, section 471 costs are the costs taken into account by the taxpayer under the unit-livestock-price method using the taxpayer's standard unit price as modified by this paragraph (c)(1). The term additional section 263A costs includes all additional costs required to be capitalized under section 263A. Tax shelters, as defined in paragraph (a)(2)(ii) of this section, that use the unit-livestock-price method for inventories must include in inventory the annual standard unit price for all animals that are acquired during the taxable year, regardless of whether the purchases are made during the last 6 months of the taxable year. Taxpayers required by section 447 or 448(a)(3) to use an accrual method that use the unit-livestock-price method must modify the annual standard price in order to reasonably reflect the particular period in the taxable year in which purchases of livestock are made, if such modification is necessary in order to avoid significant distortions in income that would otherwise occur through operation of the unit livestock method.

(2) *Available for property used in a trade or business.* The farm price method or the unit livestock method may be used by any taxpayer to allocate costs to any plant or animal under this section, regardless of whether the plant or animal is held or treated as inventory property by the taxpayer. Thus, for example, a taxpayer may use the unit livestock method to account for the costs of raising livestock that will be used in the trade or business of farming (e.g., a breeding animal or a dairy cow) even though the property in question is not inventory property.

(3) *Exclusion of property to which section 263A does not apply.* Notwithstanding a taxpayer's use of the farm price method with respect to farm property to which the provisions of section 263A apply, that taxpayer is not required, solely by such use, to use the farm price method with respect to farm property to which the provisions of section 263A do not apply. Thus, for example, assume Farmer A raises fruit trees that have a preproductive period in excess of 2 years and to which the provisions of section 263A, therefore, apply. Assume also that Farmer A raises cattle and is not required to use an accrual method by section 447 or 448(a)(3). Because Farmer A qualifies for the exception in paragraph (a)(2) of this section, Farmer A is not required to capitalize the costs of raising the cattle. Although Farmer A may use the farm price method with respect to the fruit trees, Farmer A is not required to use the farm price method with respect to the cattle. Instead, Farmer A's accounting for the cattle is determined under other provisions of the Code and regulations.

(d) *Election not to have section 263A apply*—(1) *Introduction.* This paragraph (d) permits certain taxpayers to make an election not to have the rules of this section apply to any plant produced in a farming business conducted by the electing taxpayer. The election is a method of accounting under section 446, and once an election is made, it is revocable only with the consent of the Commissioner.

(2) *Availability of the election.* The election described in this paragraph (d) is available to any taxpayer that produces plants in a farming business, except that no election may be made by a corporation, partnership, or tax shelter required to use the accrual method under section 447 or 448(a)(3). Moreover, the election does not apply to the costs of planting, cultivation, maintenance, or development of a citrus or almond grove (or any part thereof) incurred prior to the close of the fourth taxable year beginning with the taxable year in which the trees were planted in the permanent grove (including costs incurred prior to the permanent planting). If a citrus or almond grove is planted in more than one taxable year, the portion of the grove planted in any one taxable year is treated as a separate grove for purposes of determining the year of planting.

(3) *Time and manner of making the election.* A taxpayer makes the election under this paragraph (d) by not capitalizing the preproductive period costs of producing property in a farming business and by applying the special rules in paragraph (d)(4) of this section, on its timely filed original return (including extensions) for the first taxable year in which the taxpayer is otherwise required to capitalize preproductive period costs under section 263A. Thus, in order to be treated as having made the election under this paragraph (d), it is necessary to report both income and expenses in accordance with the rules of this paragraph (d) (e.g., it is necessary to use the alternative depreciation system as provided in paragraph (d)(4)(ii) of this section). Thus, for example, a farmer who deducts preproductive period costs that are otherwise required to be capitalized under section 263A but fails to use the alternative depreciation system under section 168(g)(2) for applicable property placed in service has not made an election under this paragraph (d) and is not in compliance with the provisions of section 263A. In the case of a partnership or S corporation, the election must be made by the partner, shareholder, or member.

(4) *Special rules.* If the election under this paragraph (d) is made, the taxpayer is subject to the special rules in this paragraph (d)(4).

(i) *Section 1245 treatment.* The plant produced by the taxpayer is treated as section 1245 property and any gain resulting from any disposition of the plant is recaptured (i.e., treated as ordinary income) to the extent of the total amount of the deductions that, but for the election, would have been required to be capitalized with respect to the plant. In calculating the amount of gain that is recaptured under this paragraph (d)(4)(i), a taxpayer may use the farm price method or another simplified method permitted under these regulations in determining the deductions that otherwise would have been capitalized with respect to the plant.

(ii) *Required use of alternative depreciation system.* If the taxpayer or a related person makes an election under this paragraph (d), the alternative depreciation system (as defined in section 168(g)(2)) must 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. The requirement to use the alternative depreciation system by reason of an election under this paragraph (d) will not prevent a taxpayer from making an election under section 179 to deduct certain depreciable business assets.

(iii) *Related person*—(A) *In general.* For purposes of this paragraph (d)(4), related person means —

(*1*) The taxpayer and members of the taxpayer's family;

(*2*) Any corporation (including an S corporation) if 50 percent or more of the stock (in value) is owned directly or indirectly (through the application of section 318) by the taxpayer or members of the taxpayer's family;

(*3*) A corporation and any other corporation that is a member of the same controlled group (within the meaning of section 1563(a)(1)); and

(*4*) Any partnership if 50 percent or more (in value) of the interests in such partnership is owned directly or indirectly by the taxpayer or members of the taxpayer's family.

(B) *Members of family.* For purposes of this paragraph (d)(4)(iii), *members of the taxpayer's family,* and *members of family* (for purposes of applying section 318(a)(1)), means the spouse of the taxpayer (other than a spouse who is legally separated from the individual under a decree of divorce or separate maintenance) and any of the taxpayer's children (including legally adopted children) who have not reached the age of 18 as of the last day of the taxable year in question.

(5) *Examples.* The following examples illustrate the provisions of this paragraph (d):

*Example 1.* (i) Farmer A, an individual, is engaged in the trade or business of farming. Farmer A grows apple trees that have a preproductive period greater than 2 years. In addition, Farmer A grows and harvests wheat and other grains. Farmer A elects under this paragraph (d) not to have the rules of section 263A apply to the preproductive period costs of growing the apple trees.

(ii) In accordance with paragraph (d)(4) of this section, Farmer A is required to use the alternative depreciation system described in section 168(g)(2) with respect to all property used predominantly in any farming business in which Farmer A engages (including the growing and harvesting of wheat) if such property is placed in service during a year for which the election is in effect. Thus, for example, all assets and equipment (including trees and any equipment used to grow and harvest wheat) placed in service during a year for which the election is in effect must be depreciated as provided in section 168(g)(2).

*Example 2.* Assume the same facts as in *Example 1,* except that Farmer A and members of Farmer A's family (as defined in paragraph (d)(4)(iii)(B) of this section) also own 51 percent (in value) of the interests in Partnership P, which is engaged in the trade or business of growing and harvesting corn. Partnership P is a related person to Farmer A under the provisions of paragraph (d)(4)(iii) of this section. Thus, the requirements to use the alternative depreciation system under section 168(g)(2) also apply to any property used predominantly in a trade or business of farming which Partnership P places in service during a year for which an election made by Farmer A is in effect.

(e) *Exception for certain costs resulting from casualty losses*—(1) *In general.* Section 263A does not require the capitalization of costs that are attributable to the replanting, cultivating, maintaining, and developing of any plants bearing an edible crop for human consumption (including, but not limited to, plants that constitute a grove, orchard, or vineyard) that were lost or damaged while owned by the taxpayer by reason of freezing temperatures, disease, drought, pests, or other casualty (replanting costs). Such replanting costs may be incurred with respect to property other than the property on which the damage or loss occurred to the extent the acreage of the property with respect to which the replanting costs are incurred is not in excess of the acreage of the property on which the damage or loss occurred. This paragraph (e) applies only to the replanting of plants of the same type as those lost or damaged. This paragraph (e) applies to plants replanted on the property on which the damage or loss occurred or property of the same or lesser acreage in the United States irrespective of differences in density between the lost or damaged and replanted plants. Plants bearing crops for human consumption are those crops normally eaten or drunk by humans. Thus, for example, costs incurred with respect to replanting plants bearing jojoba beans do not qualify for the exception provided in this paragraph (e) because that crop is not normally eaten or drunk by humans.

(2) *Ownership.* Replanting costs described in paragraph (e)(1) of this section generally must be incurred by the taxpayer that owned the property at the time the plants were lost or damaged. Paragraph (e)(1) of this section will apply, however, to costs incurred by a person other than the taxpayer that owned the plants at the time of damage or loss if—

(i) The taxpayer that owned the plants at the time the damage or loss occurred owns an equity interest of more than 50 percent in such plants at all times during the taxable year in which the replanting costs are paid or incurred; and

(ii) Such other person owns any portion of the remaining equity interest and materially participates in the replanting, cultivating, maintaining, or developing of such plants during the taxable year in which the replanting costs are paid or incurred. A person will be treated as materially participating for purposes of this provision if such person would otherwise meet the requirements with respect to material participation within the meaning of section 2032A(e)(6).

(3) *Examples.* The following examples illustrate the provisions of this paragraph (e):

*Example 1.* (i) Farmer T grows cherry trees that have a preproductive period in excess of 2 years and produce an annual crop. These cherries are normally eaten by humans. Farmer T grows the trees on a 100 acre parcel of land (parcel 1) and the groves of trees cover the entire acreage of parcel 1. Farmer T also owns a 150 acre parcel of land (parcel 2) that Farmer T holds for future use. Both parcels are in the United States. In 1998, the trees and the irrigation and drainage systems that service the trees are destroyed in a casualty (within the meaning of paragraph (e)(1) of this section). Farmer T installs new irrigation and drainage systems on parcel 1, purchases young trees (seedlings), and plants the seedlings on parcel 1.

(ii) The costs of the irrigation and drainage systems and the seedlings must be capitalized under section 263A. In accordance with paragraph (e)(1) of this section, the costs of planting, cultivating, developing, and maintaining the seedlings during their preproductive period are not required to be capitalized by section 263A.

*Example 2.* (i) Assume the same facts as in *Example 1* except that Farmer T decides to replant the seedlings on parcel 2 rather than on parcel 1. Accordingly, Farmer T installs the new irrigation and drainage systems on 100 acres of parcel 2 and plants seedlings on those 100 acres.

(ii) The costs of the irrigation and drainage systems and the seedlings must be capitalized under section 263A. Because the acreage of the related portion of parcel 2 does not exceed the acreage of the destroyed orchard on parcel 1, the costs of planting, cultivating, developing, and maintaining the seedlings during their preproductive period are not required to be capitalized by section 263A. See paragraph (e)(1) of this section.

*Example 3.* (i) Assume the same facts as in *Example 1* except that Farmer T replants the seedlings on parcel 2 rather than on parcel 1, and Farmer T additionally decides to expand its operations by growing 125 rather than 100 acres of trees. Accordingly, Farmer T installs new irrigation and drainage systems on 125 acres of parcel 2 and plants seedlings on those 125 acres.

(ii) The costs of the irrigation and drainage systems and the seedlings must be capitalized under section 263A. The costs of planting, cultivating, developing, and maintaining 100 acres of the trees during their preproductive period are not required to be capitalized by section 263A. The costs of planting, cultivating, maintaining, and developing the additional 25 acres are, however, subject to capitalization. See paragraph (e)(1) of this section.

(4) *Special rule for citrus and almond groves*—(i) *In general.* The exception in this paragraph (e) is available with respect to a citrus or almond grove, notwithstanding the taxpayer's election not to have section 263A apply (described in paragraph (d) of this section).

(ii) *Example.* The following example illustrates the provisions of this paragraph (e)(4):

*Example.* (i) Farmer A, an individual, is engaged in the trade or business of farming. Farmer A grows citrus trees that have a preproductive period of 5 years. Farmer A elects, under paragraph (d) of this section, not to have section 263A apply to the preproductive period costs. This election, however, is unavailable with respect to the preproductive period costs of a citrus grove incurred within the first 4 years after the trees were planted. See paragraph (d)(2) of this section. After the citrus grove has become productive in marketable quantities, the citrus grove is destroyed by a casualty within the meaning of paragraph (e)(1) of this section.

(ii) Farmer A must capitalize the preproductive period costs incurred before the close of the fourth taxable year beginning with the year in which the trees were permanently planted. As a result of the election not to have section 263A apply to preproductive period costs, Farmer A may deduct the preproductive period costs incurred in the fifth year. The costs of replanting, cultivating, maintaining, and developing the trees destroyed by a casualty are exempted from capitalization under this paragraph (e).

(f) *Effective date and transition rule.* In the case of property that is not inventory in the hands of the taxpayer, this section is generally effective for costs incurred on or after August 22, 1997, in taxable years ending after such date. In the case of inventory property, this section is generally effective for taxable years beginning after August 22, 1997. However, taxpayers in compliance with §1.263A–4T in effect prior to August 22, 1997 (See 26 CFR part 1 edition revised as of April 1, 1997.), and other administrative guidance, that continue to comply with §1.263A–4T in effect prior to August 22, 1997 (See 26 CFR part 1 edition revised as of April 1, 1997.), and other administrative guidance, will not be required to apply these new temporary rules until final regulations are published in the **Federal Register**.

## §1.471–6 [Amended]

Par. 7. Section 1.471–6 is amended as follows:

1. Adding two sentences to the end of paragraph (c).
2. Removing the second sentence in paragraph (d) and adding two sentences in its place.
3. Revising the last three sentences of paragraph (f).

The additions and revision read as follows:

*§1.471–6 Inventories of livestock raisers and other farmers.*

* * * * *

(c) * * * In addition, these inventory methods may be used to account for the costs of property produced in a farming business that are required to be capitalized under section 263A regardless of whether the property being produced is otherwise treated as inventory by the taxpayer, and regardless of whether the taxpayer is otherwise using the cash or an accrual method of accounting. Thus, for example, the unit livestock method may be utilized by a taxpayer in accounting under section 263A for the costs of raising animals that will be used for draft, breeding, or dairy purposes.

(d) * * * If this method of valuation is used, it generally must be applied to all property produced by the taxpayer in the trade or business of farming, except as to livestock accounted for, at the taxpayer's election, under the unit livestock method of accounting. However, see §1.263A–4T(c)(3) for an exception to this rule. * * *

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(f) * * * Except as otherwise provided in this paragraph, once established, the unit prices and classifications selected by the taxpayer must be consistently applied in all subsequent taxable years. For taxable years beginning after August 22, 1997, a taxpayer using the unit livestock method must, however, annually reevaluate the unit livestock prices and must adjust the prices upward to reflect increases in the costs of raising livestock. The consent of the Commissioner is not required to make such upward adjustments. No other changes in the classification of animals or unit prices shall be made without the consent of the Commissioner. See §1.263A–4T for rules regarding the computation of costs for purposes of the unit livestock method.

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Michael P. Dolan,
*Acting Commissioner of Internal Revenue.*

Approved July 28, 1997.

Donald C. Lubick,
*Acting Assistant Secretary of the Treasury.*

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