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## Reversing the Election Out of the Preproduction Period Capitalization Rules

-by Neil E. Harl\*

As many will recall, for taxable years beginning after 1986, taxpayers were required to capitalize the direct costs of production and the “proper share” of the indirect costs (including taxes) which were assignable to the production of property.<sup>1</sup> That enactment generated stiff resistance from the agricultural sector, particularly among livestock producers, with the result that legislation enacted in 1988<sup>2</sup> made the provisions inapplicable to “animals” produced by the taxpayer in a farming business for costs incurred after December 31, 1988.<sup>3</sup> For animals not “produced by the taxpayer in a farming business,” the preproductive rules continued to apply.<sup>4</sup> Thus non-material participation landlords with little or no involvement in management could be subject to the preproductive period capitalization rules.<sup>5</sup> However, the rules were not eased for producers of plants. Effective August 21, 2000, final regulations governing the application of preproductive rules to plants (and to animals still subject to the rules) were issued.<sup>6</sup>

### Opportunity to elect out of the rules

Except for designated types of firms – corporations and partnerships required to use accrual accounting, farming syndicates, tax shelters and some citrus producers, an election could be made to avoid the preproduction period capitalization rules.<sup>7</sup> Tax shelters<sup>8</sup> are not qualified taxpayers and are not eligible for the election-out provisions for farming operations.<sup>9</sup> A “tax shelter” for this purpose means a farming business that is a farming syndicate of any partnership, entity, plan or arrangement that is a tax shelter within the meaning of I.R.C. § 6662<sup>10</sup> with its principal purpose being the avoidance or evasion of federal income tax.<sup>11</sup> Marketed arrangements, in which persons carry on farming activities using the services of a common managerial or administrative service, are presumed to fall within the meaning of a tax shelter if a substantial portion of farming expenses is prepaid with borrowed funds.<sup>12</sup>

### Consequences of electing out

A taxpayer who has elected out of the capitalization regimen is limited to alternative depreciation for all property of the taxpayer or related person used predominantly in the farming business and placed in service in any taxable year during which the election is in effect.<sup>13</sup> For most farm property, that means straight-line depreciation over the class life of assets. Alternative depreciation does not preclude claiming expense method depreciation.<sup>14</sup> That provision allows a deduction of up to \$500,000 in 2011 subject to a \$2,000,000 cap.<sup>15</sup>

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However, it does preclude claiming so-called “bonus” depreciation” which is available for 100 percent of qualified investments through December 31, 2011 and is available at the 50 percent level for 2012.<sup>16</sup> That is because, in defining “qualified property” for purposes of “bonus” depreciation,<sup>17</sup> the statute states that “. . . the term ‘qualified property’ shall not include any property to which the alternative depreciation system . . . applies.”<sup>18</sup> This has become a major concern for some taxpayers who had elected out.

Also, if the election was made, plants (or animals) produced by the taxpayer are treated as I.R.C. § 1245 property for purposes of recapture of expensed amounts on disposition.<sup>19</sup>

### Who is a “related person”?

The rules are particularly important because electing out of the preproductive period capitalization rules applies not only to the taxpayer but also to “related persons.” That includes, in addition to the taxpayer, the spouse and children under the age of 18 as of the last day of the taxable year in question;<sup>20</sup> a corporation (including an S corporation) if 50 percent or more of the stock value is owned, directly or indirectly, by the taxpayer or members of the taxpayer’s family;<sup>21</sup> a corporation and any other corporation which is a member of the same controlled group;<sup>22</sup> and any partnership if 50 percent or more in value of the interests in the partnership is owned, directly or indirectly, by the taxpayer or members of the taxpayer’s family;<sup>23</sup> IRS announced that the definition of family, for purposes of the indirect ownership of corporations and partnerships, is limited to the taxpayer, the taxpayer’s spouse and the taxpayer’s children under the age of 18.<sup>24</sup>

### So is it possible to revoke the election?

As the regulations stipulate, “. . . once an election is made, it is revocable only with the consent of the Commissioner.”<sup>25</sup> The Tax Court has upheld the position of the Treasury in holding that a taxpayer is not permitted to revoke the election without IRS consent.<sup>26</sup> After 1989, a request can be made for a late revocation on Form 3115.

### What are the chances of approval of a request to revoke?

Relatively little guidance is available but it is anticipated that IRS would want to see evidence of changed circumstances – a different crop or crops involved, a different geographic area at stake, a different legal entity carrying on the operations, different ownership of the entity or some other significant economic factor or factors that were not anticipated when the original election was made.

### ENDNOTES

<sup>1</sup> I.R.C. § 263A, enacted by the Tax Reform Act of 1986, Pub. L. No. 99-514, § 803(a), 100 Stat. 2221 (1986). See generally 4 Harl, *Agricultural Law* § 28.07[1] (2011); Harl, *Agricultural Law Manual* § 4.03[10] (2011); 1 Harl, *Farm Income Tax Manual* § 3.19 (2011 ed.).

<sup>2</sup> Technical and Miscellaneous Revenue Act of 1988, Pub. L.

No. 100-647, § 6026(b), 102 Stat. 3691 (1988).

<sup>3</sup> *Id.*

<sup>4</sup> I.R.C. § 263A(d)(1)(A).

<sup>5</sup> See *Dugan v. Comm’r*, T.C. Memo. 1994-578 (income generated under livestock share lease not subject to self-employment tax). The same could be true of animals used in entertainment ventures and animals used in a private research operation.

<sup>6</sup> T.D. 8897, 65 Fed. Reg. 50,638 – 50,650, August 21, 2000, Treas. Reg. § 1.263A.

<sup>7</sup> Treas. Reg. § 1.263A-4(d).

<sup>8</sup> I.R.C. § 448(a)(3).

<sup>9</sup> Treas. Reg. § 1.263A-4(a)(2)(ii).

<sup>10</sup> See I.R.C. § 6662(d)(2)(C)(iii).

<sup>11</sup> *Id.*

<sup>12</sup> Treas. Reg. § 1.263A-4(a)(2)(ii)(B).

<sup>13</sup> I.R.C. § 263A(e)(1), (e)(2)(A); Treas. Reg. § 1.263A-4(d)(4)(ii).

<sup>14</sup> *Id.*

<sup>15</sup> Pub. L. No. 111-312, amending I.R.C. § 179(b)(1)(B), (b)(2)(B).

<sup>16</sup> See Rev. Proc. 2011-26, 2011-1 C.B. 560.

<sup>17</sup> I.R.C. § 168(k)(2).

<sup>18</sup> I.R.C. § 168(k)(2)(D)(i). Neither of the exceptions seems to apply. See I.R.C. § 168(k)(2)(D)(i).

<sup>19</sup> I.R.C. § 263A(e)(1).

<sup>20</sup> Treas. Reg. § 1.263A-4(d)(4)(iii)(B).

<sup>21</sup> Treas. Reg. § 1.263A-4(d)(4)(iii)(A)(2).

<sup>22</sup> Treas. Reg. § 1.263A-4(d)(ii)(A)(3).

<sup>23</sup> Treas. Reg. § 1.263A-4(d)(4)(iii)(A)(4).

<sup>24</sup> Notice 88-86, 1988-2 C.B. 401.

<sup>25</sup> Treas. Reg. § 1.263A-4(d)(1)(4)(ii).

<sup>26</sup> *Hodel v. Comm’r*, T.C. Memo. 1996-348. Taxpayers who had made an election before January 1, 1989, could revoke the election without IRS consent the first taxable year after December 31, 1988. Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 6026(d)(2)(B), 102 Stat. 3695 (1988). See Notice 89-67, 1989-1 C.B. 723 (effect of TAMRA on uniform capitalization election).