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CAPITALIZING PREPRODUCTIVE PERIOD EXPENDITURES

— by Neil E. Harl*

Few have forgotten the provision in the Tax Reform Act of 1986 requiring the capitalization of preproductive period expenditures for animals or crops having a preproductive period of more than two years. The provision was repealed as to animals in the Technical and Miscellaneous Revenue Act of 1988. However, problems may now be encountered by those who elected out of the provision before 1989.4

Election out

Except for corporations and partnerships required to use accrual accounting, farming syndicates, tax shelters and some citrus producers, an election could have been made to avoid the capitalization rule. Unless consent was obtained from the Commissioner, the election could only be made for the taxpayer's first taxable year beginning after December 31, 1986, and during which the taxpayer engaged in a farming business; in the case of a partnership or S corporation, the election was made by the partner or shareholder. The taxpayer was treated as having made the election if the taxpayer did not capitalize the costs of producing property used in a farming business. Once made, the election was revocable only with the consent of the Commissioner. If the election to avoid the capitalization rule was not made, a late election was allowed for good cause. In a 1991 private letter ruling, good cause was not shown by a farm partnership that was unaware that an election could be made.

If the election out was made, plants or animals produced by the taxpayer were treated as I.R.C. § 1245 property for purposes of reporting gain on disposition. In calculating the recapture amount, the taxpayer could use the farm-price or unit-livestock-price methods in determining deductions that would otherwise have been capitalized.

In the event the taxpayer (or a related person) made the election out, the alternative depreciation system (straight line depreciation over the class life for most farm property) was applied to 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 was in effect. Alternative depreciation did not preclude claiming expense method depreciation.

Revoking the election

If the taxpayer elected out of the capitalization rules, and did not revoke the election during the first taxable year after December 31, 1988, the taxpayer appears to be limited to the alternative depreciation system. In general, that means straight line depreciation over the class life of the asset. Any uniform relief in such situations would appear to require additional legislation.

FOOTNOTES

2 I.R.C. § 263A.
9 Treas. Reg. § 1.9100-1(a).
14 I.R.C. § 168(g)(2).

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