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to:

Senior Counsel (SL)

(Large & Mid-Size Business)

from:

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subject: Wine grape growing and the Uniform Capitalization Rules of 263A

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =

ISSUES

1. Where the taxpayer grows a grape crop and subsequently processes the crop into wine, when does the actual preproductive period of the grape crop end for purposes of § 263A of the Internal Revenue Code (Code)?

2. Which costs incurred between the harvest of a grape crop and blossoming of the subsequent crop are subject to capitalization?

CONCLUSIONS

1. The actual preproductive period of a grape crop grown for use in the taxpayer's wine production ends no later than the onset of the crush of the grapes.

2. Preproductive period costs incurred between the end of the actual preproductive period of a grape crop and the blossoming of the subsequent crop are generally deductible as a cost of maintaining the vine. Preproductive period costs incurred between the harvest of the crop and the end of the actual preproductive period of the crop are capitalized to the crop unless they are "field costs" that provide no benefit to crop.

FACTS

The taxpayer operates vineyards that produce wine grapes and a winery that produces wines. For federal income tax purposes, the taxpayer uses an overall accrual method of accounting and treats the grape growing and wine making activities as a single trade or business.

The grape vines set blossoms in the spring, and the grapes are harvested in the fall. Most or all of the harvested grapes are sent to taxpayer's winery to be crushed to produce juice that taxpayer will process into wine. Depending upon circumstances, the taxpayer may sell some of its harvested grapes to other wine producers, or may purchase grapes from other grape producers to supplement its own harvest.

LAW

Section 263A (UNICAP) in general

Section 263A(b)(1) provides that, except as otherwise provided, § 263A shall apply to real or tangible personal property produced by the taxpayer.

Section 263A(g)(1) provides that, for purposes of § 263A, the term "produce" includes construct, build, install, manufacture, develop or improve. Section 1.263A-2(a)(1) provides that, for purposes of § 263A, "produce" includes the following: construct, build, install, manufacture, develop, improve, create, raise or grow.

Section 263A(a)(1) provides that in the case of any property to which § 263A applies, the direct costs of the property and the indirect costs properly allocable to the property shall be included in inventory costs (in the case of property that is inventory in the hands of the taxpayer) or shall be capitalized (in the case of other property).

Section 1.263A-1(e)(2)(i) provides generally that direct material costs of producers include the costs of those materials that become an integral part of specific property

produced and those materials that are consumed in the ordinary course of production and that can be identified or associated with particular units or groups of units of property produced. Direct labor costs of producers include the costs of labor that can be identified or associated with particular units or groups of units of specific property produced.

Section 1.263A-1(e)(3)(i) provides that "indirect costs" are defined as all costs other than direct material costs and direct labor costs (in the case of property produced) or acquisition costs (in the case of property acquired for resale). Taxpayers subject to section 263A must capitalize all indirect costs properly allocable to property produced or property acquired for resale. Indirect costs are properly allocable to property produced or property acquired for resale when the costs directly benefit or are incurred by reason of the performance of production or resale activities. Indirect costs may be allocable to both production and resale activities, as well as to other activities that are not subject to section 263A. Taxpayers subject to section 263A must make a reasonable allocation of indirect costs between production, resale, and other activities.

Preproductive periods and preproductive period costs

Section 263A(d)(1) provides that § 263A does not apply to the production of any animal or any plant with a preproductive period of 2 years or less if the taxpayer is not required to use an accrual method of accounting under § 447 or § 448(a)(3). See also § 1.263A-4(a)(2). 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. § 1.263A-4(b)(2)(i)(A). See also Notice 2000-45, 2000-2 C.B. 256.

Section 1.263A-4(b)(1) provides that unless otherwise provided, § 263A requires the capitalization of the direct costs and an allocable portion of the indirect costs that directly 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). The types of direct and indirect costs that generally must be capitalized by taxpayers under § 263A are described in Section 1.263A-1(e), and specific examples of the types of costs typically incurred in the trade or business of farming are provided in § 1.263A-4(b)(1)(i) and (ii).

Section 1.263A-4(b)(1)(i) provides that the costs of producing a plant typically required to be capitalized under § 263A include the costs incurred so that the plant's growing process may begin (preparatory costs), such as the acquisition costs of the seed, seedling, or plant, and the costs of planting, cultivating, maintaining, or developing the plant during the preproductive period (preproductive period costs). Preproductive period costs include, but are not limited to, management, irrigation, pruning, soil and water conservation (including costs that the taxpayer has elected to deduct under section 175), fertilizing (including costs that the taxpayer has elected to deduct under section

180), frost protection, spraying, harvesting, storage and handling, 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).

Section 1.263A-4(b)(2)(i)(C)(2)(i) provides in pertinent part that field costs, such as irrigating, fertilizing, spraying and pruning, that are incurred after the harvest of a crop or yield but before the crop or yield is sold or otherwise disposed of are not required to be included in the preproductive period costs of the harvested crop or yield because they do not benefit and are unrelated to the harvested crop or yield.

Preproductive period

Section 1.263A-4(b)(2)(i)(C) provides that the plant's actual preproductive period [as distinct from the nationwide weighted average preproductive period of the plant] is used for purposes of determining the period during which a taxpayer must capitalize preproductive period costs with respect to a particular plant.

Section 1.263A-4(b)(2)(i)(C)(1) provides in pertinent part that in the case of the crop or yield of a plant that will have more than one crop or yield, the actual preproductive period begins when the plant has become productive in marketable quantities and the crop or yield first appears, for example, in the form of a sprout, bloom, blossom, or bud.

Section 1.263A-4(b)(2)(i)(C)(2)(i) provides in pertinent part that in the case of 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.

Farming business

Section 263A(e)(4) provides that the term "farming business" means the trade or business of farming, but does not include the operation of a nursery or sod farm or the raising or harvesting of tress bearing fruit, nuts, or other crops, or certain ornamental trees.

Section 1.263A-4(a)(4)(i) provides generally that a farming business means a trade or business involving the cultivation of land or the raising or harvesting of any agricultural or horticultural commodity. Harvesting does not include contract harvesting of an agricultural or horticultural commodity grown or raised by another.

Section 1.263A-4(a)(4)(ii)(A) provides that a farming business includes processing activities that are normally incident to the growing, raising, or harvesting of agricultural or horticultural products; for example, the harvesting, washing, inspecting and packaging of fruits and vegetables for sale are incidental activities of the trade or business of raising fruits and vegetables.

By contrast, § 1.263A-4(a)(4)(ii)(B) provides that a 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. For example, the processing of grain into breads, cereals and similar food products is not normally incident to the growing and harvesting of grain and is not part of a farming business. § 1.263A-4(a)(4)(iii), Example 2. Similarly, the slaughtering, processing and packaging or canning of poultry are not normally incident to the growing or raising of poultry and are not part of a farming business. § 1.263A-4(a)(4)(iii), Example 3.

ANALYSIS

1. Where the taxpayer grows a grape crop and subsequently processes the crop into wine, when does the actual preproductive period of the grape crop end for purposes of § 263A of the Internal Revenue Code (Code)?

Grape vines produce multiple crops of grapes. Accordingly, the actual preproductive period of a grape crop ends when the crop is "sold or otherwise disposed of." § 1.263A-4(b)(2)(i)(C)(2)(i).

The taxpayer retains physical custody and legal title of the grapes as they grow to maturity; after harvest, the grapes are sent to taxpayer's winery and are crushed to produce juice that is processed into wines that are sold to customers. At what point along this process, then, does the actual preproductive period (APP) of the crop end? Does the APP extend until the wines produced from the crop are sold? Or does the APP end at an earlier point in time?

We note initially that the grapes themselves are never subject to a "sale or other disposition" as these terms are customarily used in federal income tax law; only the wine produced from the grapes is sold or otherwise disposed of. Despite the express language of § 1.263A-4(b)(2)(i)(C)(2)(i) linking the end of the APP with a "sale or other disposition," however, we believe that the APP of a grape crop grown for use in producing the taxpayer's own wines must end no later than when the crop is crushed. We believe that the crush constitutes an appropriate latest date for the end of the APP for several reasons.

First, the crush marks the point in time when the crop loses its physical character as grapes. The crush converts the grape crop into must (juice) and marc (residue of the grapes). These materials are, respectively, a raw material and a byproduct of wine production; they do not constitute grapes or a crop of grapes in any ordinary sense of these terms.

Second, the crush marks the point in time when the taxpayer stops growing grapes and starts producing wine. These two production activities are quite distinct in their methods and resulting products. Grape growing involves the cultivation of multicrop plants to produce grapes, a perishable agricultural product. Winemaking involves fermenting and manipulating the raw material of grape juice into wine, a packaged and manufactured product.

Third, because crushing the grapes terminates both the grape crop and its production, the crush also marks the point in time when taxpayer ceases to incur costs to produce grapes and begins to incur costs to produce wine. The costs of direct materials (which become physically incorporated into the grapes) and direct labor (which must be identified or associated with particular units of grapes produced) can no longer be incurred with respect a grape crop once it has been crushed out of existence. §§ 1.263A-1(e)(2)(i), 1.263A-4(b)(1). Similarly, indirect costs are not properly allocable to the grape crop after the crush because the crush terminates the production of the grape crop and thus indirect costs can no longer directly benefit, or be incurred by reason of, the production of grapes. §§ 1.263A-1(e)(3)(i), 1.263A-4(b)(1). In sum, delaying the end of the actual preproductive period of a grape crop beyond the crush would extend capitalization into a time period when there are no costs that may properly be capitalized into the crop.

Fourth, the crush marks the end of the "farming business" of grape growing under § 63A(e)(4), and the beginning of the nonfarming trade or business of producing wine. Growing grapes is a farming business because it involves the cultivation of land and the raising of grapes, which are an agricultural commodity. § 1.263A-4(a)(4)(i). The farming business of growing grapes includes certain processing activities that are normally incident to the growing, raising, or harvesting of grapes, such as noncontract harvesting, washing and inspecting. § 1.263A-4(a)(4)(ii)(A). At first impression, the crushing of grapes and the production of wine might also seem to be "normally incident" to the growing of grapes because these activities are the anticipated continuations of growing wine grapes. The regulations make it clear, however, that the preparation of processed food products (such as wine) is not part of a farming business, even where the farming business also produces the agricultural commodity (grapes) that constitute the raw material for the processed food product. For example, the milling of flour and production of baked goods are not part of the farming business of raising grains, even though such activities are a logical and foreseeable consequence of raising grains. §§ 1.263A-4(a)(4)(ii)(B), 1.263A-4(a)(4)(iii), Example 2.

In sum, we believe that despite the "sale or other disposition" language in § 1.263A-4(b)(2)(i)(C)(2)(i), the APP of grapes grown for self use must end no later than the onset of the crush because this marks the end of the grape crop, the growing process, and the farming business. Extending the APP beyond this point would result in the capitalization of inappropriate costs into a "crop" that no longer exists, and would be

contrary to both the general principles of § 263A and the special rules that implement such principles for farming businesses.

2. Which of the costs incurred between the harvest of a grape crop and blossoming of the subsequent crop are subject to capitalization?

Grape vines are grown in commercial quantities in the United States, and their nationwide weighted average preproductive period is more than 2 years. See Notice 2000-45. Accordingly, § 263A applies to the costs of producing grape vines, unless an election is made under § 263A(d)(3) not to apply the provisions of § 263A. § 1.263A-4(a)(2), (b)(1).

A taxpayer growing a grape vine must capitalize the direct costs and an allocable portion of the indirect costs of producing the vine. §§ 1.263A-1(e), 1.263A-4(b)(1). Specifically, a taxpayer growing a grape vine must capitalize the preparatory costs of the vine and the preproductive period costs of the vine that are incurred during the APP of the vine. § 1.263A-4(b)(1)(i). The APP of the grape vine ends when the vine first becomes productive in marketable quantities. § 1.263A-4(b)(2)(i)(C)(2)(i). After the end of the APP, preproductive period costs are generally capitalized to a crop during the preproductive period of the crop and are deducted as a cost of maintaining the vine when incurred between the end of the APP of one crop and the beginning of the APP of the subsequent crop. § 1.263A-4(b)(2)(i)(D), Example (7)(ii).

A special exception applies to the period between the harvesting of a crop and the sale or other disposition of the crop. Section 1.263A-4(b)(2)(i)(C)(2)(i) provides that "field costs, such as irrigating, fertilizing, spraying and pruning" are not required to be capitalized into the harvested crop because "they do not benefit and are unrelated to the harvested crop or yield." The cost of the harvest itself is a preproductive cost that is capitalized into the crop if (as is usual) it is incurred during the APP of the crop. § 1.263A-4(b)(1)(i).

The listed examples– irrigation, fertilization, spraying and pruning – illustrate the common characteristic of the "field costs" qualifying for the exception: they maintain and improve the health of the vines, but they do not (and cannot) provide any benefits to the crop, which has already been severed from the vines. Stated more precisely in terms of UNICAP principles, "field costs" are cost which (i) are not direct costs of the crop, and (ii) are not indirect costs allocable to the crop because they do not directly benefit, and are not incurred by reason of, the production of the crop.

Following these principles, the irrigation, fertilization, spraying or pruning of the vines are "field costs" because they do are not directly benefit, and are not incurred by reason of, the production of a grape crop that has already been severed from the vines. On the other hand, costs such as administration, tax depreciation and repairs on farm buildings,

farm overhead and taxes (other than state and Federal income taxes) are not field costs because they directly benefit, or are incurred by reason of, the production of the crop.

Finally, we note that § 1.263A-4(b)(2)(i)(C)(2)(i) provides that the field cost exception applies during the period between harvest and the "sale or disposition" of the crop. Consistent with our conclusions in the first issue, we believe that field cost exception ends when the APP of the crop ends, which, in the case of grapes grown for self use, is the onset of the crush.

Please call if you have any further questions