T.C. Memo. 2002-317

Under Section 263A, farmers are required to capitalize preproductive expenses for plants with a preproductive period exceeding two years, based on the nationwide weighted average, even if specific regulatory guidance is lacking.

Summary

Pelaez & Sons, Inc., a citrus grower, deducted developmental expenses for citrus trees, arguing that their experience showed a preproductive period of less than two years, exempting them from capitalization under Section 263A. The IRS disallowed these deductions, asserting that citrus trees generally have a preproductive period exceeding two years and require capitalization. The Tax Court held that despite the lack of specific IRS guidance on the nationwide weighted average preproductive period for citrus, the statute mandates capitalization for plants exceeding the two-year period based on this national average. The court found that Congressional intent and industry standards indicated citrus trees typically exceed this period, and the taxpayer's specific experience was insufficient to override the general rule. Additionally, the court upheld the IRS's adjustment for a closed tax year as a permissible correction of an accounting method change under Section 481.

Facts

Pelaez & Sons, Inc. (the corporation), a Florida S corporation, began citrus farming in the late 1980s, employing advanced growing techniques to accelerate production. In 1989 and 1991, the corporation planted citrus trees and incurred developmental expenses (herbicides, fertilizer, etc.). For 1989 and 1990, the corporation deferred deducting these expenses, unsure if the trees would yield a marketable crop within two years. Based on initial fruit production within two years, the corporation deducted accumulated 1989 and 1990 developmental expenses on its 1991 return and continued deducting annual developmental costs in subsequent years. The IRS issued a notice of adjustment, disallowing these deductions for 1991-1994, arguing they should have been capitalized under Section 263A.

Procedural History

The IRS issued a Notice of Final S Corporation Administrative Adjustment (FSAA) for the corporation's 1992, 1993, and 1994 tax years, disallowing deductions related to citrus tree developmental expenses. The corporation challenged the FSAA in Tax Court, contesting the application of Section 263A and arguing that the 1991 tax year adjustment was time-barred. The Tax Court considered whether the corporation was required to capitalize these expenses and whether the 1991 adjustment was permissible.

Issue(s)

1. Whether, under Section 263A, the corporation is required to capitalize

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developmental expenses for citrus trees, even in the absence of specific IRS guidance on the nationwide weighted average preproductive period for citrus trees?

2. Whether the IRS is precluded from adjusting the corporation's 1991 tax year deductions due to the statute of limitations, when the adjustment is made in a subsequent year (1992) as a result of a change in accounting method?

Holding

1. No, because Section 263A requires capitalization for plants with a nationwide weighted average preproductive period exceeding two years, and congressional intent and industry practice indicate citrus trees generally fall into this category, regardless of the lack of specific IRS guidance.

2. No, because the corporation's change from capitalizing to deducting preproductive expenses constitutes a change in accounting method, allowing the IRS to make adjustments under Section 481 in a subsequent (open) tax year to correct for deductions improperly taken in a closed tax year.

Court's Reasoning

The court reasoned that Section 263A(d)(1)(A)(ii) exempts plants with a preproductive period of '2 years or less' based on the 'nationwide weighted average preproductive period.' While the IRS had not issued specific guidance for citrus trees, the statute's language and legislative history, particularly Section 263A(d)(3)(C) regarding citrus and almond growers' inability to elect out of capitalization for the first four years, imply that Congress considered the preproductive period for citrus to exceed two years. The court noted that the corporation's own expert testimony and industry literature suggested that while some fruit production might occur within two years with advanced techniques, commercially viable production typically takes longer. The court rejected the argument that the lack of IRS guidance invalidated the nationwide average standard, finding the statute's intent clear. Regarding the statute of limitations, the court determined that the corporation's decision to deduct expenses in 1991, after initially deferring and effectively capitalizing them, constituted a change in accounting method. This change, affecting the timing of deductions for a material item, triggered Section 481, allowing the IRS to adjust the 1992 tax year to prevent the double benefit of deductions taken in the closed 1991 year and again through depreciation or reduced sales proceeds in subsequent years. The court quoted Rev. Proc. 92-20, defining a change in accounting method as including a change in the treatment of a material item that affects the timing of income or deductions.

Practical Implications

This case clarifies that taxpayers in the farming industry must adhere to the capitalization rules of Section 263A for plants with preproductive periods exceeding

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two years based on the nationwide weighted average, even without explicit IRS guidelines for each specific plant type. It highlights that congressional intent and general industry standards can be used to determine the preproductive period when specific IRS guidance is absent. For tax practitioners, this case emphasizes the importance of understanding industry norms and legislative history in applying tax statutes, especially when regulations are lacking. It also serves as a reminder that changes in the treatment of capitalizing versus deducting expenses can be considered a change in accounting method, potentially triggering Section 481 adjustments, even if the initial decision was based on uncertainty about regulatory guidance. This can have significant implications for tax planning and compliance, especially in agricultural businesses dealing with preproductive expenses.

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