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# IRS Catches-Up With The 1986 Tax Act - Chief Counsel's Office Says Vineyard Qualifies For Expense Method Depreciation

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**- by Roger A. McEowen***

## Overview

Twenty-six years after the Tax Reform Act of 1986 made important changes to the Internal Revenue Code concerning the definition of property that qualifies for expense method depreciation (I.R.C. §179), the Chief Counsel's Office of IRS has finally recognized that those changes allow vineyards (and, by analogy, orchards and groves) to qualify for I.R.C. §179. The change is certainly welcome, and conforms the IRS position to what some practitioners had thought was the proper approach since the key statutory changes took effect. The key point is that the IRS now agrees that I.R.C. §179 is available when the vineyard is placed in service even in situations where the taxpayer established the vineyard years earlier by planting the seeds and capitalizing expenses during the pre-production period.

## Impact of Expense Method Depreciation

In recent years, expense method depreciation (I.R.C. §179) has provided significant tax savings for taxpayers with qualified business assets. That's primarily because the amount of the depreciation deduction has been increased tremendously – topping out at $500,000 for 2011. It's now at $139,000 at the federal level[1] for 2012 and, without congressional action, will drop to $25,000 for 2013. The current $139,000 amount is for the aggregate basis of all eligible property placed in service during the year,[2] not for each item of qualified property. It's an off-the-top depreciation allowance that may be taken at the taxpayer's election each year.

> **Note:** For 2012, expense method depreciation is phased out for taxpayers with cost of qualifying property exceeding $560,000. For each dollar of investment in excess of $560,000 per year, the allowable expense amount is reduced by $1. Thus, at $560,000, the full deduction is available, and at $699,000, nothing is available.[3]

In the agricultural context, the allowance is usually thought of as being available for farm machinery and equipment. But, for orchards, groves and vineyards, the IRS position has been that they are not eligible for I.R.C. §179 because the capitalized direct and indirect costs are not considered to be placed in service until the property becomes productive. Based on the IRS view, the only way such property could be eligible for I.R.C. §179 was if the taxpayer purchased an established orchard, grove or vineyard. But, a recent Chief Counsel's Advice reflects a change in the IRS position, and opens up the door to allow taxpayers to use I.R.C. §179 even if they established such property themselves and capitalized the direct and indirect costs associated with the property during the pre-productive period with the property being placed in service years later.[4]

## Eligible Property

To be eligible for I.R.C. §179, the property must

be tangible property to which I.R.C. §168 applies, be I.R.C. §1245 property and be acquired by purchase for use in the taxpayer's active conduct of the taxpayer's trade or business.[5] However, certain items of tangible depreciable personal property are not eligible for expense method depreciation. In general, any property that would not be eligible for investment tax credit (under the rules when the investment tax credit was available) is ineligible for expense method depreciation. Likewise, property acquired by gift, inheritance, by estates or trusts and property acquired from a spouse, ancestors or lineal descendants is not eligible for expense method depreciation. For property traded in, only the cash boot that is paid is eligible for expense method depreciation.

For the farmer or rancher, however, expense method depreciation is potentially available for a wide array of assets. For example, not only can expense method depreciation be claimed by election on machinery and equipment, as well as purchased breeding stock, pickup trucks and business automobiles, it can also be claimed on tile lines, fences, feeding floors, grain bins and silos because all of those assets were eligible for investment tax credit when it was available and were classified as "other property" under I.R.C. § 1245.

> **Note:** Taxpayers can select those assets to which they would like to have expense method depreciation apply. If expense method depreciation is selected for a particular asset, depreciation cannot be claimed on that portion of the asset's basis, the basis of the qualifying property must be reduced by the amount of the expensing deduction.

**Taxable Income Limitation**

Expense method depreciation can be claimed only to the extent of taxable income from an active trade or business, but W-2 wage income is considered income from a trade or business. So if a farmer or rancher also has an off-farm job, the W-2 wage income from that job is considered income from an active trade or business for purposes of I.R.C. §179.

**Application of I.R.C. §179 To Vineyards**

**Early IRS position.** In Rev Rul 67-51,[6] the IRS ruled that fruit orchards or groves are ineligible for I.R.C. §179. At the time the ruling was issue, that position followed the statutory definition of qualified property for I.R.C. §179 which required the property to be tangible personal property of a character subject to the allowance for depreciation under I.R.C. §167, purchased for use in the taxpayer's trade or business (or for the production of income), and have a useful life of 6 years or more.[7] In the ruling, the IRS also noted that "tangible personal property" did not include land, and because "trees are part and parcel of the land in which they are rooted," trees of a fruit orchard or grove bought and held for production of income were not tangible personal property for purposes of I.R.C. §179.[8]

In May of 2011, the IRS updated an Audit Technique Guide (ATG) in which it maintained the position that vineyards are not eligible I.R.C. §179 property. In the ATG, IRS referred to Rev. Rul. 67-51. However, the definition of what property qualifies for I.R.C. §179 was changed by the 1986 Tax Reform Act. Under that Act, property eligible for I.R.C. §179 (as noted above) is defined as tangible property to which I.R.C. §168 applies (in other words, it is depreciable), is I.R.C. §1245 property.[9] That provision states that I.R.C. §1245 property is any property subject to depreciation under I.R.C. §167 and which falls into one of six classes, the first of which is personal property (I.R.C. § 1245(a)(3)(A)), and the second of which (I.R.C. §1245(a)(3)(B)), in relevant part, is other property (not including a building or its structural components) whose basis has been reduced by depreciation, amortization or the deductions that are treated as amortization under I.R.C. §1245(a)(2), during a period in which the property was used as an integral part of manufacturing, production or extraction. Clearly, vineyards (and orchards and groves) that are acquired by purchase for use in the taxpayer's trade or business are depreciable and meet the other requirements to be eligible I.R.C. §179 property. Thus, the purchase of an

established vineyard would be eligible property. But what about expensing a vineyard once it is placed in service upon becoming productive several years after the taxpayer planted the seeds to establish it? The question really boils down to whether a vineyard is "other property" that is used as an integral part of manufacturing, production or extraction as defined in I.R.C. §1245(a)(3)(B). In the ATG, the IRS referenced a 1979 U.S. Tax Court case to support its apparent position that vineyards are ineligible property.[10] But, in that 1979 opinion the court utilized the prior definition of eligible property in determining that grapevines were not "tangible personal property." At the time, the statute did not reference I.R.C. §1245(a)(3). The ATG doesn't really say what the IRS position is on the issue since the statute was modified, apparently leaving the matter open for audit and eventual litigation. Now, the IRS has answered the question.

**CCA 201234024[11]**

Under the facts of the CCA, an individual taxpayer elected I.R.C. §179 for a vineyard when it was placed in service (e.g., when it became productive) in 2009. The taxpayer had planted the vineyard in 2005 and capitalized the costs of the land preparation, labor costs and planting costs over three years. The Chief Counsel's Office first determined that the vineyard was §1245 property, noting that the statutory definition of "tangible personal property" for purposes of I.R.C. §179 had been changed since the issuance of Rev. Rul. 67-51 and that a vineyard qualifies as "other tangible property" under I.R.C. §1245(a)(3).[12] As such, the CCA state that Rev. Rul. 67-51 "no longer applies for purposes of §179 of the 1986 Code." The CCA also notes that the vineyard is tangible property to which I.R.C. §168 applies by virtue of I.R.C. §168(e)(3)(D)(ii) which classifies any tree or vine bearing fruit or nuts as 10-year property. The CCA also notes that the taxpayer acquired the vineyard by purchase. Thus, if it is used in the taxpayer's active conduct of a trade or business, it is qualified I.R.C. §179 property.

**Planning Opportunity**

The CCA confirms what some practitioners have believed since 1986, and is welcome relief. Even though the CCA was not issued until after the maximum I.R.C. §179 deduction was reduced to $139,000 from the $500,000 level that it was at in 2011, tax returns for the open tax years (generally three years back) can be amended to either make or revoke an I.R.C. §179 election. That means that taxpayers that put a vineyard, orchard or grove in service in the past three years but didn't elect I.R.C. §179 can now do so. The Small Business Jobs Act of 2010 specifies that taxpayers can revoke an expense method depreciation election for any tax year that begins before 2012. Because the IRS previously stated that the statutory provision concerning revocations of expense method depreciation elections also applies to making such elections, a taxpayer may make an expense method depreciation election on an amended return for tax years beginning before 2012. Legislation enacted in late 2010 extends the ability to revoke an expense method election on an amended return through 2012. In IRS Info. Ltr. 2009-59,[13] the IRS stated that taxpayers can make or revoke an expense method depreciation election on an amended return involving an open tax year beginning after 2007 and before the date specified in I.R.C. §179(c)(2) without the need for Treasury Regulations to be issued. The late 2010 amendment to I.R.C. §179(c)(2) extended the date to tax years through December 31, 2012. In the Info. Ltr, the IRS stated that taxpayers can rely on the guidance set forth in Rev. Proc. 2008-54, Section 7, for making and revoking such elections.

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[1] Not all states "couple" with the federal provision. Taxpayers must check their own state's rules for claiming the deduction on their state income tax return.

[2] Property is deemed to be placed in service when it is in a state of readiness or availability for use. *See, e.g.,* Brown v. Comr., T.C. Sum. Op. 2009-171.

[3] Under current law, the $560,000 limitation drops to $200,000 for 2013.
[4] Chief Counsel.Adv. 201234024 (May 9, 2012).
[5] Also, for tax years beginning in 2010 or 2011, up to $250,000 of qualified real property (qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property) qualifies for I.R.C. §179,. Off-the-shelf computer software also qualifies if it is placed in service in a tax year beginning before 2013.
[6] 1967-1 C.B. 68.
[7] I.R.C. §179(d) before amendment by P.L. 97-34, §202(a).
[8] Citing Treas. Reg. § 1.179-3(b).
[9] I.R.C. §1245 property is defined in I.R.C. §1245(a)(3).
[10] Kimmelman v. Comr., 72 T.C. 294 (1979).
[11] May 9, 2012. An IRS Chief Counsel Advice is typically requested by an IRS examining agent that has a return under audit and is unsure of the IRS position on a particular issue. Request is made of the National Office of IRS to rule on the facts under audit. The response is provided to the agent.
[12] The CCA notes that this would be the result regardless of whether a vineyard is or is not an inherently permanent structure.
[13] Feb. 17, 2009. The Info. Ltr. follows-up on Rev. Proc. 2008-54 where the IRS, in Section 7, provided guidance for making and revoking an I.R.C. §179 election on an amended return. The Info. Ltr. makes it clear that Treasury Regulations need not be issued to allow such an election to be made or revoked on an amended return.