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INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

District Director

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's EIN:

Tax Year Involved:

Date of Conference:

LEGEND:

Taxpayer:
State A:
M:

ISSUES:

(1) Whether the plants acquired by Taxpayer are seeds and young plants acquired for further cultivation or development for purposes of § 1.162-12 of the Income Tax Regulations.

(2) Whether § 263A of the Internal Revenue Code applies to any of Taxpayer's plants.[1]

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[1] Taxpayer has also requested relief under § 7805(b) to limit the retroactive application of any adverse conclusion in this technical advice memorandum. This request will be addressed in a separate technical advice memorandum.

CONCLUSIONS:

(1) The following plants acquired by Taxpayer are seeds and young plants acquired for further cultivation or development: bare root trees, balled and burlapped trees, bare root shrubs, balled and burlapped shrubs, "B" state shrubs, bare root rose bushes, perennial seedlings, perennial cuttings, annual seedlings, annual cuttings, houseplant seedlings, and houseplant cuttings. Thus, Taxpayer may deduct the acquisition costs of these plants under § 1.162-12. Trees, perennials, annuals, and houseplants, that are ready for immediate resale when purchased, are not seeds and young plants acquired for further cultivation and development. Taxpayer is required to capitalize the acquisition costs of these plants.

(2) Because Taxpayer has validly elected under § 263A(d)(3) not to apply § 263A to plants produced in its business, § 263A does not apply to the following plants: bare root trees, balled and burlapped trees, bare root shrubs, balled and burlapped shrubs, "B" state shrubs, bare root rose bushes, perennial seedlings, perennial cuttings, annual seedlings, annual cuttings, houseplant seedlings, and houseplant cuttings. The § 263A(d)(3) election does not apply to the trees, perennials, annuals, and houseplants, that are ready for immediate resale when purchased, as these items are not produced in Taxpayer's business, but are merely acquired for resale. Accordingly, § 263A applies to these items.

FACTS:

Taxpayer is a State A corporation that is owned more than 50% by members of the M family, as defined in § 447(e). Taxpayer uses a February 28 fiscal year end and an overall accrual method of accounting. Taxpayer operates a nursery and primarily sells growing plants, fertilizer, pesticides, pots, and gardening implements to builders, landscapers, and retail customers in State A. Taxpayer has annual sales of under $25,000,000 and maintains divisional income statements for each of its six retail locations and a complete set of books for the consolidated enterprise.

For the year at issue, Taxpayer operated a large greenhouse facility, which was used to cultivate, raise, and care for Taxpayer's growing crops. Taxpayer maintains an extensive nursery staff that has received specific training certifying the employees as nursery professionals. Taxpayer's employees cultivate, raise, and care for all of Taxpayer's growing plants. For example, Taxpayer must provide appropriate amounts of water, ensure that the plants receive proper sunlight, protect the plants from disease and pests, provide proper nutrients, protect the plants from adverse temperatures, and generally ensure the growth and sustenance of each plant. Taxpayer plants most of its

growing crops into the containers in which the plants are sold to its customers. Taxpayer also purchases some plants that are in their ultimate containers and are ready for immediate resale.

Because of the effect of the weather and other natural elements, Taxpayer is at significant risk with respect to its plants. The plants sold by Taxpayer to its customers are generally subject to a guarantee policy that provides a full refund to customers or replacement if the plant dies. Further, Taxpayer has financial risk with respect to market demand and price levels for its plants.

Taxpayer purchases most of its plants in various stages of development from the initial grower of the plant, although Taxpayer grows some plants from cuttings of its own plants or from seeds. Taxpayer then cultivates these plants using various methods and sells the plants to its customers as healthy, marketable plants. The various stages in which a plant may be originated or purchased by Taxpayer are described below:

(1) Plants are grown from seeds originally planted by Taxpayer.

(2) Plants are purchased as seedling plugs in a seedling tray that can hold up to 425 plants. Taxpayer plants the seedling plugs into containers and grows them in a greenhouse that is specifically designed for this purpose.

(3) Plants are purchased as cuttings from suppliers or harvested as cuttings from Taxpayer's own plants. Taxpayer plants the cuttings in containers and grows them in a greenhouse that is specifically designed for this purpose.

(4) Plants are purchased "bare root" and are planted by Taxpayer. Bare root plants are purchased by Taxpayer with no soil surrounding the roots and with all feeder roots and branches trimmed off. Taxpayer purchases these plants from November to February each year, when the plants are in a dormant state. The plants are sent to Taxpayer in bundles or boxes on refrigerated trucks to protect them from heat or cold. Upon receiving the plants, Taxpayer examines them for health and damage. The plants are then properly pruned and soaked in vitamin B-1 and fungicide to stimulate root growth and prevent disease. After soaking, Taxpayer plants the bare root material in one of several growing locations to develop a root system and foliage and to grow to a marketable state.

(5) Plants are purchased "balled and burlapped" and are planted by Taxpayer. Balled and burlapped plants are purchased with a small amount of soil surrounding the roots, which are wrapped in burlap. When

Taxpayer purchases the balled and burlapped plants, 70 to 80% of the root system has been cut off. Taxpayer plants balled and burlapped material into containers to develop a root system and foliage and to grow to a marketable state.

(6) Plants are purchased in the container in an unmarketable "B" state and cultivated to a marketable "A" state before sale to customers. Taxpayer typically purchases these plants in the fall and cultivates them throughout the winter for sale beginning in April. During this cultivation period, the plants are hardened-off, acclimated to the local climate, and grown to a state that meets Taxpayer's quality standards.

(7) Plants are purchased in the container ready for immediate resale to customers. The majority of these plants are bought and sold by Taxpayer after it sells out of its existing stock of plants. These purchases and sales generally do not occur until April, May, and June.

The plants that Taxpayer has on-hand at the end of its fiscal year are classified as trees, shrubs, rose bushes, perennials, annuals, or houseplants. The growing process for each type of plant is described below:

Trees
Taxpayer purchases trees in either a bare root state, a balled and burlapped state, or in various size containers that are ready for immediate resale (Categories 4, 5, and 7 above). The bare root and balled and burlapped trees are between approximately one to three years old when purchased and take approximately four to six months to properly root and mature.

Shrubs
Taxpayer purchases shrubs and bushes (other than rose bushes) in either a bare root state, a balled and burlapped state, or a "B" state (Categories 4, 5, and 6 above). These plants are generally one and a half to two years old when purchased and take approximately six months to mature before being sold to customers. The revenue agent states that some shrubs are purchased in the container and are ready for immediate resale to customers (Category 7 above).

Rose Bushes
Taxpayer purchases all of its rose bushes in bare root form (Category 4 above). The bushes are approximately four to six inches long when purchased. Taxpayer plants them into containers until they are rooted, established, and brought to flower. This cultivation process takes approximately three months.

Perennials
Taxpayer purchases perennials as seedling plugs or cuttings that are not larger than one inch in length (Categories 2 and 3 above). Taxpayer plants the perennials into larger containers and grows the plants in a greenhouse for four to eight weeks before sale to its customers. The revenue agent states that some perennials are purchased in the container and are ready for immediate resale to customers (Category 7 above).

Annuals
Taxpayer purchases annuals as seedling plugs or cuttings that are not larger than one inch in length (Categories 2 and 3 above). Taxpayer plants the annuals into larger containers and grows them in a greenhouse for six to eight weeks before sale to its customers. The revenue agent states that some annuals are purchased in the container and are ready for immediate resale to customers (Category 7 above).

Houseplants
Taxpayer purchases certain houseplants (geraniums, chrysanthemums, miniature roses, and azaleas) as seedling plugs and cuttings that are planted by Taxpayer into larger containers (Categories 2 and 3 above). The growing process for houseplants is similar to that for perennials and annuals. All other houseplants are purchased in the container and are ready for immediate resale to customers (Category 7 above).

For federal income tax purposes, Taxpayer currently deducts the cost of all its plants, including the purchase price of the plant, direct labor costs, and any overhead costs associated with the plant. Taxpayer utilizes the straight line method of depreciation in applying alternative depreciation system rules to depreciate its fixed assets, as required for farmers who deduct the costs of their growing crops. Taxpayer does not use the crop method of accounting and, pursuant to § 263A(d)(3), has properly elected not to apply the capitalization provisions of § 263A to plants produced in a farming business. Taxpayer does, however, inventory unsold items other than its growing plant inventory (such as fertilizer, pesticides, pots, and gardening implements) and applies the provisions of § 263A to these unsold items. The revenue agent questions whether Taxpayer should be allowed to currently deduct the acquisition costs of all its plants.[2]

LAW AND ANALYSIS:

Section 162(a) allows a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Section

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[2] The revenue agent has not raised an issue with regard to the cost of seeds that are originally planted by Taxpayer (Category 1 above).

1.162-12(a) provides as follows:

> A farmer who operates a farm for profit is entitled to deduct from gross income as necessary expenses all amounts actually expended in the carrying on of the business of farming . . . . If a farmer does not compute income upon the crop method, the cost of seeds and young plants which are purchased for further development and cultivation prior to sale in later years may be deducted as an expense for the year of purchase, provided the farmer follows a consistent practice of deducting such costs as an expense from year to year.

Section 263A(a) provides that in the case of any property to which this section applies, the direct costs of the property and the property's proper share of those indirect costs allocable to the property shall be capitalized. A brief historical background of the tax treatment of inventories and farmers may be helpful in understanding how § 263A operates in this case.

Beginning in 1919, taxpayers who purchased or produced property and sold such property were required to use inventories and an accrual method of accounting. See Regulations 45 section 203. Article 1581 and section 212. Article 24(l), the predecessors to §§ 1.471-1 and 1.446-1(c)(2). The Internal Revenue Service administratively excepted farmers from these rules. Farmers were permitted to use the cash method of accounting. In addition, whether on the cash or an accrual method, farmers were not required, and, in fact, were not permitted to inventory growing crops. See, e.g., I.T. 1368, I-1 C.B. 72 (1922), and O.D. 995, 5 C.B. 63 (1921). However, section 29.22 (a)-7, the predecessor to § 1.61-4, did provide that even on the cash method, the deduction of the acquisition cost of a purchased item (as opposed to a grown or raised item) was deferred until the year the item was sold. In Stokes v. Commissioner, 22 T.C. 407 (1954), the court held that this regulation required a nursery grower to defer the deduction of the acquisition cost of plants until the year in which the plants were sold even though the nursery grower was permitted to use the cash method and was not otherwise required to use inventories. Shortly after Stokes was decided, the regulations were amended to provide an exception to the purchased item rule. Under this exception, the cost of seeds and young plants purchased for further development and cultivation may be deducted in the year paid. See § 1.162-12(a); see also § 1.61-4(a).

In the late 1960's, Congress became concerned with the mismatching of income and expenses inherent in the farming tax rules. In 1969, Congress enacted § 278, which required the capitalization of the preproductive period expenses of citrus trees. In 1971, this provision was extended to include almond trees. In 1976, Congress enacted provisions requiring certain farmers to use an accrual method of accounting, and to capitalize preproductive period expenses. See § 447. Congress excepted

nursery farmers from the requirements of § 447. In addition, Congress enacted § 464, limiting the deductions of certain farming expenses by farm syndicates.

Also, in 1976, the Service published Rev. Rul. 76-242, 1976-1 C.B. 132, holding that accrual method farmers that did not use the crop method were required to inventory growing crops. Under this ruling, nursery growers and florists would be required to inventory growing trees and growing plants.

In response to Rev. Rul. 76-242, Congress enacted section 352 of the Revenue Act of 1978. Section 352 provides that an accrual method farmer, nursery grower, or florist that was not required by § 447 to capitalize preproductive period costs could not be required to inventory growing crops. The legislative history of section 352 indicates that Congress believed that except as otherwise provided in § 447, and until Congress had the opportunity to study the matter further, farmers (including nursery growers) should be permitted to use the cash method of accounting and deduct the cost of seeds and young plants purchased in one year, which are intended to be sold as farm products in a later year and, even if an accrual method is used, to be excepted from the inventory requirements with respect to any growing (unharvested) crops. See H.R. Rep. No. 1445, 95th Cong., 2d Sess. 116 (1978), 1978-3 (Vol.1) C.B. 290, and S. Rep. No. 1263, 95th Cong., 2d Sess. 166 (1978), 1978-3 (Vol. 1) C.B. 464.

In 1986, Congress repealed § 278 and the preproductive period expense capitalization rules under § 447 and made farmers, as well as other producers and resellers, subject to uniform capitalization rules set forth in § 263A.

Section 263A(a) provides that in the case of any property to which this section applies, the direct costs of the property and the property's proper share of those indirect costs allocable to the property shall be capitalized. Section 263A(b) provides that this section shall apply to real or tangible personal property produced by the taxpayer and real or personal property described in § 1221(1) which is acquired by the taxpayer for resale. Section 1.263A-2(a)(1)(i) provides that for purposes of § 263A, "produce" includes, inter alia, "raise" or "grow." Thus, any plants that are produced by the taxpayer, as well as any plants or other items acquired for resale are within the general rules of § 263A.

There are two relevant exceptions to the general rules of § 263A. First, § 263A(b)(2)(B) provides an exception for resellers whose average annual gross receipts for the 3-taxable year period ending with the taxable year preceding the current taxable year do not exceed $10,000,000 (small reseller exception). Of course, the acquisition costs of merchandise purchased for resale must continue to be inventoried even under the small reseller exception. See §§ 1.61-3 and 1.471-1. Second, § 263A(d) provides an exception for property produced in a farming business (farming

exception). Section 1.263A-4T(a)(3)(i) defines a farming business to mean a trade or business involving the cultivation of land or the raising or harvesting of any agricultural or horticultural commodity. Examples of farming include the trade or business of operating a nursery or sod farm. The trade or business of merely buying and reselling plants grown or raised by another is not a farming business. Because a taxpayer calls itself a farmer does not qualify it for the tax treatment accorded farmers under the Code. In order to determine whether a taxpayer has properly characterized itself as a farmer, it is necessary to ascertain whether the taxpayer is, in fact, cultivating land or raising and harvesting agricultural or horticultural commodities.

Under the farming exception, a taxpayer is generally not required to capitalize costs under § 263A with respect to property produced in a farming business if the taxpayer is neither precluded by § 448(a)(3) from using the cash method nor required by § 447 to use an accrual method and (1) the property produced is an animal, (2) the property produced is a plant with a preproductive period of two years or less, or (3) the property produced is a plant and the taxpayer makes an election under § 263A(d)(3).

The election under § 263A(d)(3) allows a farmer to deduct the preproductive period costs of plants with a preproductive period greater than two years that are produced in a farming business. This election must be made for the taxpayer's first taxable year in the farming business. Once made, this election may be revoked only with the consent of the Commissioner.

In August 1997, rules under § 263A for farmers were issued as both temporary and proposed regulations. Nurserymen were concerned that the temporary regulations changed the tax treatment of purchased plants and shared their concerns with the Service. In response to these concerns, the Service issued Announcement 97-120, 1997-50 I.R.B. 61, which assures nurserymen that if they are using the farming exception, they are allowed to deduct the cost of seeds and young plants purchased for further development and cultivation even if the plants are partly grown by another person or are grown by the nursery in temporary containers.

Thus, under the foregoing rules, the deductibility of purchased items is governed in the first instance by § 1.162-12. Under § 1.162-12(a), if a farmer does not compute income upon the crop method, the cost of seeds and young plants which are purchased for further development and cultivation prior to sale in later years may be deducted as an expense for the year of purchase, provided the farmer follows a consistent practice of deducting such costs as an expense from year to year. Section 352 did not change this rule. On the contrary, in enacting section 352, Congress intended that this rule would remain in effect until Congress provided to the contrary.

In 1986, Congress enacted § 263A, which does provide to the contrary. As noted above, except as provided in the farming exception, § 263A requires the capitalization of the costs of seeds and young plants, as well as the preproductive expenditures of plants. Thus, § 263A supersedes section 352. Moreover, by virtue of the priority ordering rules of § 261, § 263A may require the capitalization of costs that would otherwise be deductible under sections such as § 1.162-12.

Thus, the application of these rules to the instant case initially requires a determination under § 1.162-12 regarding whether the items purchased by Taxpayer are seeds and young plants acquired for further development and cultivation. The revenue agent's concern is whether the items purchased by Taxpayer are "young" plants and whether they are acquired "for further development and cultivation." With regard to what is a "young" plant, there is no authority that defines that term for purposes of § 1.162-12. However, we interpret the use of "young plants" in § 1.162-12(a) as reinforcing the primary requirement that the plants be acquired for further development and cultivation, which is the essence of a farming activity versus a retail activity. Thus, in determining the proper treatment of Taxpayer's acquisition costs, we will focus primarily on the requirement that the plants be acquired for further development and cultivation. This determination must be made with regard to each category of Taxpayers plants and with regard to each type of growing process, as follows.

Bare Root Trees

Bare root trees are between approximately one to three years old when purchased with no soil surrounding the roots and with all feeder roots and branches trimmed off. Taxpayer purchases these trees from November to February each year, when the trees are in a dormant state. The trees are sent to Taxpayer in bundles or boxes on refrigerated trucks to protect them from heat or cold. Upon receiving the trees, Taxpayer examines them for health and damage. The trees are then properly pruned and soaked in vitamin B-1 and fungicide to stimulate root growth and prevent disease. After soaking, Taxpayer plants the bare root trees in one of several growing locations to develop a root system and foliage. Bare root trees take approximately four to six months to properly root and to grow to a marketable state, These facts indicate that Taxpayer acquired its bare root trees for further development and cultivation.

Balled and Burlapped Trees

Balled and burlapped trees are between approximately one to three years old when purchased with a small amount of soil surrounding the roots wrapped in burlap. When Taxpayer purchases the balled and burlapped trees, 70 to 80% of the root system has been cut off. Taxpayer plants balled and burlapped trees into containers to develop a root system and foliage. Balled and burlapped trees take approximately four to six months to properly root and to grow to a marketable state. These facts indicate that

Taxpayer acquired its balled and burlapped trees for further development and cultivation.

Trees Purchased in Containers Ready for Immediate Resale
Taxpayer purchases trees in the container ready for immediate resale to customers. These trees primarily are bought and sold by Taxpayer to meet customer demands and to supplement its existing stock of trees. Thus, these trees were ready for immediate resale when acquired and were not further developed or cultivated.

Bare Root Shrubs
Bare root shrubs are generally one and a half to two years old when purchased with no soil surrounding the roots and with all feeder roots and branches trimmed off. Taxpayer purchases these shrubs from November to February each year, when the shrubs are in a dormant state. The shrubs are sent to Taxpayer in bundles or boxes on refrigerated trucks to protect them from heat or cold. Upon receiving the shrubs, Taxpayer examines them for health and damage. The shrubs are then properly pruned and soaked in vitamin B-1 and fungicide to stimulate root growth and prevent disease. After soaking, Taxpayer plants the bare root shrubs in one of several growing locations to develop a root system and foliage. Bare root shrubs take approximately six months to mature and to grow to a marketable state. These facts indicate that Taxpayer acquired its bare root shrubs for further development and cultivation.

Balled and Burlapped Shrubs
Balled and burlapped shrubs are generally one and a half to two years old when purchased with a small amount of soil surrounding the roots wrapped in burlap. When Taxpayer purchases the balled and burlapped shrubs, 70 to 80% of the root system has been cut off. Taxpayer plants balled and burlapped shrubs into containers to develop a root system and foliage. Balled and burlapped shrubs take approximately six months to mature and grow to a marketable state. These facts indicate that Taxpayer acquired its balled and burlapped shrubs for further development and cultivation.

"B" State Shrubs
Shrubs purchased in a "B" state are generally one and a half to two years old when purchased and are unmarketable because they do not meet Taxpayer's quality standards. Taxpayer typically purchases these shrubs in the fall and cultivates them throughout the winter for sale beginning in April. During this six month cultivation period, the shrubs are hardened-off, acclimated to the local climate, and grown to a marketable "A" state, a state that meets Taxpayer's quality standards. These facts indicate that Taxpayer acquired its "B" state shrubs for further development and cultivation.

Shrubs Purchased in Containers Ready for Immediate Resale

Taxpayer purchases shrubs in the container ready for immediate resale to customers. These shrubs primarily are bought and sold by Taxpayer to meet customer demands and to supplement its existing stock of shrubs. Thus, these shrubs were ready for immediate resale when acquired and were not further developed or cultivated.

Bare Root Rose Bushes

Rose bushes are all purchased in bare root form with no soil surrounding the roots and with all feeder roots and branches trimmed off. Taxpayer purchases rose bushes from November to February each year, when the plants are in a dormant state. The rose bushes are sent to Taxpayer in bundles or boxes on refrigerated trucks to protect them from heat or cold. Upon receiving the rose bushes, Taxpayer examines them for health and damage. The rose bushes are then properly pruned and soaked in vitamin B-1 and fungicide to stimulate root growth and prevent disease. After soaking, Taxpayer plants the bare root rose bushes in one of several growing locations until they are rooted, established, and brought to flower. Bare root rose bushes take approximately three months to grow to a marketable state. These facts indicate that Taxpayer acquired its bare root rose bushes for further development and cultivation.

Perennial Seedlings

Perennial seedling plugs are not larger than one inch in length when purchased in a seedling tray that can hold up to 425 plants. Taxpayer plants the seedling plugs into containers and grows them for four to eight weeks in a greenhouse that is specifically designed for this purpose. These facts indicate that Taxpayer acquired its perennial seedling plugs for further development and cultivation.

Perennial Cuttings

Perennial cuttings are not larger than one inch in length when purchased from suppliers or harvested from Taxpayer's own plants. Taxpayer plants the cuttings into containers and grows them for four to eight weeks in a greenhouse that is specifically designed for this purpose. These facts indicate that Taxpayer acquired its perennial cuttings for further development and cultivation.

Perennials Purchased in the Container Ready for Immediate Resale

Taxpayer purchases perennials in the container ready for immediate resale to customers. These plants primarily are bought and sold by Taxpayer to meet customer demands and to supplement its existing stock of perennials. Thus, these plants were ready for immediate resale when acquired and were not further developed or cultivated.

Annual Seedlings

Annual seedling plugs are not larger than one inch in length when purchased in a seedling tray that can hold up to 425 plants. Taxpayer plants the seedling plugs into containers and grows them for six to eight weeks in a greenhouse that is specifically

designed for this purpose. These facts indicate that Taxpayer acquired its annual seedling plugs for further development and cultivation.

Annual Cuttings
Annual cuttings are not larger than one inch in length when purchased from suppliers or harvested from Taxpayer's own plants. Taxpayer plants the cuttings in containers and grows them for six to eight weeks in a greenhouse that is specifically designed for this purpose. These facts indicate that Taxpayer acquired its annual cuttings for further development and cultivation.

Annuals Purchased in the Container Ready for Immediate Resale
Taxpayer purchases annuals in the container ready for immediate resale to customers. These plants primarily are bought and sold by Taxpayer to meet customer demands and to supplement its existing stock of annuals. Thus, these plants were ready for immediate resale when acquired and were not further developed or cultivated.

Houseplant Seedlings
Houseplant seedling plugs are not larger than one inch in length when purchased in a seedling tray that can hold up to 425 plants. Taxpayer plants the seedling plugs into containers and grows them for four to eight weeks in a greenhouse that is specifically designed for this purpose. These facts indicate that Taxpayer acquired its houseplant seedling plugs for further development and cultivation.

Houseplant Cuttings
Houseplant cuttings are not larger than one inch in length when purchased as cuttings from suppliers or harvested from Taxpayer's own plants. Taxpayer plants the cuttings into containers and grows them for four to eight weeks in a greenhouse that is specifically designed for this purpose. These facts indicate that Taxpayer acquired its houseplant cuttings for further development and cultivation.

Houseplants Purchased in Containers Ready for Immediate Resale
Taxpayer purchases houseplants in the container ready for immediate resale to customers. These plants primarily are bought and sold by Taxpayer to meet customer demands and to supplement its existing stock of houseplants. Thus, these houseplants were ready for immediate resale and were not further developed or cultivated.

To summarize, we think the following of Taxpayer's items are seeds and young plants acquired for further development and cultivation: bare root trees, balled and burlapped trees, bare root shrubs, balled and burlapped shrubs, "B" state shrubs, bare root rose bushes, perennial seedlings, perennial cuttings, annual seedlings, annual cuttings, houseplant seedlings, and houseplant cuttings. The following items are not seeds and young plants acquired for further development and cultivation: trees,

shrubs, perennials, annuals, and houseplants, that are purchased in the container ready for immediate resale.

We can now analyze the application of § 263A to Taxpayer's various plants. First we will discuss the application of § 263A to the items that are seeds and young plants acquired for further development and cultivation. Because the plants cultivated and developed by Taxpayer are regarded as property produced by Taxpayer, the general rules under § 263A would require the capitalization of the acquisition and preproductive period expenses. However, since Taxpayer is neither precluded by § 448(a)(3) from using the cash method nor required by § 447 to use an accrual method, Taxpayer qualifies to use the farming exception of § 263A(d). Although Taxpayer generally does not develop any plant for more than six months, some of the plants grown by Taxpayer may have a preproductive period in excess of two years. To avoid capitalizing the cost of these plants, Taxpayer made a § 263A(d)(3) election under which taxpayer uses the alternative depreciation system described in § 168(g)(2) and treats the plants as § 1245 property. By virtue of this election, Taxpayer is not required by § 263A to capitalize the acquisition costs or preproductive period expenses of the seeds and young plants acquired for further cultivation and development.

We now analyze the items that are not seeds and young plants acquired for further cultivation and development. These items are not produced in a farming business and, therefore, may not be accounted for under the farming rules of § 263A(d). Rather, as under pre-§ 263A law, the acquisition costs of these items must be capitalized. In addition, since Taxpayer's gross receipts exceed $10 million, it is not eligible to use the small reseller exception. Accordingly, under the general rules of § 263A, Taxpayer must capitalize the direct and indirect costs allocable to acquiring and holding these items for sale.

In summary, Taxpayer engages in both farming and resale activities. Taxpayer has adopted a hybrid method of accounting under which it uses the farming rules for its farming activities and the non-farming rules for its non-farming activities. However, we do not believe that Taxpayer may account for all plants under the farming rules. The plants that are not "produced" by Taxpayer, but are merely bought and resold must, like the fertilizer, pesticides, pots, and gardening implements, be accounted for under the non-farming (reseller) rules under § 263A.

A copy of this technical advice memorandum is to be given to Taxpayer. Section 6110(k)(3) provides that it may not be used or cited as precedent.