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Mastering the UNICAP Rules of IRC 263A: Allocating Direct and Indirect Costs for Producers of Tangible Property

An Advanced Case Study With Calculations and Schedules

WEDNESDAY, DECEMBER 16, 2015, 1:00-2:50 pm Eastern

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Mastering the UNICAP Rules of IRC 263A

Dec. 16, 2015

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MASTERING THE UNICAP RULES OF IRC 263A

Kari Peterson

What is UNICAP?

- §263A – General rule
  - Provides for the capitalization and inclusion in inventory costs of certain expenses
    - Applies to real or personal property acquired for resale
    - Applies to real or personal property produced by the taxpayer
  - Allocable costs shall be included in inventory
    - Direct costs
    - Property’s share of indirect costs

What is UNICAP?

- History of UNICAP
- Pre-1986
  - Full absorption method which required taxpayers to include certain costs into ending inventory
- Tax Reform Act of 1986
  - Broadened the definition of which costs were required to be included
- Final regulations issued for tax years after 1993
  - Addition of de minimis rules/safe harbors
  - Clarifications
- Proposed regulations on “negative 263A costs”

Who do the UNICAP rules apply to?

- All taxpayers with inventory unless an exception applies
  - Manufacturers with production and/or resale activities
  - Restaurants
  - Wholesale distributors
  - Retail stores
  - Many other industries

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Who do the UNICAP rules apply to?

- Common exceptions
  - Resellers of personal property with average annual gross receipts ≤ $10 million – Treas. Reg. § 1.263A-3(b)
    - “Small reseller exception”
    - Does NOT apply to producers
  - Resellers with de minimis production activities – Treas. Reg. § 1.263A-3(a)(2)(ii)
    - Gross receipts from sale of property produced < 10% of total gross receipts, and
    - Labor costs allocable to production activities < 10% of total labor costs
  - Long-term contracts

Who do the UNICAP rules apply to?

- Common exceptions (cont.)
  - Property provided incident to services
    - De minimis amount and not inventory in the hands of service provider
      - Cost of property ≤ 5% of price charged for services and property
  - De minimis rule for producers with < $200,000 of total indirect costs
    - Very difficult to fit within this exception
  - Inventories valued at fair market value
    - If inventories valued at net realizable value (which is less than historical cost and replacement cost), not required to capitalize additional §263A costs

Who do the UNICAP rules apply to?

- If no longer meet an exception, must file Form 3115 to change to apply UNICAP
  - If eligible, automatic under §11 of Rev. Proc. 2015-14
  - Non-automatic under Rev. Proc. 2015-13

Mastering the UNICAP Rules of IRC 263A

Ross Margelefsky

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What is included?

- Taxpayers must capitalize direct costs and a properly allocable share of indirect costs
- Generally requires taxpayers to capitalize costs over and above the costs that are capitalized for book purposes
- Any cost which (but for section 263A) may not be taken into account in computing taxable income is not treated as a cost properly allocable to property produced or acquired for resale

Direct Costs

- Producers must capitalize direct material costs and direct labor costs
  - Include the cost of materials that become an integral part of specific property produced
  - Include materials that are consumed in the ordinary course of production
  - Include the costs of labor that can be identified or associated with particular units or groups of units of specific property produced
- Resellers must capitalize the acquisition costs of property acquired for resale

Indirect Costs

- Defined as all costs other than direct material costs and direct labor costs or acquisition costs
- Indirect costs must be capitalized when they directly benefit or are incurred by reason of the performance of production or capitalizable resale activities

Indirect Costs

Required to be capitalized (§1.263A-1(e)(3)(ii)):

- Indirect labor
- Officers' compensation
- Pension & related costs
- Employee benefits
- Indirect materials
- Purchasing costs
- Handling costs
- Storage costs
- Cost recovery
- Depletion
- Rent
- Taxes (other than income
- Insurance
- Utilities
- Repairs & maintenance
- Engineering & design costs
- Spoilage
- Tools & equipment
- Quality control
- Bidding costs (successful bids)
- Licensing & franchise costs (including sales-based royalties)
- Interest (only if §263A(f) applies)
- Capitalizable service costs

Purchasing Costs

- Costs associated with operating a purchasing department or office within a trade or business, including personnel costs relating to:
  - The selection of merchandise
  - The maintenance of stock assortment and volume
  - The placement of purchase orders
  - The establishment and maintenance of vendor contracts
  - The comparison and testing of merchandise
- Based upon the activities performed and not upon job title or classification
- 1/3 – 2/3 rule for allocating labor costs

Handling Costs

- Capitalizable:
  - Processing
  - Assembling
  - Repackaging
  - Transporting
    - From vendor to Taxpayer
    - From one storage facility to another storage facility
    - From storage facility to retail sales facility
    - From retail sales facility to storage facility
    - From retail sales facility to another retail sales facility
- Deductible:
  - Distribution costs
  - Delivery of custom-ordered items
  - Pick and pack costs

UNICAP

Indirect Costs

Not required to be capitalized (§1.263A-1(e)(3)(iii)):

- Selling and distribution costs
- R&E costs
- Section 179 costs
- Section 165 losses
- Cost recovery on temporarily idle assets
- Income taxes
- Strike expenses
- Warranty and product liability costs
- On-site storage costs
- Unsuccessful bidding costs
- Deductible service costs

Service Costs

- Defined as a type of indirect costs that can be identified specifically with a service department or function or that directly benefit or are incurred by reason of a service department or function.

- Service departments are defined as administrative, service, or support departments that incur service costs.

Service Costs

Capitalizable (§1.263A-1(e)(4)(iii)):

- Administration and coordination of production or resale activities
- Personnel operations
- Purchasing operations
- Materials handling and warehousing and storage operations
- Accounting and data services operations
- Data processing
- Security services
- Legal services

UNICAP

Service Costs

Deductible (§1.263A-1(e)(4)(iv)):

- Overall management/policy
- Strategic business planning
- General financial accounting
- General financial planning
- Personnel policy
- Quality control policy
- Safety engineering policy
- Insurance/risk management policy
- Environmental management policy
- General economic analysis
- Internal audit
- Shareholder/public relations
- Tax services
- Marketing
- Selling
- Advertising

Section 263A Calculation

Typical Book/Tax UNICAP Differences

- Practical capacity/abnormal costs (ASC 330-10-30)
- Standard cost variances
- Off-site warehousing (other than retail sales facility)
- Pick and pack labor
- Transportation costs
- R&D costs
- Minimum royalties (not sales based) and licensing costs
- Environmental costs (See Rev. Rul. 2005-42)
- G&A (mixed service) costs
- Schedule M-3 adjustments (e.g., depreciation, pension, stock options/ASC 718, bonuses)

Mastering the UNICAP Rules of IRC 263A

December 16, 2015

Jolaine L. Hill, CPA

KATZ SAPPER & MILLER

Methods to Allocate Costs

- Producers
  - Facts and circumstances method
  - Simplified service cost method
  - Simplified production method
  - Simplified production method with historic absorption ratio
- Resellers
  - Facts and circumstances method
  - Simplified service cost method
  - Simplified resale method
  - Simplified resale method with historic absorption ratio

Producers – Facts and Circumstances

- Provides an allocation of costs based on the facts and circumstances of the business
- Provides a more accurate allocation of 263A costs to ending inventory than the simplified production method
- Adds additional complexity to develop and apply the method

Producers – Facts and Circumstances

- Methods used under facts and circumstances:
  - Specific Identification Method – Costs are traced to a cost objective, for example, a specific activity, on the basis of a cause and effect or other reasonable relationship between the costs and the specific cost objective
  - Burden Rate Method – Indirect costs are allocated based on a ratio, such as labor hours, to the activity using predetermined rates that approximate the actual amount of indirect costs incurred
  - Standard Cost Method – Direct and Indirect costs are allocated to the activity through the use of pre-established standard allowances, without reference to actual costs incurred

Producers – Facts and Circumstances

- Variances under burden rate and standard cost method:
  - Any significant variances would need to be reallocated as a production cost and capitalized to the extent allocable to ending inventory.
    - Net positive variance: Total predetermined cost under standard cost method > total actual indirect costs
    - Net negative variance: Total actual indirect costs > total predetermined cost under standard cost method
    - Note that changing the treatment in variances from deducting to allocating could be a change in accounting method
  - Periodic change to facts and circumstances method to reflect current operating conditions is not a change in accounting methods.
  - A change in the concept behind the burden rate or standard cost, for example, from being based on direct labor hours to direct machine hours, is a change in accounting method.

Producers – Facts and Circumstances

- Example of a burden rate method
  - Facts
    - Direct labor in ending inventory - $200,000
    - Sec 263A costs related to production activities - $1,000,000
    - Total Sec 471 direct labor - $3,500,000
  - Formula
    - Direct labor in ending inventory x (Sec 263A costs related to production/total Sec. 471 direct labor) = Sec 263A costs allocated to ending inventory
    - $200,000 x ($1,000,000/$3,500,000) = $57,143

Producers – Simplified Service Cost

- Determines the amount of mixed service costs allocable to production activities
- Must be elected and can only be revoked with consent of the Commissioner
- Must be used for all production and resale activities of the business with regards to eligible property
- Eligible property:
  - Inventory property
  - Non-inventory property held primarily for sale to customers in the ordinary course of business, for example, real estate
  - Certain self-constructed assets
  - Self-constructed tangible personal property produced on a routine and repetitive basis

Producers – Simplified Service Cost

- A manufacturer can elect to exclude self-constructed assets from the simplified service cost method. However, costs must be allocate to these assets using a facts and circumstances method.
- Formula:
  - Allocation ratio x Total mixed service costs = Capitalizable mixed service costs
- Total mixed service costs – total costs incurred during the taxable year in all departments or functions that perform mixed service activities

Producers – Simplified Service Cost

- Two allocation ratios available:
  - Production cost allocation ratio
    - Sec. 263A production costs/total costs
    - Note that Sec. 263A costs and total costs exclude total mixed service costs
    - Sec. 263A production costs are the total costs, not including mixed service costs and interest, that are allocable to property produced under Sec. 263A that are incurred in the taxpayer's business during the tax year, for example, material
    - May be a disadvantage when there is a product when material cost is significant

Producers – Simplified Service Cost

- Labor-based allocation ratio
  - Sec. 263A labor costs/total labor costs
  - Note that Sec. 263A costs and total costs exclude total mixed service costs
  - Favorable method when there are a large number of employees who work in deductible activities, for example, sales and marketing

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Producers – Simplified Production Method

- Allocates all additional Sec. 263A costs based on overall turnover ratio of inventory
- Must be elected and can only be revoked with consent of the Commissioner
- Eligible property:
  - Inventory property
  - Non-inventory property held primarily for sale to customers in the ordinary course of business, for example, real estate
  - Certain self-constructed assets
  - Self-constructed tangible personal property produced on a routine and repetitive basis

Producers – Simplified Production Method

- If the business has significant production and resale activities, the simplified production method must be used for both types of activities
- General formula:
  - Absorption ratio x Sec. 471 costs remaining on hand at end of year = Additional Sec. 263A costs allocable to ending inventory
    - Absorption ratio = Additional Sec. 263A costs incurred during the tax year/Sec. 471 costs incurred during the tax year
- If producer using this method has less than $200,000 in indirect costs in a taxable year, the producer is deemed to have no additional Sec. 263A costs for that year
  - Related party and aggregation rules apply

Producers – Simplified Production Method

- Advantages
  - Taxpayer does not have a significant amount of in transit and/or raw material inventory
  - Costs incurred evenly throughout the production process
- Disadvantages
  - May increase taxable income by capitalizing more costs than might be capitalized under another method
    - Does not distinguish between different types of inventory
    - Costs are spread evenly across entire ending inventory
    - Since an average absorption method is assumed, ending inventory may be overstated or understated if there are items that would have a different absorption method

Producers – Simplified Production Method with Historic Absorption Ratio

- When election can be made
  - Simplified production method has been used for the most recent 3 tax years preceding the election
  - Additional Sec. 263A costs have been capitalized using an actual absorption ratio for the 3 most recent tax years
- Cut-off method election
- Revocation of election requires IRS consent
  - Must prove unusual circumstances exist
- Fixed percentage is based on costs capitalized during the taxpayer's 3-year test period
  - Fixed percentage is used instead of an actual absorption ratio for each year in the 5-year period (qualifying period)

Producers – Simplified Production Method with Historic Absorption Ratio

- Advantage
  - UNICAP absorption ratio calculation is done only every 6 years
- Disadvantage
  - Lack of flexibility
    - Locked-in absorption ratio may overstate inventory
  - Historic absorption ratio must be used with simplified production method
    - May lead to overcapitalizing costs into inventory
  - Availability of records necessary for retesting every 6 years

Producers – Simplified Production Method with Historic Absorption Ratio

- Historic absorption ratio
  - Additional Sec. 263A costs incurred during the test period/Sec. 471 costs incurred during the test period
- Timeline
  - Test Period
    - Years 1, 2, and 3
  - Qualifying Period
    - Years 4, 5, 6, 7, and 8
  - Recomputation Year
    - Year 9

Producers – Simplified Production Method with Historic Absorption Ratio

- Example of calculation of historic absorption ratio
  - Facts
    - Taxpayer elects to use historic absorption ratio for 2015
    - Tax ending inventory for 2015 is $16,000,000

Year	Combined Absorption Ratio	Sec 471 Costs	Sec 263A Costs Incurred During Test Period
2012	5.1%	$25,000,000	$1,275,000
2013	4.6%	$29,000,000	$1,334,000
2014	5.3%	$33,000,000	$1,749,000

Producers – Simplified Production Method with Historic Absorption Ratio

- Historic absorption ratio = $4,358,000/$87,000,000 = 5.0%
- $16,000,000 x 5.0% = $800,000 Sec 263A costs in ending inventory

Resellers – Facts and Circumstances

- Allocation of service costs for a department or activity based on factors or relationships that relate the service costs to the benefits received from the service department or activity, for example, payroll for the department.

Resellers – Facts and Circumstances

- Methods:
  - Direct Reallocation Method – total costs of all mixed service departments are allocated only to resale departments and then from those departments to particular activities
  - Step-Allocation Method
    - Service department's costs are allocated as follows:
      - To other mixed service departments
      - Departments that incur only deductible service costs
      - Departments that engage in resale activities
  - Algebraic Equations – linear or matrix
  - Other reasonable allocation methods

Resellers – Simplified Service Cost Method

- Determines the amount of mixed service costs allocable to resale activities
- Must be elected and can only be revoked with the consent of the Commissioner
- Formula:
  - Sec. 263A labor costs allocable to capitalizable resale activities/total labor costs
  - Note that labor costs exclude mixed service labor costs
- Total mixed service costs – total costs incurred during the taxable year in all departments or functions that perform mixed service activities

Resellers – Simplified Service Cost Method

- Example
  - Facts
    - $3,000,000 total mixed service costs of which $2,000,000 is labor costs

Type	Amount of Labor
Purchasing, storage, handling	$4,000,000
Selling	$13,000,000
General management	$2,000,000
Mixed service labor	$2,000,000
Total labor	$21,000,000

Resellers – Simplified Service Cost Method

- $3,000,000 x $4,000,000/$19,000,000 = $631,579
  - $4,000,000 of purchasing, storage and handling labor is Sec 263A labor costs that are allocable
  - $19,000,000 is total labor costs less mixed service labor costs

Resellers – Simplified Service Cost Method

- Advantage
  - In many cases, simpler method
- Disadvantage
  - Fact and circumstances method may produce a more favorable tax result

Resellers – Simplified Resale Method

- Allocates capitalizable resale costs between ending inventory and cost of goods sold
- Must be elected and can only be revoked with the consent of the Commissioner
- Based on overall turnover-type ratios
- Intended to be used by businesses that are exclusively wholesalers or retailers
  - Could be used by businesses that also perform de minimis production activities
    - De minimis production activities based on facts and circumstances
    - If gross receipts from production activities are less than 10% of the total gross receipts and labor costs related to production activities are less than 10% of the total labor costs, activity presumed to be de minimis

Resellers – Simplified Resale Method

- General formula:
  - Combined absorption ratio x Sec. 471 costs remaining on hand at year end = Sec. 263A costs capitalized to ending inventory

Resellers – Simplified Resale Method

- Combined absorption ratio is the sum of the storage and handling costs absorption ratio and the purchasing costs absorption ratio
  - Storage and handling costs absorption ratio = Current year's storage and handling costs/(beginning inventory + current year's purchases)
    - Current year costs include allocated mixed service costs
  - Purchasing costs absorption ratio = Current year's purchasing costs/current year's purchases
    - Current year costs include allocated mixed service costs

Resellers – Simplified Resale Method

- Example
  - Facts:
    - Beginning inventory is $12,000,000
    - Purchases are $80,000,000
    - Ending inventory subject to Sec. 263A is $15,000,000
    - Inventory is FIFO

Type	Additional Sec 263A Costs	Capitalized Mixed Service Costs
Storage and handling	$2,000,000	$200,000
Purchasing	$1,000,000	$100,000

Resellers – Simplified Resale Method

- Calculation
  - Storage and handling costs absorption ratio
    - ($2,000,000 + $200,000)/($12,000,000 + $80,000,000) = 2.39%
  - Purchasing costs absorption ratio
    - ($1,000,000 + $100,000)/$80,000,000 = 1.38%
  - Combined absorption ratio
    - 2.39% + 1.38% = 3.77%
  - Sec. 263A costs to ending inventory
    - 3.77% x $15,000,000 = $565, 500

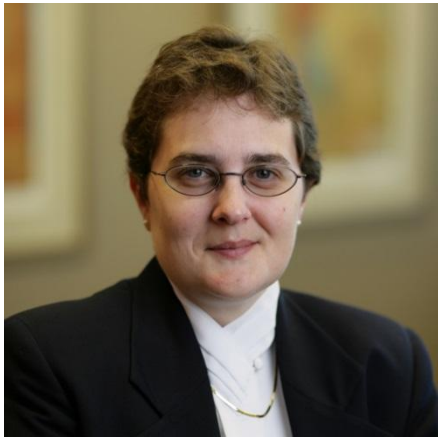
Resellers – Simplified Resale Method with Historic Absorption Ratio

- When election can be made
  - Simplified resale method has been used for the most recent 3 tax years preceding the election
- Cut-off method election
- Revocation of election requires IRS consent

Resellers – Simplified Resale Method with Historic Absorption Ratio

- Historic absorption ratio
  - Sec. 263A costs incurred during the test period/ Total Sec. 471 costs incurred during the test period
    - Sec. 263A costs incurred = combined absorption ratios x Sec. 471 costs with respect to purchases
    - Test period is 3 years immediately before the tax year of the election
- Qualifying period is 5 years
- Recomputation required in the year after the qualifying period ends

Questions? Contact Jolaine



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Jolaine Hill is a director in Katz, Sapper & Miller's Tax Services Group. She has been with the firm since 1998 and has more than 25 years of experience in public accounting. In her current role, Jolaine is primarily responsible for tax compliance issues that include the technical review of tax returns. She is also charged with ensuring that the accounting staff remains current on tax issues.