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

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

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Section 263A: Uniform Capitalization Rules

By Jolaine Hill, CPA

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The Uniform Capitalization (UNICAP) rules of Section 263A of the Internal Revenue Code (IRC) prescribe the method for determining the types and amounts of costs that must be capitalized rather than expensed in the current period. The UNICAP rules apply to those who, in the course of their trade or business, produce real property for use in the business or activity; produce real property for sale to customers; or acquire property for resale. ("Produce" means to construct, build, develop or improve property.)

Section 263A is significant for the real estate industry, and it is specifically important for land developers and large homebuilders whose average annual gross receipts are more than $10 million and contracts are in excess of two years. For construction contractors using the percentage of completion method under Section 460, the regulations under Section 460 mirror the regulations under Section 263A.

The UNICAP rules require a taxpayer to capitalize all direct costs and certain indirect costs properly allocable to property produced or property acquired for resale.

- Direct costs are defined as the direct material costs and direct labor costs for a contractor or large homebuilders and the acquisition costs for a land developer.
- Indirect costs are defined as all costs other than those considered direct material costs and direct labor costs or acquisition costs. Indirect costs are properly allocable to property produced when the costs directly benefit or are incurred by reason of the performance of construction or development activities.

Indirect costs can be categorized into two groups: those that must be capitalized and those that are allowed to be expensed in the current period. Indirect costs allowed to be expensed in the current period include marketing, selling, advertising and distribution expenses; general and administrative expenses not related to construction or development; officers' salaries that are not related to construction or development activities; research and experimental expenses; as well as depreciation and amortization.

A taxpayer that produces property must capitalize all costs incurred before, during and after the construction or development of the property. Pre-construction and pre-development costs must be capitalized, including the carrying costs, real estate taxes, and costs of zoning requests related to the holding of realty for future development. Construction and development period costs are those costs that fall between the date on which construction or development begins and construction or development ends. Construction or development is deemed to have ended once the property is placed in service or ready for sale. Any costs incurred after the construction or development would be considered post-construction or development costs. Interest, however, only needs to be capitalized during the construction or development stage.

There are various methods that can be used to allocate the direct and indirect costs to the property produced. Depending on the taxpayer's needs and type of construction or development, one of the following methods can be used:

- A specific identification method, where costs are traced to a cost objective – a specific contract, for example – on the basis of a cause and effect or other reasonable relationship between the costs and the specific contract.
- A burden rate method, where indirect costs are allocated based upon a ratio, such as labor hours, to the contract using predetermined rates that approximate the actual amount of indirect costs incurred.
- A standard cost method, where direct and indirect costs are allocated to the contract through the use of pre-established standard allowances, without reference to actual costs incurred. Any significant variances would need to be reallocated.

The updated UNICAP rules will affect many contractors and land developers as many of the costs that were previously deductible as period costs are now accumulated and allocated between the contract or development costs and current period costs. The UNICAP rules also delay the expensing of capitalized costs, which ultimately results in the acceleration of taxable income.

Connect with Jolaine

Jolaine Hill is a director in Katz, Sapper & Miller's Tax Department and Construction Services Group. 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.

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