

Final UNICAP Regulations Expand Some Exceptions but Eliminate Others

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Property of small manufacturers and small resellers is excluded, and the cost of developing computer software remains currently deductible.

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Approximately seven years after the enactment of Section 263A, the Treasury adopted final Regulations dealing with the uniform capitalization (UNICAP) rules (TD 8482, 8/6/93). Accompanying the final Regulations were new Proposed Regulations on the treatment of certain distribution expenses (IA-64-91, 8/6/93). In addition, the Preamble to the final Regulations states that a Revenue Procedure will be issued shortly concerning the transitional rules for making any required accounting method changes. Although the final Regulations make several changes to the Temporary Regulations (TD 8131, 3/30/87; TD 8148, 8/7/87) and settle various questions posed by them, some issues still are unresolved.

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The first part of this article discusses the changes in the way the final Regulations apply to particular types of taxpayers and particular types of property, as well as changes in the rules for determining which costs must be included in inventory or otherwise capitalized and which may be expensed. In addition, possible solutions are noted for the issues that remain unresolved. The second part of this article will analyze the changes to the cost allocation provisions and discuss the effective dates and transition rules.

APPLICATION

The Regulations confirm that the UNICAP rules apply to producers of tangible personal and real property, as well as to taxpayers that acquire tangible or intangible property for resale. Nevertheless, there are exceptions and other special rules.

Small-manufacturer exception. In response to comments concerning the administrative burden of complying with the UNICAP rules, the Regulations except qualifying "small" manufacturers. Under Reg. 1.263A-2(b)(3)(iv) , a manufacturer that uses the simplified production method and, during its tax year, incurs total indirect costs of \$200,000 or less may treat its additional Section 263A costs as zero. For this purpose, any nonproduction costs not required to be capitalized under Reg. 1.263A-1(e)(3)(iii) (e.g., selling and distribution costs) may be excluded from the computation of the \$200,000 threshold. Taxpayers that use a method other than the simplified production method (e.g., facts and circumstances) may have to file a Form 3115 (Application for Change in Accounting Method) or otherwise change their election in order to qualify for this exception.

Small-reseller exception. Under Section 263A(b)(2)(B) , the UNICAP rules do not apply to personal property acquired for resale by a taxpayer with average annual gross receipts of \$10 million or less for the three preceding tax years. The Temporary Regulations had left unresolved whether some minimal manufacturing activity would prevent a taxpayer from qualifying for this exception. The final Regulations provide that a small reseller may disregard de minimis production activities.

Whether production activities are de minimis is based on all the facts and circumstances. In addition, production activities are presumed de minimis if (1) gross receipts from the sale of the produced property and (2) labor costs of the production activities are less than 10% of total gross receipts and labor costs, respectively, for the entire trade or business.

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Moreover, small resellers are exempted from the general UNICAP rule that property produced under contract for a taxpayer is treated as produced by the taxpayer. Accordingly, third-party contract production does not prevent an otherwise qualified taxpayer from using the small-reseller exception.

Intellectual property. Under Section 263A(b) (and the Temporary Regulations), "a film, sound recording, video tape, book, or similar property" is tangible personal property, and thus its production is subject to the UNICAP rules. There had been considerable concern over the intended scope of "similar property" in the temporary rules, e.g., whether it might encompass self-developed computer software, thereby superseding the Service's long-standing position in Rev. Proc. 69-21, 1969-2 CB 303 . The Preamble to the final Regulations states that the UNICAP provisions are not intended to override Rev. Proc. 69-21 . Thus, the costs of developing computer software remain currently deductible.

The Regulations provide additional guidance on what other types of intellectual property may be tangible for purposes of Section 263A . For example, there must be an intent or a reasonable likelihood that there will be mass distribution of the tangible medium embodying the intellectual property. If such distribution is merely incident to the distribution of a principal product of the creator of the intellectual property, however, the property is not tangible. Examples in the Regulations of intangible intellectual property include stock, securities, debt instruments, mortgages, loans, and de minimis property provided to a client incident to the provision of services, such as a will prepared by an attorney or blueprints prepared by an architect.

Ownership. The Regulations confirm that, except in two limited instances, for the UNICAP rules to apply to the production of property, the producer must own the property. While this conclusion might seem self-evident, the Preamble to the Regulations does not reveal the degree to which this interpretation was called into question by the Service under the Temporary Regulations. In numerous speeches, and in requests for rulings and accounting method changes filed under Section 263A , Treasury and IRS personnel made it clear that they believed the UNICAP rules applied to taxpayers that engaged in production services with respect to property they did not own either legally or equitably. Thus, for example, third-party subcontractors or toll manufacturers would have been required to defer the deduction of their processing costs notwithstanding that they did not own the property being processed and that, accordingly, the inventory rules did not generally apply to the costs incurred in performing processing services.¹ This position has been withdrawn implicitly in the final Regulations. Accordingly, for the UNICAP rules to apply, a taxpayer engaged in processing activities generally must be the legal or

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equitable owner of the property being produced.

As stated above, the Regulations contain two exceptions to this interpretation. Certain home construction contracts of builders that do not satisfy the \$10 million gross receipts test in Section 460(e)(1) (regarding use of the percentage of completion method of accounting for long-term contracts) are subject to Section 263A even though the contractor may not be the owner of the property. Also subject to the UNICAP rules are taxpayers that are treated under Section 263A(g)(2) as the producers of property produced for them under contract with a third party. The Regulations do not state what types of production contracts come within this exception. The Treasury has indicated, however, that it will resolve this issue in connection with the adoption of final Regulations on interest capitalization.²

Lower of cost or market. The statute and Temporary Regulations were silent on the application of the UNICAP rules to the lower of cost or market method of inventory valuation. The legislative history of Section 263A, however, contained a blanket statement that the statute did not apply to the determination of market value under that method. IRS expressed considerable concern that the UNICAP rules could be easily circumvented by FIFO taxpayers who took the position that UNICAP did not apply to the determination of the replacement or reproduction cost of goods. Under that interpretation, Section 263A costs that were tentatively added to the cost of inventories under the UNICAP rules would be immediately written off under the lower of cost or market method. To prevent this result, Notice 88-86, 1988-2 CB 401, provided a restrictive interpretation of the market exception to the UNICAP rules. This interpretation is included in the final Regulations, which make it clear that the UNICAP rules apply to the determination of market value under the lower of cost or market method unless that determination is based on the selling price of the goods. Thus, the UNICAP rules apply where market value is based on replacement or reproduction costs.

COSTS SUBJECT TO UNICAP

The types of costs that are subject to the UNICAP rules depend in part on whether the taxpayer produces property or acquires it for resale.

PRODUCERS OF PROPERTY

The final Regulations change and clarify several provisions in the Temporary Regulations relating to the types of costs that must be capitalized under Section 263A by producers of property.

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Engineering and design costs. The treatment of engineering and design costs was uncertain under the Temporary Regulations, despite their inclusion in the list of indirect costs to be capitalized under Section 263A . Reg. 1.263A-1(e)(3)(ii)(P) provides that engineering and design costs that do not qualify as research and experimental expenses under Section 174 are subject to Section 263A . The Regulations do little to clarify many of the ambiguities, however.

Engineering and design costs include expenses incurred prior to the beginning of production (e.g., costs related to research, experimental, engineering, and design activities), but the Regulations do not explain how to allocate such costs. For example, if production occurs later in the year, are the preproduction engineering and design costs deferred and allocated to the units actually produced as a result of subsequent engineering and design activity? Alternatively, if no units are produced during the year, are engineering and design costs expensed as not related to current production? If future production is likely, must these costs be deferred and allocated to the subsequent production? Finally, are these engineering and design costs treated as current-year overhead, so that they are allocated on some reasonable basis to the unrelated units produced in the current year?

While the Regulations do not answer these questions directly, they can be read as supporting the last approach stated above. Reg. 1.263A-1(e)(3)(ii)(C) treats contributions to employee plans for past services as current-year overhead to be allocated to current production despite the fact that the past service relates to prior years' production. Thus, there is not necessarily a precise matching of overhead deemed incurred during the year with the units actually produced as a result of that expense. In fact, where a more precise matching was desired (i.e., the bidding expense rules), Reg. 1.263A-1(e)(3)(ii)(T) specifically requires bidding expenses to be deferred until the contract is awarded and the related units produced. If comparable treatment had been intended for engineering and design costs incurred prior to production, a similar rule presumably would have been included in the Regulations.

Defining engineering and design costs by reference to Section 174 creates a distinct disadvantage for producers of property not engaged in natural or physical science research. Section 174 specifically excludes from its scope research in the social sciences or humanities. Thus, even though their research activities may be comparable, a manufacturer of a new high-technology product would not capitalize its research expenses, but the social science research expenses of an author or of a developer of a new video game would be capitalized under this rule.

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Computer software development costs also do not qualify as Section 174 research expenditures, but they are specifically excluded from capitalization in the Preamble to the final Regulations, as noted above, under the authority of Rev. Proc. 69-21 . It may be difficult to justify this favorable treatment for computer software without liberalizing the capitalization rule attributable to social science research.

Preproduction costs. Reg. 1.263A-2(a)(3)(ii) contains a generic rule with respect to expenses incurred prior to production that requires taxpayers to capitalize all direct and indirect costs allocable to property (1) that is held for future production, or (2) where it is reasonably likely that production will occur at some future date.³ Under the Temporary Regulations, it was not clear whether a taxpayer could expense the costs of holding property it had not yet decided to develop. The final Regulations provide parity between raw materials held for production and real property not held for production but that likely will be developed in the future.

This rule is particularly relevant for taxpayers that hold property ostensibly as an investment, but that might develop the property if it cannot be sold. If future development is "reasonably likely," the costs of carrying the property (such as property taxes, insurance, delay rentals, title expenses, general and administrative costs associated with these activities, and other similar costs) must be capitalized and recovered generally when the property is sold. The Regulations provide little guidance on when future production is reasonably likely and thus make this determination highly subjective and factual.

Bidding costs. Reg. 1.263A-1(e)(3)(ii)(T) generally continues the rules for contract bidding costs that were in Temp. Reg. 1.263A-1T(b)(iii)(R) . Deferred bidding costs must be allocated to the units that are the subject of the contract. Thus, if five units are awarded under a contract, the deferred bidding costs must be allocated to all five, even if they are produced in different tax years. The Regulations do not address the treatment of contracts containing a provision for optional units (i.e., whether the bidding costs must also be allocated to the optional units if exercise is likely), or whether deferred bidding costs may be allocated non-pro rata (e.g., a marginal cost allocation). Absent guidance to the contrary, any reasonable method of treating optional units, and any allocation supported by the facts should be acceptable.

Some commenters were concerned that the bidding cost rules might apply to the ordinary costs of soliciting orders. The Regulations clarify that only two types of contracts are covered:

(1.) Specific property. An agreement to produce or sell a specific unit of property entered into before the taxpayer produces or acquires the specific property to be delivered to the customer.

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(2.) Fungible property. An agreement to produce or sell fungible property to the extent that, at the time the agreement is entered into, the taxpayer has on hand an insufficient quantity of completed fungible items of such property that may be used to satisfy that agreement plus any other production or sales agreements of the taxpayer concerning the same fungible property.

Temporarily idle equipment and facilities. In continuing the rule in the Temporary Regulations that exempts from the UNICAP rules depreciation, amortization, and cost recovery allowances on equipment and facilities that have been placed in service but are temporarily idle, Reg. 1.263A-1(e)(3)(iii)(E) clarifies that the exception applies only to those specific expenses. Thus, insurance, taxes, and similar costs related to temporarily idle facilities and equipment remain subject to capitalization. Also, rental expense on temporarily idle leased property is not excepted under this narrow rule despite the fact that a large economic component of the rent generally is the depreciation, amortization, or cost recovery expense incurred by the lessor. Accordingly, this exception is a very limited substitute for the practical capacity method that remains banned by the final Regulations.

Equipment and facilities are temporarily idle when they are taken out of service for a finite period. The Regulations, however, fail to clarify the result where a portion of a facility is either temporarily or completely idle during the course of a year. May a facility be broken down into component parts in order to apply the rule to the idle portion?

Another aspect of the Regulation that is particularly difficult to interpret is the rule that facilities and equipment are not temporarily idle during normal interruptions in their operation. In contrast, Example 2 of Reg. 1.263A-1(e)(3)(iii)(E)(2) holds that a manufacturing facility is temporarily idle for the two weeks during which it is closed to retool its assembly line. There appears to be no adequate explanation for the distinction between this example and the "normal interruption" rule, unless retooling is not a normal interruption. Nonetheless, a manufacturing facility would not appear to be out of service during retooling because that endeavor usually requires the facility to be open for the employees who are engaged in the retooling. Thus, the only logical interpretation of the "normal interruption" provision seems to be that very short-term downtime caused by standard occurrences does not cause equipment or facilities to be out of service, but longer downtime for abnormal activities (such as retooling) is not a normal interruption, perhaps even if such activities are performed regularly.

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Section 179; warranty and product liability costs. The Regulations expand the list of indirect costs that are not subject to the UNICAP rules to include Section 179 costs (the election to expense certain depreciable business assets) (Reg. 1.263A-1(e)(3)(iii)(C)) and warranty and product liability costs (Reg. 1.263A-1(e)(3)(iii)(H)). As explained in Notice 88-86 , the Service views warranty and product liability costs as a type of marketing and selling expenses.

Taxes. Consistent with the Temporary Regulations, Reg. 1.263A-1(e)(3)(ii)(L) generally requires capitalization of taxes attributable to labor, materials, supplies, equipment, land, or facilities used in production or resale activities, to the extent they are properly allocable to property produced or property acquired for resale. The Regulations clarify that franchise taxes based on income, in addition to state, local, and foreign income taxes, are excluded from this requirement.

Optional capitalization of period costs. Reg. 1.263A-1(j)(2) adopts the rule (introduced in Notice 88-86) allowing taxpayers to elect to capitalize certain costs that are otherwise deductible, provided:

- (1.) The method is consistently applied.
- (2.) It is used to compute beginning and ending inventories and cost of goods sold.
- (3.) It does not result in a material distortion of income (i.e., a distortion relating to the source, character, amount, or timing of the cost capitalized or any other item affected by the capitalization).

The types of costs for which capitalization may be elected include only indirect expenses for which some portion of the costs incurred by the taxpayer is properly allocable to property produced or property acquired for resale. Thus, the rule enables taxpayers to avoid allocating expenses that are attributable to both (1) property produced or property purchased for resale and (2) non-production or non-resale activities. All such expenses are deemed allocable to production or resale activities. The optional capitalization rule effectively expands the service department direct reallocation rule and likely will be similarly interpreted. It is uncertain, however, whether this rule overrides the prohibition against optional capitalization of interest expense where only a portion is required to be capitalized.

Costs with delayed accrual. The final Regulations do not address the treatment of costs that are not properly accruable until a year subsequent to that in which the related production occurs. This delayed accrual might result, for example, under the economic performance requirement of Section 461(h) . The issue will most likely arise with payment-type liabilities under Section 461(h) , as well as with vacation pay, nonqualified deferred compensation, and retiree medical expenses.

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One possible solution is to allocate these costs to the goods produced during the normal accrual year, even though this is not the production to which the costs relate. A somewhat complex alternative is to allocate these costs to the related production of goods in the year prior to accrual. Under this approach, a LIFO taxpayer would treat an appropriate part of the costs as adjustments to the carrying value of LIFO layers for prior years, and a FIFO taxpayer would adjust inventory values only to the extent the costs of the goods produced in the prior year remained in inventory. The portion of the costs not treated as an inventory adjustment would be deducted in the year of accrual. A third possibility is simply to deduct all such costs in the year of accrual, on the theory that the costs do not relate to current production.

RESELLERS OF PROPERTY

The Regulations make several changes to the costing rules applicable to taxpayers acquiring property for resale. The most salient are discussed below.

Indirect costs. The Temporary Regulations specifically listed purchasing, storage, and handling costs as costs that resellers were required to capitalize. Although those rules also referred to certain other indirect costs, some commenters claimed that the treatment of such costs was uncertain under the Temporary Regulations. Reg. 1.263A-3(c)(1) clarifies that in addition to acquisition costs, resellers must capitalize indirect costs (as described in Reg. 1.263A-1(e)(3)) properly allocable to property acquired for resale, which includes purchasing, storage, and handling costs. The list in Reg. 1.263A-1(e)(3) , however, is considerably broader than just the costs relating to those three activities. In most instances, general and administrative costs and other overhead expenses that directly benefit or are incurred by reason of the taxpayer's resale activities must be capitalized as well.

Handling costs. Reg. 1.263A-3(c)(4)(i) provides a bright-line test whereby handling costs incurred at a retail sales facility with respect to property sold to customers need not be capitalized. In addition, handling costs incurred at a dual-function storage facility need not be capitalized to the extent they are incurred with respect to property sold to retail customers on-site. Dual-function storage facility handling costs attributable to on-site sales are determined by applying the ratio of (1) gross on-site sales to (2) total gross sales of the facility.

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Temp. Reg. 1.263A-1T(d)(3)(ii)(C) defined handling costs as expenses attributable to handling, processing, assembling, repackaging, and other similar activities, including transporting property acquired for resale. The final Regulations define each of these components. Of particular note is the definition of assembling costs, in Reg. 1.263A-3(c)(4)(ii), which include "costs associated with incidental activities that are necessary in readying property for resale (e.g., attaching wheels and handlebars to a bicycle acquired for resale)."

Unfortunately, this example does not clarify the rule. Most taxpayers might argue that in the context of Subpart F, a similar assembly activity constitutes production or manufacturing for purposes of avoiding the foreign base company sales rules. The Service itself has ruled that minor processing and assembly-like operations constitute manufacturing for purposes of avoiding the separate LIFO pooling requirements for property purchased for resale. It is difficult, if not impossible, to reconcile the assembly rule in the Section 263A Regulations with the law that has developed under Sections 951, 472, 936, and others, which distinguish between production and resale activities. Attaching wheels and a handlebar to a bicycle frame may involve as much production as many manufacturers are required to provide in assembling purchased component parts into a finished product held for sale. Thus, it is unclear why the Regulations conclude that attaching wheels and handlebars is merely incidental.

Exclusions from handling costs. Under Temp. Regs. 1.263A-1T(d)(3)(ii)(C)(2), (3), and (4), handling costs did not include costs associated with repackaging items after a sale occurs and distribution costs, including delivering items to a customer and delivering certain "custom-ordered" items from a storage facility to the taxpayer's store. The final Regulations did not include any guidance on the treatment of these types of costs, but new rules have been set forth in Proposed Regulations.

Distribution costs are defined narrowly in Prop. Reg. 1.263A-3(c)(4)(vi)(A) as only those transportation expenses incurred outside a storage facility in delivering goods to an unrelated customer. Thus, under the proposed rules distribution expenses do not include all of the costs incurred in getting property to the customer after an order has been placed. As stated in the Preamble to the Proposed Regulations, IRS believes that Congress intended that costs incurred prior to loading goods for final shipment should be capitalized. Furthermore, the Service felt that any expansion of the distribution-costs exception could operate to mismatch income and expense since, as explained in the Preamble, usually income is recognized on final shipment of an item, and deducting costs incurred prior to shipment would potentially distort income.

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The Proposed Regulations significantly restrict the custom-ordered goods UNICAP exception that was in the Temporary Regulations. Under Prop. Reg. 1.263A-3(c)(4)(vi)(B) , only costs incurred outside a storage facility (including costs incurred on a loading dock) in delivering custom-ordered goods to a retail sales facility need not be capitalized. Repackaging costs are subject to capitalization under the Proposed Regulations.

The Preamble to the Proposed Regulations specifically states that the distribution-costs and custom-order exceptions in the Temporary Regulations apply until the Proposed Regulations are adopted. (It also states that IRS is considering eliminating the custom-order exception in final Regulations.) The Preamble to the final Regulations provides that the repackaging-cost exception in the Temporary Regulations also applies until the Proposed Regulations are made final.

CONCLUSION

Although final procedural rules have not yet been issued, taxpayers should begin to determine what changes are required to implement the final UNICAP Regulations. In addition, taxpayers should take this opportunity to reconsider their prior elections. Many taxpayers now regret the choices made during the rush to file their 1987 tax returns. The Service has been quite reasonable in granting requests to change such elections. Nevertheless, taxpayers should thoroughly consider this subject before committing themselves to a particular course of action.

1

The Service's position under the Temporary Regulations would have overridden Rev. Rul. 81-272, 1981-2 CB 116 .

2

"Production contract" is defined in Prop. Reg. 1.263A(f)-1(c)(2)(ii) (concerning interest capitalization).

3

The "preproduction" rule discussed in the text, above, concerned certain engineering and design expenses that must be treated as indirect costs of production even though the property to which such costs relate may not yet have been produced. The generic preproduction rule identifies certain existing property (e.g., raw materials) as subject to the Section 263A capitalization requirements even though production has not yet begun with respect to the property.

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