HOME BUILDER SUBJECT TO UNIFORM CAPITALIZATION RULES

The Tax Court ruled in Frontier Custom Builders, Inc., TC Memo 2013-231, that a speculative and custom home builder was subject to the UNICAP rules. The UNICAP rules have been part of the tax code for more than 25 years, and require the capitalization of all direct costs and certain indirect costs in the cost of property produced for resale. The impact of these rules is that certain indirect costs are not deductible in the year paid; they must be capitalized into the cost of the property and deducted only when the property is sold.

The taxpayer in this case, Frontier, had argued that it was more of a sales and marketing organization instead of a construction organization because it contracted out all of the actual construction work to subcontractors.

The Tax Court did not buy Frontier’s argument and found that Frontier was a producer of real property subject to the UNICAP rules.

The Tax Court then addressed which indirect costs were subject to capitalization. It was determined that all or a portion of the following costs were subject to capitalization using a combination of the simplified production and simplified service cost methods under the UNICAP rules: CEO’s salary, employee bonuses, project managers’ salaries, accounting salaries, IT department salaries, related payroll taxes and employee benefit costs, builder’s risk insurance, general liability and vehicle insurance, mobile phones and others.

Because Frontier took the position that it was not subject to the UNICAP rules, Frontier had not kept any records of expense allocations and therefore could not provide the Tax Court any contemporaneous records to support an allocation of the indirect costs between production and non-production activities. For example, if Frontier could have produced documentation that 90 percent of these costs were applicable to nonproduction activities, for example certain employee salaries, then none of the costs would have to be capitalized under certain de minimis rules. Since Frontier could not provide any documentation as to how to allocate these costs, the Tax Court followed the IRS’s calculation as to the allocation of these costs to production activities.

Certain taxpayers in the real estate and construction industries are not subject to these UNICAP rules:

› Homebuilders whose average annual gross receipts are less than $10 million for the three preceding tax years and whose home construction contracts are completed within two years, and

› Construction contractors subject to the long-term contract rules of Section 460.
Taxpayers subject to the UNICAP rules should periodically review their activities and produce contemporaneous documentation of the allocation of all indirect costs to production and nonproduction activities in order to minimize the amounts of indirect costs that must be capitalized under the UNICAP rules.

If you have any questions about how these exemptions may apply to your business or documenting the allocation of costs between production and nonproduction activities, we would be happy to assist you.

**RECORDKEEPING A MUST TO AVOID PASSIVE ACTIVITY LOSS DEDUCTION LIMITATIONS AND THE NET INVESTMENT INCOME TAX.**

Real estate professionals and other taxpayers are not subject to the Passive Activity Loss (PAL) deduction limitation of Section 469 if they can demonstrate that they materially participate in a real estate or other activity.

A taxpayer must meet certain participation tests in order to demonstrate material participation in an activity. We have discussed these tests in detail in previous Keiter blog articles.

Among the tests are the following:

› The taxpayer spends more than 500 hours in the activity,
› The taxpayer spends more than 100 hours in the activity and more hours than anyone else,
› The taxpayer spends more than 100 hours in an activity and aggregating all of the 100 hour activities, the total hours are more than 500 hours.

Over the last couple of years there has been increased IRS audit activity with respect to these rules. In a large number of these cases, the deductions from the activity are being limited under the PAL rules because the taxpayer does not have contemporaneous records to document meeting one of these material participation standards.

Contemporaneous documentation of material participation becomes even more important with the coming of the 3.8 percent Net Investment Income Tax (NII) tax that is effective for 2013 and future years as part of the Affordable Care Act.

Income from real estate activities and other business activities is subject to this NII tax if the taxpayer does not materially participate in the activity.

Taxpayers that wish to avoid the PAL deduction limits and/or the NII tax should make sure that they are keeping contemporaneous records to document their participation in the activities.

Questions? Contact your Keiter representative or information@keitercpa.com | 804.747.0000