

IRS Code Section 263A – How Can It Impact Your Business?

In the past few months, our accounting firm has observed increased activity by the Internal Revenue Service performing audits of equipment dealerships. As a part of these audits, the IRS is looking closely at whether Code Section 263A applies and, if so, whether or not the Code Section is being followed.

- Code Section 263A, enacted as a part of the Tax Reform Act of 1986, requires taxpayers to capitalize direct and indirect costs properly allocable to certain real property and tangible personal property produced by the taxpayer and the real property and certain personal property that is acquired by the taxpayer for resale.
- Section 1.263A-1(e) of the Regulations provides that resellers must capitalize the acquisition cost of property acquired for resale, as well as certain indirect costs that are allocable to property acquired for resale.
- Section 1.263A-3 sets forth detailed rules with respect to the proper treatment of purchasing, handling, and storage costs, which are the indirect costs most often incurred by resellers.
- Section 1.263A-3 was promulgated in 1993 and last amended in 1994. This part of the Act is what the IRS is reviewing during their audits.

Section 263A may apply when a business has more than \$10 million in sales for the year. The Section is receiving renewed attention from the IRS because more and more businesses exceed the \$10 million threshold. The IRS has not changed the required sales level since the original enactment in 1986.

The calculation of 263A is very complicated and detailed. A business many times can have no costs for handling and storage costs. The calculation is based on merchandise sold exclusively to retail customers as “on-site sales” and the Company has no off-site storage or a warehousing facility. Section 1.263A-3 can apply to everyone if the Company has over \$10 million in sales and the purchasing involves labor, indirect and total mixed service costs.

The calculation of 263A is completed each year. The most significant impact to your business would be for the first year the calculation is required. In applying 263A for the first year, capitalized costs could be as much as \$500,000, which could equate to a \$150,000 increase in tax liability. The amount of the capitalized costs and subsequent tax liability depends on the amount of labor and indirect costs plus inventory levels. In following years, you could see a drop or slight increase in 263A, which would have a minimal impact on your business.

The key facts are: If your company has more than \$10 million in sales, then you should be talking to your tax advisor/accountant and asking if IRS Code Section 263A is applicable and if not, why not.

If you have any questions or need further information, please contact your accountant or Association office.