



# Tax Update

April 2011

## The Tax Code Offers a Possible Cash Infusion for Real Estate Developers

by Mark DiPietrantonio, Senior Tax Manager

The last few years have been difficult for real estate developers. After the housing bubble burst and the credit markets dried up, many real estate developers found themselves holding onto vacant pieces of property, which served as little more than parking lots for idle equipment.

While their development activity may have been delayed, developers' costs associated with the property continued to come due—costs such as property taxes, insurance and interest on loans. To make matters even worse for these developers, the Internal Revenue Code (IRC) generally requires that these indirect costs of production be capitalized rather than currently deducted, thus delaying any tax benefit of these costs until the property is sold.

The Uniform Capitalization rules (UNICAP) of IRC Section 263A require the capitalization of all direct costs and indirect costs during any periods of production. The courts have ruled that, for most indirect costs such as property taxes, insurance and impact fees, the period of production begins as soon as property is acquired for the purpose of development and lasts until the developed property is sold.

For purposes of interest paid on acquisition indebtedness, however, the United States Tax Court has held that under special tax rules, the period of production begins only once physical production activities have begun on the property, allowing the current deduction of interest costs incurred before any physical development of the property occurs. Additionally, even in the case of property on which development has already begun, interest expense may be currently expensed during certain periods when physical production activities cease due to economic difficulties.

Therefore, at a time when developers are in search of current cash flows to continue meeting their financial obligations until they can resume their development activities, they may be able to take advantage of the UNICAP rules to currently deduct the interest paid on their properties during periods of nonproduction.

This article will discuss the UNICAP rules and the associated benefits available to developers. The professionals at Schneider Downs can assist your organization in realizing the benefits of these tax rules.

---

## Capitalization of Costs Under IRC § 263A

The UNICAP rules mandate the capitalization of both direct and indirect costs associated with a real estate development. For a real estate developer, the direct costs generally include direct material and direct labor. Treas. Reg § 1.263A-1(e)(3)(ii) provides the following examples of indirect costs that are required to be capitalized:

- bidding costs
- capitalizable service costs (including capitalizable mixed service costs)
- cost recovery allowances
- engineering and design
- employee benefit expenses
- handling costs
- indirect labor costs
- indirect material costs
- insurance
- interest (see special rules under § 263A(f))
- licensing and franchise costs
- officers' compensation
- pension and other related costs
- purchasing costs
- quality control
- rent
- repairs and maintenance
- spoilage
- storage costs
- taxes
- tools and equipment
- utilities

The UNICAP rules require capitalization of all of these costs during the production period. In 1995, the United States Tax Court defined what constitutes the “production period.” Surprisingly, according to the court, the definition of the production period varies, depending on which indirect cost is at issue.

In the case of *Von Lusk v. Commissioner*, 104 T.C. 207 (1995), the court held that for all indirect costs except for interest, the production period begins at acquisition. IRC § 263A(f) provides a special rule for the allocation of interest to property produced by the taxpayer. This special rule says that for interest expense, the production period begins once physical production activities begin.

### When Do “Physical Production Activities” Begin?

The term physical production activities includes any physical activity that constitutes production within the meaning of Treas. Reg. §1.263A-8(d)(1).

---

The following is a partial list of activities, any one of which constitutes a physical production activity with respect to the production of real property (Treas. Reg. §1.263A-12(e)(2)):

- Clearing, grading or excavating raw land;
- Demolishing a building or gutting a standing building;
- Engaging in the construction of infrastructure, such as roads, sewers, sidewalks, cables and wiring;
- Undertaking structural, mechanical or electrical activities with respect to a building or other structure; or
- Engaging in landscaping activities.

The following activities are **not** considered physical production activities (Treas. Reg. §1.263A-12(f)):

- Planning and design—Testing of soil, preparing architectural blueprints or models, or obtaining building permits.
- Incidental repairs—Physical activities of an incidental nature that may be treated as repairs under §1.162-4.

Thus, the production period begins and interest must be capitalized with respect to real property if any physical production activities are undertaken, whether alone or in preparation for the construction of buildings or other structures, or with respect to the improvement of existing structures.

For example, the clearing of raw land constitutes the production of designated property, even if it is only cleared prior to resale.

### **Suspension of Production Period**

Once physical production activities have begun, Treas. Reg. Section 1.263A-12(g)(1) provides that if production activities subsequently cease for at least 120 consecutive days, a taxpayer may currently deduct interest with respect to that unit of property until physical production activities resume.

Production activities are not considered to have ceased if they cease because of circumstances inherent in the production process, such as normal adverse weather conditions, scheduled plant shutdowns, or delays due to design or construction flaws, the obtaining of a permit or license, or the settlement of ground fill to construct property. Thus, a cessation of production activities caused by a prolonged strike or an economic recession will qualify for the 120-day rule.

### **What Type of Property Is Subject to the UNICAP Rules?**

In general, the capitalization of interest rules under §263A(f) apply to any property that is produced by the taxpayer and that is:

- real property; or,
- tangible personal property that meets any of the following classification thresholds:
-

- 
- Property with a class life of 20 years or more that is not inventory in the hands of the taxpayer or a related person;
  - Property with an estimated production period exceeding two years; or
  - Property with an estimated production period exceeding one year and estimated cost of production exceeding \$1,000,000.

## Conclusion

In light of recent economic conditions, many real estate developers may have experienced a suspension of physical production activities on their developments that would allow for a current deduction, rather than capitalization, of interest expense under the UNICAP rules. In addition, some developers may be eligible for a refund of previous years' taxes paid on capitalized interest if the suspension period dates back to those previous years.

Please contact your Schneider Downs representative if you think that your organization may benefit from these tax code provisions.

If you have any questions regarding these tax code provisions or think that your organization may benefit, please contact your Schneider Downs representative at 412-261-3644.

This brochure describes certain services of Schneider Downs & Co., Inc. that may be available depending upon the client's particular needs. The specific terms of an engagement letter will govern in determining the services actually to be rendered by Schneider Downs to a particular client.



*Mark DiPietrantonio has extensive experience in all areas of tax planning, research and compliance and provides services to the firm's clients that include the coordination and delivery of tax compliance services to closely held businesses and their shareholders, developing, communicating and implementing tax strategies, and overall corporate tax planning.*

*Mark also has experience in multistate tax planning and compliance and the representation of clients before the Internal Revenue Service and the Pennsylvania Board of Appeals and Board of Finance and Revenue.*

*Contact Mark at 412-697-5247 or [mdipietrantonio@schneiderdowns.com](mailto:mdipietrantonio@schneiderdowns.com).*