Cost Of Goods Sold

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If corporation manufactures products or purchases them for resale, they generally must value inventory at the beginning and end of each tax year to determine the cost of goods sold. Some of the expenses may be included in figuring the cost of goods sold (COGS). Cost of goods sold is deducted from the gross receipts to figure the gross profit for the year. If the corporation includes an expense in the cost of goods sold, they cannot deduct it again as a business expense (double charge). Under the uniform capitalization rules, the corporation must capitalize the direct costs and part of the indirect costs for certain production or resale activities. Indirect costs include rent, interest, taxes, storage, purchasing, processing, repackaging, handling, and administrative costs.

The COGS may be deducted on line 2, page 1 of Form 1120. The cost of goods sold is calculated on Schedule A, page 2 of Form 1120. The provisions of IRC Section 263A - "Capitalization and Inclusion in Inventory Costs of Certain Expenses" affect the preparation of Schedule A for many corporations. The next part of this chapter provides a brief introduction to Section 263A, commonly referred to as the "Uniform Capitalization Rules."

DOMESTIC PRODUCTION ACTIVITIES DEDUCTION

A business engaged in a qualifying production activity is eligible to take a tax deduction (incentive) of 3% in tax years 2005 and 2006. The deduction increases to 6% in year 2007, and 9% in year 2010. A business engaged in activities like; manufacturing, selling, leasing, or licensing items that have been manufactured in the United States, construction services including building and renovation of residential and commercial properties, etc., may qualify for the Domestic Production Activities Deduction. These are the "qualified production activities" eligible for claiming the deduction under Internal Revenue Code Section 199. The deduction is calculated on Form 8903, and appears on line 25 Form 1120, and on line 35 Form 1040. For further information see the instructions for Form 8903.

INTRODUCTION TO THE UNIFORM CAPITALIZATION RULES

The purpose of Section 263A is to provide a uniform set of rules for the identification of costs that must be capitalized and included in the cost of inventory or self-constructed assets. The uniform capitalization rules apply to:

1. All producers;
2. All resellers of real property; and
3. "Large" resellers of personal property.

Definition of producer. If a corporation constructs, builds, installs, manufactures, develops or improves real or tangible personal property, it is a "producer." The property may be produced for sale to customers in the ordinary course of the corporation's business (i.e., inventory), or for use by the corporation in its business (i.e., a self-constructed asset). If, however, the property is produced under a "long-term contract," defined as a contract for the manufacture, building, installation, or construction of property that will not be started and completed in the same tax year, the property is not generally subject to Section 263A. Instead, it is subject to the provisions of IRC Section 460, "Special Rules for Long-Term Contracts."

Definition of Reseller. If a corporation acquires real or personal property for resale to customers in the normal course of business, it is a "reseller." This generally includes wholesalers, retailers, and distributors. All resellers of real property and "large" resellers of personal property are subject to Section 263A. To determine whether a corporation is "large," it calculates its average gross receipts for the three immediately preceding tax

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years. If the average exceeds $10 million, the corporation is "large" and the uniform capitalization rules apply. If the average does not exceed $10 million, the corporation is "small" and the uniform capitalization rules do not apply with respect to its resale activities. This is an annual test using a three-year moving average. The first year the corporation is large, it must adopt the uniform capitalization rules.

Example 1: Trading Corporation began business in 1996. For its tax years 1996-2010, the corporation qualified as a small reseller of personal property under the uniform capitalization rules. The corporation reports the following gross receipts from its 2008-2010 Form 1120.

	2008	**2009**	**2010**
Gross receipts	$1,100,000	$1,250,000	$1,300,000

The Corporation's average annual gross receipts for 2008 through 2010 are $1,216,667, calculated as follows: [$1,100,000 + $1,250,000 + $1,300,000 /3]. Thus, for 2010 it continues to qualify as a "small" business and is not subject to the uniform capitalization rules for inventory.

Application of the Uniform Capitalization Rules to Producers. Section 263A requires producers to identify all direct and indirect costs of production. If the asset is being produced for resale to customers, the production costs are reported on Schedule A, Cost of Goods Sold, and included in the determination of inventory cost. If the asset is being produced for use in the taxpayer's business, the production costs are capitalized as part of the tax basis of the asset and recovered through depreciation expense deductions. Per the Section 263A regulations, the following costs are production costs:

1. Direct Materials - This includes the costs of materials that become a part of the property produced by the corporation and materials that are consumed in the production process, to the extent they can be associated with specific units or groups of units of property produced.

2. Direct Labor - This is the cost of labor directly involved in the production of specific units or groups of units of property produced, including:

- Base pay;
- Overtime;
- Shift differential pay;
- Vacation pay;
- Holiday pay;
- Sick leave pay;
- Payroll taxes;
- Payments to supplemental unemployment benefit plans.

It also includes payments to independent contractors directly involved in the production activity.

3. Indirect Costs - This includes all costs, other than direct materials and direct labor, that are allocable to the production of property. These costs include, but are not limited to:

- Indirect labor and indirect materials
- Employee benefits, such as life and health insurance premiums
- Retirement plan contributions
- Purchasing, handling, and storage costs
- Depreciation
- Taxes
- Rent
- Insurance
- Utilities
- Officers' compensation
- Repairs and maintenance
- Tools and equipment, to the extent they are not otherwise capitalized
- Bidding costs
- Service department costs, including security, data processing, accounting, legal, and personnel.

If the indirect cost is incurred for the exclusive benefit of the production activity (e.g., depreciation of factory equipment), it is 100% allocable to production. If, however, the cost benefits both production and non-production activities (e.g., personnel, accounting, and data processing costs), it is partially allocated to production

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