



IRS Continues to Deny Dealership Overhead Deductions

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The continued debate over the appropriate application of 263A will soon include the courts. One case has already been petitioned to the Tax Court, but will take some time to resolve. In 2010, there will likely be a significant amount of activity on this issue, as it results in a potential significant increase in tax for many dealerships. Moss Adams has been actively involved in this debate, including participation in the AICPA committee on 263A, regular communication with the various IRS liaisons addressing the issues, and coordination with other large CPA firms.

Below is a synopsis of what has occurred so far:

- The IRS has recently stepped up its change in treatment of dealership deductible overhead and operating costs. This began several years ago when the IRS claimed that the automotive retail industry as a whole is noncompliant with 263A an Internal Revenue Code Section that postpones certain overhead deductions until inventory is sold.
- Even as recently as 2006, the IRS had continued to formally approve the "industry accepted" method of applying 263A.
- The IRS announced in October 2009 that it will suspend examination of auto dealership Section 263A issues from 9/15/09 through 12/31/10.
- During this hiatus, various organizations and CPA firms, including NADA, AICPA, State Associations, and Praxity an alliance of independent CPA firms are discussing the issues with the IRS.

Introduction:

This report is designed to inform dealerships subject to the uniform capitalization rules of the current status of the Internal Revenue Service's position on applying these rules. Although the law has not changed on this subject since the late 1980's, the interpretation of the law is what is in a current state of "flux". This report is designed to discuss the current climate on this issue and will provide the following information:

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- History of 263A
- General Rule of 263A
- Simplified Resale Method for calculating capitalization under 263A
- Current Method used to calculate capitalization under 263A
- Current IRS Proposals
- Status of the IRS Proposals

History:

Section 263A was added to the Internal Revenue Code in 1986 with the promulgation of the Internal Revenue Code of 1986 which replaced the Internal Revenue Code of 1954. The statute is often referred to as the uniform capitalization (UNICAP) rules.

General Rule:

Section 263A applies to taxpayers whose average annual gross receipts in the previous three years have exceeded \$10 million. It provides, in general, that the direct and indirect costs properly allocable to property that is inventory in hands of the taxpayer must be included in inventory costs. For purposes of 263A, inventory includes property produced by the taxpayer and property acquired by the taxpayer for resale.

The statute provides authority to the Treasury to issue regulations for the compliance and simplification of applying 263A. Specifically, within the statutory language, the Internal Revenue Code provides that the Treasury will issue simplified procedures for applying the UNICAP rules for property acquired for resale.

The regulations were finalized by the Internal Revenue Service in 1993. At first glance, the regulations appear to be quite flexible in applying the UNICAP rules. For example, the regulations permit a taxpayer to apply any reasonable method to properly allocate direct and indirect costs among units of property produced or acquired for resale. However, the regulations define what is reasonable as a method that will not differ significantly in result from the simplified methods prescribed in the regulations.

The regulations contain two simplified method for taxpayers: a simplified production method and a simplified resale method. As discussed later, whether a taxpayer is a reseller, a producer, or a combination of both is based on facts, circumstances and interpretations. However, prior to discussing this debate, we will first examine the Simplified Resale Method as authorized in the Treasury Regulations at 1.263A-3.

Simplified Resale Method:

A taxpayer may elect to use the simplified resale method if the taxpayer is not involved in production activities. However, if a taxpayer is involved in de-minimis production activities incident to its resale of personal property, they may still elect the simplified resale method. A taxpayer's production activity is presumed de-minimis under the following conditions:

1. The gross receipts from the sale of the property produced by the reseller are less than 10 percent of the total gross receipts of the trade or business; and
2. The labor costs allocable to the trade or business' production activities are less than 10 percent of the reseller's total labor costs allocable to its trade or business.

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Otherwise, unless the taxpayer can prove that their production activities are incidental based on the facts and circumstances, they will be required to elect the simplified production method or a method with results not significantly different from the results of the simplified production method.

The indirect costs most often incurred by resellers are purchasing, handling, and storage costs (263A costs). Under the simplified resale method the additional 263A costs are allocable to inventory at the close of the taxable year by applying the following formula:

Combined Absorption Ratio x Inventory on hand at year-end = 263A Costs

The resulting product under the general allocation formula is the additional 263A costs that are added to the taxpayer's inventory held at year-end. The combined absorption ratio is defined as the sum of the storage and handling costs absorption ratio and the purchasing costs absorption ratio.

Storage and Handling Costs:

Handling costs include costs attributable to processing, assembling, repackaging, transporting, or other similar activities with respect to property acquired for resale. Handling costs are generally required to be capitalized. However, handling costs are not required to be capitalized if such costs are incurred at a retail sales facility.

A retail sales facility is defined as a facility where a taxpayer sells merchandise exclusively to retail customers in on-site sales. For this purpose, a retail sales facility includes those portions of any specific retail site which are:

1. customarily associated with and are an integral part of the operations of that retail site; and
2. generally open each business day exclusively to retail customers which retail customers normally shop, and which are adjacent to or in immediate proximity to other portions of the specific retail site.

For example, two lots of an automobile dealership physically separated by an alley or an access road would generally be considered one retail sales facility, provided customers routinely shop on both of the lots to select the specific automobiles that they wish to acquire.

Storage costs are generally capitalized under section 263A to the extent they are attributable to the operation of an off-site storage or warehousing facility. However storage costs attributable to an on-site storage facility are not required to be capitalized. If a facility is a dual-function (on-site and off-site) storage facility, storage costs must be capitalized to the extent the facility's costs are attributable to off-site storage.

The regulations, however, do provide a safe-harbor for retail facilities that have 10% or less of off-site sales activity. If a retail facility can meet this objective standard, they are deemed to have 100% of their activity as an on-site storage facility. Thus, no storage costs need to be allocated to the facility.

Storage and Handling Costs Absorption Ratio:

Under the simplified resale method, the storage and handling costs absorption ratio is determined as follows:

$$\frac{\text{Current year's storage and handling costs}}{\text{Beginning inventory plus current year's purchases}}$$

Purchasing Costs:

Purchasing costs are costs associated with operating a purchasing department or office within a trade or business, including personnel costs. Personnel cost included as purchasing costs include those who are involved with the following items:

- The selection of merchandise
- The maintenance of stock assortment and volume
- The placement of purchase orders
- The comparison and testing of merchandise.

Whether someone is involved in a purchasing activity depends on the facts and circumstances. The regulations emphasize that someone will not be included or excluded from purchasing activities merely by their job title. For example, someone with the title of "Marketing Manager" may be included in purchasing activities based on their activities.

The allocation of a person's purchasing activity and non-purchasing activity will be accepted if a reasonable method is used. A method is deemed reasonable if it is based on the amount of time a person spends on each activity.

1/3-2/3 rule for allocating Purchasing Activity Labor Costs

The regulations authorize the use of a 1/3-2/3 rule for allocating labor costs performing both purchasing and non-purchasing activities if elected by the taxpayer. The following summarizes the 1/3-2/3 rule:

- If less than 1/3 of a person's time is allocated to purchasing activities, none of their labor costs are allocated to purchasing.
- If the person's purchasing activity is between 1/3 and 2/3 of a person's time, any reasonable method of allocation is allowed such as the proportion of time based on the person's activity.
- If greater than 2/3 of a person's time is allocated to purchasing activities, all of that person's labor costs are allocated to purchasing.

Purchasing Costs Absorption Ratio:

Under the simplified resale method, the purchasing costs absorption ratio is determined as follows:

$$\frac{\text{Current year's purchasing costs}}{\text{Current year's purchases}}$$

Mixed Service Costs:

Mixed Service Costs are indirect service costs that are required to be allocated pursuant to 263A. Examples of mixed service costs include:

- Administrative costs
- Personnel costs (including recruiting, hiring, and relocating)
- Purchasing operations cost
- Materials handling and storage costs
- Accounting and data servicing (including cost accounting and other functions)
- Professional Services (including legal, audit, consulting and security services)

Mixed service cost can be allocate in different ways, but must be reasonable. One method is to allocate mixed service costs to purchasing, handling, and storage costs based on a corresponding activity such as labor costs. For example, to calculate the mixed service costs associated with purchasing the following formula is applied:

$(\text{Labor Cost allocable to purchasing} / \text{Total labor Costs}) \times \text{Total Mixed Service Costs}$

Current Method:

Currently we are applying 263A costs in the following manner:

Determine Purchasing Costs allocation

- Determine the employees that are involved in purchasing activities and how much of their time they are spending on such activities.
- Calculate the 263A labor for purchasing using the 1/3 - 2/3 rule
- Apply the Mixed Service Costs to purchasing costs based on the ratio of purchasing wages over total wages excluding clerical wages.
- Determine the purchasing cost absorption ratio as the relationship between current year purchasing costs over the current year purchases.

Determine Storage and Handling Costs allocation

- Handling costs are not allocated due to the facilities being a Retail Sales Facility based on the facts, circumstances, and nature of the dealership.
- Storage costs are allocated if there it is determined that there are storage sites that are not on-site storage lots. These would include locations that are not visited by customers to view inventory.
- Apply the Mixed Service Costs to storage and handling costs based on the ratio of storage and handling wages over total wages excluding clerical wages.
- Determine the storage and handling cost absorption ration by taking the current year's storage and handling costs over the beginning inventory plus the current year's purchases.

Apply Combined Absorption Ratio to calculate 263A Cost to be Capitalized

- Combine the Purchasing absorption ration and the Storage and Handling absorption ratios to obtain the combined absorption ratio.
- Multiply the Combined absorption ratio to the ending inventory determined without regard to the current or prior year's 263A adjustment.
- Apply the product to the current inventory as the 263A capitalization costs.
- The effect on income is the net of deducting the prior period's capitalization and adding back the current year adjustment.

Current IRS Proposal:

The IRS for several years has claimed that the automotive retail industry as a whole is non-compliant with 263A. This claim culminated in 2007 with the issuance of a Technical Advice Memorandum (2007 TAM) issued by IRS Counsel. The 2007 TAM examines the following three issues:

- Production and Handling Issues
- Retail Sales Facility Issues
- Identification and Allocation of Cost Issues

Production and Handling Issues

One issue the Service is claiming is that when the dealer installs parts on new and used vehicles/trucks owned by the taxpayer, the installation activity constitutes production activity. The service is also taking the position that costs attributable to repair/installation activities with respect to customer vehicles constitute handling costs, and that certain minor repair/installation activities with respect to taxpayer owned vehicles are also handling costs.

The ramification of these positions is that the dealer may be excluded from using the simplified resale method due to the activities that the Service is considering production activities. Another effect that is created from this interpretation is that the additional costs that are considered handling costs increase the handling and storage absorption ratio. Thus, the total costs that are required to be capitalized are increased.

Retail Sales Facility Issue

As discussed previously, handling and storage costs do not need to be capitalized if the dealership is a Retail Sale facility. The regulations provide a safe-harbor position that if the dealership has 10% or less of off-site or non-retail sales that it is a deemed retail facility.

The Service has proposed and is taking the position that the following sales are wholesale sales:

- Vehicles sold to retail customers that are financed through leases, and
- All vehicle that are traded with other dealerships

The consequence of these interpretations again is the increase in the handling and storage costs and the absorption ratio. Again, increasing the overall burden of what is required to be capitalized into inventory at year-end.

Identification and Allocation of Costs

The last issue examines the costs that are being capitalized as Mixed Service Costs. The following specific costs are identified in the 2007 TAM as Mixed Service Costs:

- Salaries - executive costs including payroll tax and employee benefits
- Salaries - administrative costs including payroll taxes and employee benefits
- Rent, real estate taxes, utilities, repair and office supplies allocable to administrative departments.
- Data processing costs
- Legal and audit costs

If a taxpayer was not including these costs to their calculations, the effect of including these costs will increase the required capitalization. This final issue is an issue for those dealerships that have generally been non-compliant and have not been capitalizing any costs pursuant to 263A. In contrast to the previous two issues where interpretations of the law are at issue, this final issue is merely a question of facts.

Status of IRS Proposals:

The IRS announced in October of 2009 that it will suspend examination of auto dealership Section 263A issues from 9/15/09 through 12/31/10. During this period, other dealership inventory issues will continue to be evaluated and examined, if appropriate. However, dealership exams in process as of 9/15/09 can continue to develop Section 263A issues; although, dealers currently undergoing an exam in which Section 263A issues are under consideration as defined in Rev. Proc. 2008-52 (2008-2 CB 587) can elect to change their method of accounting. Effective 1/1/11, the examination of auto dealership Section 263A issues will resume with examiners "instructed to consider and apply all appropriate penalties."

Look out for future FLASH's, which will include significant developments as they occur.

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