



IRS

IRC §263A

TAM 200736026

Addresses Dealership UNICAP Issues

**A
u
t
o
m
o
t
i
v
e

A
l
e
r
t**

**Motor
Vehicle
Technical
Advisor**

**January
2008**

Introduction

In a September 2007 National Office Technical Advice Memorandum, TAM 200736026, the IRS addressed Uniform Capitalization (UNICAP) issues with respect to a specific automobile dealership. The TAM is a complex document addressing many UNICAP issues. These issues can be broadly categorized as (1) "Production" issues and (2) "Storage and Handling Costs" issues. Due to the technical nature and number of issues, this document is not intended to be a comprehensive discussion of dealership UNICAP issues. The TAM analyzed one specific dealership and cannot be used or cited as precedent. Nevertheless, the TAM provides insight as to how the Service would interpret similar facts for similarly situated taxpayers. Although non-precedential, an analysis of conclusions in TAM 200736026 should be considered to the extent a dealership's facts and circumstances are similar to those in the TAM.

The Primary Issues

In the "Producer" category, the issues for consideration in the TAM were whether the repair/installation activities relating to dealership owned and/or customer owned vehicles in the dealership's service department constituted production activity (i.e., resulted in the production of property subject to section 263A). This also impacts whether a dealership's repair/installation activities are handling costs as discussed below.

The "Storage and Handling Costs" issues concern whether certain sales (e.g., sales of vehicles to finance companies in cases of customers who lease their vehicles) constitute off-site sales or on-site sales to retail customers and whether the dealership's two locations containing vehicles constitute on-site, off-site, or dual function storage facilities. The transactions considered by the TAM include trade-in vehicles (some of which were subsequently disposed of at auction), dealer trade vehicles, leased vehicles, fleet sale vehicles, and parts sales to various customer categories.

The TAM also addresses many sub-issues related to the primary issues discussed above.

"Producer" Issues

Internal Revenue Code Section 263A defines the term "produce" very broadly. Production activities include construct, build, install, manufacture, develop, or improve. The terms "install" and "improve" are particularly relevant for dealerships. Dealership service and body shops regularly install parts and may improve both customer and dealership owned vehicles. Although dealerships may be involved in a production activity, it is not considered to be producing property subject to section 263A unless it is also the owner of the property. The TAM concludes that because the dealership was the owner of its new and used vehicle inventory, the dealership engaged in production activities relating to those vehicles. The dealership was not the "producer"

of customer owned vehicles because it did not have the benefits and burdens of ownership (*i.e.*, the customer did, an artisan's lien notwithstanding).

Dealerships may perform differing levels of repair, installation, and improvement on new and used vehicles. Whether a dealership's activities in servicing new and used vehicles constitute production or handling activities depends on the specific facts. For example, a dealership may install parts to make the vehicle more saleable or replace defective parts to make the vehicle more readily marketable or to add utility to the product. The TAM concluded that "Costs that make property more readily marketable and/or add utility to a product, making it more suitable for use and consumption, are production costs."

The TAM also concluded that some minor activities may not constitute production of property and that to the extent that certain activities are not production activities, the related costs are handling costs and not costs of producing property. The UNICAP regulations require handling costs to be capitalized, unless they are incurred at a retail sales facility with respect to property sold to retail customers at the facility (or the on-site portion of a dual function storage facility). A dealership must consider its activities in light of the conclusions in the TAM. Whether a dealership's activities in servicing new and used vehicles constitute production activities or handling costs depends on the specific facts.

In addition to the items discussed above, the TAM considers subcontractor activities, certain de minimis exceptions, and whether the taxpayer is permitted to use the simplified resale method. In order to fully understand and apply the conclusions in the TAM, these additional issues must be considered.

Storage and Handling Issues

Essentially, a dealership will not be a retail sales facility unless it exclusively engages in on-site sales to the final purchasers of the vehicle. Thus, as a practical matter the second major category of issues addressed in the TAM center around whether the dealership's primary location is a dual function storage facility. A dual function facility is one in which there are both on-site and off-site sales. On-site sales are defined as sales made to retail customers physically present at a facility.

A typical dealership enters into many types of transactions. The TAM considers the following transactions and determines whether they are on-site sales to retail customers. (1) Vehicles taken in trade or purchased at auction and subsequently resold at wholesale; (2) Vehicles sold to another dealership at cost; (dealer trades) (3) Leased vehicles; (4) Vehicles sold as part of a fleet sale; and (5) Wholesale sales of certain parts.

Applying the regulatory definition of on-site sales, the TAM concluded that "...few of the sales under consideration constitute on-site sales to retail customers." The TAM expands on that conclusion by explaining that most of the vehicles in question are not sold to the final purchaser of the merchandise. For instance, most vehicles disposed of on the wholesale market are not sold to the end user. Likewise, the TAM concluded that dealer trades are not sold to the "end user". Finally, the TAM concludes that vehicles leased to customers are sold to an off site leasing or credit company and do not qualify as on-site sales.

Assuming that fleet customers purchase fleet vehicles at the dealership's location, fleet sales do qualify as on-site sales. The TAM also addressed several parts sales scenarios. The reader should refer to the full text of the TAM for the conclusions on

parts sales.

As a result of the TAM's conclusion that the primary dealership facility engages in both on-site and off-site sales, the location qualifies as a dual function storage facility and the dealership must determine storage and handling costs attributable to the off-site sales.

The TAM also considered a second dealership location that was not physically attached or an integral part of a retail sales facility where the dealer engaged in no sales to retail customers. The TAM ruled that this second location was an off-site storage facility.

The TAM's Conclusions – Summary

To summarize, under the circumstances described in the ruling, the TAM reached the following conclusions on key issues (list is not all inclusive):

- (1) the dealership's repair/installation activities relating to customer owned vehicles do not constitute production activities because the dealership does not hold the benefits and burdens of vehicle ownership;
- (2) the dealership's repair/installation activities relating to dealership owned vehicles may constitute production activities under IRC 263A; and
- (3) vehicles sold at wholesale, dealer trades, leased vehicles, and some parts sales are not on-site sales to retail customers and as a result the dealership's main location is a dual function storage facility for purposes of IRC 263A.

The TAM addresses numerous other issues including qualifications for a de minimis exception to the production activity requirements, identification of mixed service costs, and qualifications for and operation of the simplified resale method and the simplified production methods. The entire TAM should be considered and the reader should not limit their consideration to the issues described in this document.

What Does This Mean for Dealerships?

In general UNICAP requires certain taxpayers to capitalize, or add, certain cost to inventory increasing the value of the inventory for tax purposes. Capitalizing additional costs to inventory may result in additional tax costs to the dealership. The UNICAP rules contain certain de minimis rules and methods to simplify compliance. Prior to the issuance of the TAM, many tax practitioners interpreted the UNICAP regulations quite differently.

UNICAP is a method of accounting and changes to methods of accounting require that the taxpayer seek approval from the IRS prior to making the change. Dealers who wish to change a method of accounting complete a Form 3115, Application for Change in Method of Accounting and submit it to the IRS following the requirements applicable to the particular change.

The Department of the Treasury and IRS Chief Counsel included auto dealership UNICAP issues in the 2007-2008 Priority Guidance Plan. Thus, precedential guidance on these two general issues will be forthcoming.