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# IRC §263A Auto Dealership Questions & Answers

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## Introduction:

Internal Revenue Code (IRC) Section 263A (§263A) has been the topic of considerable discussion among auto dealership owners and their CPAs of late §263A is a complex provision for which the regulations provide simplifying elections to assist taxpayers in its application and is an issue that dealers and CPAs have been considering when filing tax returns for many years.

§263A's recently elevated profile is likely due to a number of factors including an increase in dealership examinations. In addition, in a very limited number of examinations, some examiners have considered whether the operations in an auto dealership's body shop and service department cause the dealership to be a "reseller with production activities" (Producer Issue). If a dealership is to be considered a reseller with production activities, it would require a significant amount of additional work for the dealership/CPA and could result in additional tax due for the dealership.

The Producer Issue has not been previously considered an issue at dealerships by the IRS and there is no specific guidance. In order to clarify the issue and to provide guidance to the industry, we have requested a Generic Legal Advice Memorandum (GLA). In addition to the Producer Issue, we have asked for industry specific guidance on several other §263A issues. Although normally the GLA process does not contemplate involvement from external customers, in this case NADA was invited to submit a white paper expressing the industry view of the issues.

Since the Producer Issue is new and conceivably could have an adverse affect on this industry, the Service has agreed to stand down on the Producer Issue only pending the decision reached in the GLA. During the stand down period, the Service has committed to the NADA that agents generally will not raise the producer issue. The stand down does not affect and agents will continue to consider other appropriate §263A issues.

In an effort to clarify some of the basic questions related to auto dealership §263A, we have developed the following questions and answers. The following consists of an *overview* of the application of IRC §263A to auto dealerships and *is not intended to be a comprehensive discussion* of the IRC §263A concepts.

If you have any questions or would like to discuss these issues you may contact the Motor Vehicle Technical Advisor team.

# IRC 263A

## Auto Dealership Questions and Answers

### Motor Vehicle Technical Advisor 1-9-07

**NOTE:** The following questions and answers consist of an overview of the application of IRC 263A to auto dealerships and are not intended to be a comprehensive discussion of the IRC 263A concepts.

	<u>Question</u>	<u>Answer</u>
1.	<b>What property is subject to IRC 263A?</b>	IRC §263A applies to : <ul style="list-style-type: none"> <li>- Real and tangible personal property produced by a taxpayer</li> <li>- Real or personal property acquired by a taxpayer for resale.</li> </ul>
2.	<b>Are any dealers exempt from the uniform capitalization rules?</b>	<p>The uniform capitalization rules do not apply to personal property acquired for resale by an auto dealer whose average annual gross receipts for the three previous tax years do not exceed \$10 million. Auto dealers in this capacity are referred to as small resellers §1.263A-3(a)(1)).</p> <p>Gross receipts are the total amount derived from all of the auto dealer's trades or businesses (Reg. §1.263A-3(b)(2). A controlled group of businesses is considered as one entity and the gross receipts of each member of such group are aggregated for purposes of applying this test (Reg. §1.263A-3(b)(3)).</p>
3.	<b>What types of costs are capitalized under 263A?</b>	<p>Section 263A costs for auto dealers include section 471 inventory costs and additional section 263A costs. Generally, §1.263A-1(e) describes the types of costs that must be capitalized by taxpayers. Dealers must capitalize the acquisition cost of property acquired for resale, as well as indirect costs described in §1.263A-1(e)(3), which are properly allocable to property acquired for resale.</p> <p>The indirect costs most often incurred by auto dealers are purchasing, handling, and off-site storage costs and generally consist of direct and indirect labor costs (including the costs of pension plans and other fringe benefits), occupancy expenses including rent, excess of book over tax depreciation, insurance, security, taxes, utilities and maintenance, materials and supplies; depreciation, insurance of vehicles and equipment; tools; telephone; travel; and the general and administrative costs that directly benefit or are incurred by reason of the taxpayer's activities (Reg. § 1.263A-3(c)(2)).</p>
4.	<b>What costs are included in the definition of purchasing costs?</b>	<p>Purchasing costs include personnel costs relating to:</p> <ul style="list-style-type: none"> <li>-the selection of merchandise;</li> <li>-the maintenance of stock assortment and volume;</li> <li>-the placement of purchase orders;</li> <li>-the establishment and maintenance of vendor contracts;</li> <li>-the comparison and testing of merchandise.</li> </ul> <p>The determination of whether a person is engaged in purchasing activities is based upon the activities performed by that person and not upon the person's title or job classification. If a person performs both purchasing and non-purchasing activities, the dealer must reasonably allocate the worker's labor costs between these activities.</p> <p>A dealer may elect the 1/3-2/3 rule for allocating labor costs of persons performing both purchasing and non-purchasing activities. If elected, the dealer must allocate the labor costs of all such persons using the 1/3-2/3 rule.</p> <p>Under this rule:</p>

		<ul style="list-style-type: none"> <li>-if less than one-third of a person's activities are related to purchasing, none of that person's labor costs are allocated to purchasing;</li> <li>-if more than two-thirds of a person's activities are related to purchasing, all of that person's labor costs are allocated to purchasing; and</li> <li>-in all other cases, the dealer must reasonably allocate labor costs between purchasing and non-purchasing activities (Reg. § 1.263A-3(c)(3)).</li> </ul>
5.	<b>What costs are included in the definition of handling costs?</b>	<p>Handling costs include costs attributable to loading and unloading, processing, assembling, repackaging, transporting, and other similar activities with respect to property acquired for resale.</p> <p>Generally, transportation costs required to be capitalized include costs incurred in transporting property-</p> <ul style="list-style-type: none"> <li>-from the vendor to the dealer,</li> <li>-from one of the dealer's storage facilities to another of its storage facilities;</li> <li>-from the dealer's storage facility to its retail sales facility</li> <li>-from the dealer's retail sales facility to its storage facility;</li> <li>-from one of the dealer's retail sales facilities to another of its retail sales facilities (Reg. § 1.263A3(c)(4)).</li> </ul>
6.	<b>Which storage costs must be capitalized?</b>	<p>Storage costs are capitalized under section 263A to the extent they are attributable to the operation of an off-site storage or warehousing. Storage costs attributable to the operation of an on-site storage facility are not required to be capitalized under section 263A. Storage costs attributable to a dual function storage facility must be capitalized to the extent that the facility's costs are allocable to offsite storage (Reg. §1.263A-3(c)(5)(i)).</p>
7.	<b>What is the definition of an offsite storage facility?</b>	<p>An off-site storage facility is defined as a facility that is not an on-site storage facility. An on-site storage facility is defined as a storage or warehousing facility that is physically attached to, and an integral part of, a retail sales facility (Reg. §1.263 A-3 (c)(5)(ii)(A)).</p> <p>A storage facility is considered an integral part of a retail sales facility when the storage facility is an essential and indispensable part of the retail sales facility. For example, if the storage facility is used exclusively for filling orders or completing sales at the retail sales facility, the storage facility is an integral part of the retail sales facility (Reg. §1.263A3(c)(5)(ii)(C)).</p> <p>A retail sales facility is defined as a facility where a dealer sells merchandise exclusively to retail customers in on-site sales. For this purpose, a retail sales facility includes only those portions of any specific retail site-</p> <ul style="list-style-type: none"> <li>- which are customarily associated with and are an integral part of the operations of that retail site;</li> <li>- which are generally open each business day exclusively to retail customers;</li> <li>- in which retail customers normally and routinely shop to select specific items of merchandise;</li> <li>- which are adjacent to or in immediate proximity to other portions of the specific retail site (Reg. §1.263A-3(c)(5)(ii)(B)(1)).</li> <li>-</li> </ul> <p>Thus, 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 (Reg. §1.263A3(c)(5)(ii)(B)(2)).</p> <p>In contrast, a dealer may operate a wholesale warehouse where wholesale sales</p>

		are made to customers physically present at the facility. The wholesale customers resell the goods they purchase to final retail customers. Because no retail sales are conducted at the facility, all storage costs attributable to the wholesale warehouse must be capitalized (Reg. §1.263A-3(c) (5)(v)).
8.	<b>What is a dual-function storage facility?</b>	A dual-function storage facility is defined as a storage facility that serves as both an off-site storage facility and an on-site storage facility. Dual-function storage facilities could be utilized by new or used auto dealerships ranging in size from a small dealership with limited space to a mega-dealer to an auto mall where several dealers share the facility. A dual-function storage facility also includes any facility where sales are made to retail customers in on-site sales and to retail customers in sales that are not on-site sales., <b>or other customers</b> (Reg. §1.263A-3(c)(5)(ii)(G)).
9.	<b>How are storage costs associated with a dual-function storage facility allocated between the off-site storage function and the on-site storage function?</b>	Storage costs associated with a dual-function storage facility are allocated between the off-site storage function and the on-site storage function using the ratio of gross on-site sales of the facility (i.e., gross sales of the facility made to retail customers visiting the premises in person) to the total gross sales of the facility (Reg. §1.263A-3(c)(5)(iii)(B)).  If 90 percent or more of the costs of a facility are attributable to the on-site storage function, the entire storage facility is deemed to be an on-site storage facility. In contrast, if 10 percent or less of the costs of a storage facility are attributable to the on-site storage function, the entire storage facility is deemed to be an off-site storage facility (Reg. §1.263A-3(c)(5)(iii)(C)).
10.	<b>What types of costs are included as general and administrative (G&amp;A) costs?</b>	G&A costs (capitalizable service costs) that directly benefit or are incurred by reason of the dealer's production or resale activities are included as §263A costs. Mixed service costs are G&A costs that are partially allocable as capitalizable service costs and partially deductible as non-production or non-resale activity costs. If G&A costs benefit only an inventory function, the costs should be allocated totally to that function.  Types of capitalizable service costs include:  <ul style="list-style-type: none"> <li>- The administration and coordination of production or resale activities (wherever performed in the business organization of the dealer);</li> <li>- Personnel operations, including the cost of recruiting, hiring, relocating, assigning, and maintaining personnel records of employees;</li> <li>- Purchasing operations, including purchasing materials, vehicles, parts, equipment, etc., scheduling and coordinating delivery from the manufacturer or suppliers, expediting and follow-up;</li> <li>- Materials handling, warehousing and storage functions; and</li> <li>- Accounting and data services operations, including, for example, cost accounting, accounts payable, disbursements, and payroll functions.</li> </ul> For purposes of administrative convenience, if 90 percent or more of a mixed service department's costs are deductible service costs, a dealer may elect not to allocate any portion of the service department's costs as additional §263A costs. This election applies to all of the dealer's mixed service departments and constitutes the adoption of (or a change in) method of accounting. Under this election, if 90 percent or more of a mixed service department's costs are capitalizable service costs, the dealer must allocate 100 percent of the department's costs as additional §263A costs (Reg. §1.263A-1(g)(4)(ii)).
11.	<b>What allocation methods can a dealer use to allocate its mixed service costs?</b>	A dealer may use a direct allocation method (which generally allocates mixed service costs to departments engaged in production or resale activities), the simplified service cost method (Reg. §1.263A-1(h)), or any other allocation method based on a factor or relationship that reasonably relates the service costs to the benefits received from the service departments or activities. An allocation method is deemed reasonable if it is used consistently, is not an attempt to circumvent the requirements or principles of §263A, and the total costs actually capitalized do not differ significantly from those that would be using another

		<p>permissible method (Reg. §1.263A-1(f)(4)).</p> <p>Under the simplified service cost method, a dealer computes its capitalizable mixed service costs using the formula: Allocation ratio x Total mixed service costs.</p>
12.	<b>How does the simplified resale method work?</b>	<p>The simplified resale method is applied as follows: The combined absorption ratio is multiplied by the §471 costs remaining on hand at the end of each taxable year in which the simplified resale method is applied. The resulting product is the additional §263A costs that are added to the dealer's ending §471 costs to determine the section 263A costs that are capitalized (Reg. 1.263A-3(d)(3)).</p> <p>The combined absorption ratio is defined as the sum of the storage and handling costs absorption ratio and the purchasing costs absorption ratio (Reg. §1.263A-3(d)(3)(C)(1)).</p> <p>Section 471 costs remaining on hand at year end are generally costs that the dealer incurs during its current taxable year, which remain in its ending inventory at year end. (Reg. §1.263A3(d)(3)(C)(2)).</p> <p>The storage and handling costs absorption ratio is determined as follows: Current year's storage and handling costs divided by beginning inventory plus current year's purchases. Current year's storage and handling costs are defined as the total storage costs plus the total handling costs incurred during the taxable year that relate to the dealer's property acquired for resale and other eligible property. .</p> <p>Beginning inventory in the denominator of the storage and handling costs absorption ratio refers to the §471 costs of any property acquired for resale or other eligible property held by the dealer as of the beginning of the taxable year. Current year's purchases generally mean the dealer's §471 costs incurred with respect to purchases of property acquired for resale during the current taxable year.</p> <p>The purchasing costs absorption ratio is determined as follows: Current year's purchasing costs divided by Current year's purchases. Current year's purchasing costs are defined as the total purchasing costs incurred during the taxable year that relate to the dealer's property acquired for resale and other eligible property. Purchasing costs must include the amount of allocable mixed service costs. Current year's purchases generally are the dealer's §471 costs incurred with respect to purchases of property acquired for resale during the current taxable year (Reg. §1.263A3(d)(3)(E)(2)).</p>
13.	<b>What is the Historic Absorption Ratio Election and how does it work?</b>	<p>Reg. §1.263A-3(d)(4)(i) permits dealers using the simplified resale method to elect to use a historic absorption ratio in determining additional §263A costs allocable to eligible property remaining on hand at the close of their taxable years. A dealer's historic ratio is based on the percentage of additional §263A costs capitalized by the dealer during a three-year test period. Therefore, a dealer may only make a historic absorption ratio election if they have used the simplified resale method for three or more consecutive taxable years immediately prior to the year of election and have capitalized additional §263A costs using an actual absorption ratio for their three most recent consecutive taxable years.</p>