



IRS

Factory Image Upgrade Payments

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Introduction

In recent years, many automobile manufacturers implemented programs intended to encourage dealers to construct new dealership property or upgrade and enhance their current locations. Each manufacturer's program is unique. But the various programs all generally provide payments to dealers related to the facilities upgrades.

The programs are not new and similar programs may be found in other retail industries such as gas stations and fast food establishments. Recently, the proper tax treatment of the issue as it relates to auto dealerships has become a topic of increased conversation and generated inquiries to the Motor Vehicle Technical Specialist Program (MVTSP). The MVTSP program does not have access to and has not analyzed all programs nor is there any official IRS guidance. However, this document will briefly address the issue and consider current tax law and guidance in light of the facts as we know them.

Programs and Types of Payments

The programs vary by manufacturer. But all include some form of payment to dealers intended to encourage dealers to upgrade their dealership facilities. Plan documents for each program must be reviewed individually and the facts and circumstances unique to each program must be considered.

Generally, each program provides the dealer with payments provided that they meet factory timelines, facility standards, and other program rules. Timing of the payments can vary by manufacturer and perhaps even by dealership. Some programs provide payments based only on completion of various construction milestones. Others provide payment based upon the number of vehicles purchased or sold. But in the programs we've seen to date, most, if not all, of the payments related directly to the facility upgrade construction.

What Are The Tax Questions Related to Imaging Payments?

Simply put, how should the payments be classified and reported for tax purposes?

Some in the industry maintain that all imaging payments must be reported in income. Others claim that the payments should be excluded from income and perhaps reduce the basis of the property being renovated and/or constructed.

Various arguments have been advanced to support all of the above possible treatments. Some believe that the body of available law strongly supports including the payments in income. Others advance the theory that the payments are a non-taxable inducement to the dealership to engage in the facility upgrade or that the payments are merely a payment by the manufacturer of dealership expenses and that the proper treatment is to reduce the depreciable basis of the property. Others argue that the payments are loans from the manufacturer to the dealership.

How Does Current Tax Law Apply to Imaging Payments?

Although the need for and possibility of formal guidance is still being considered, current tax law and guidance supports the inclusion of facility upgrade payments in income. The Internal Revenue Code (IRC) and Regulations, several court cases, and various rulings and administrative guidance support this conclusion. *(The following discussion is*

intended only as an overview and may not include all applicable guidance.)

IRC section 61 defines gross income as all income from whatever source unless specifically excluded.

IRC section 118 provides that, in the case of a corporation, gross income does not include any contribution to the capital of a taxpayer, whether the contribution is by a shareholder or nonshareholder. (Note that section 118 only applies to corporations. There is no comparable rule for partnerships or LLCs.) The classic contribution to capital contemplated by section 118 would be the value of land or other property contributed to a corporation by a governmental unit for the purpose of inducing the corporation to locate its business in a particular community.

Section 118 also provides, however, that a “contribution to the capital of a taxpayer” does not include any contribution in aid of construction, or any other contribution as a customer or potential customer. In most of the imaging programs with which the Service is familiar, the payment from the manufacturer to the dealership is to aid the construction of new facilities or to renovate existing facilities. It’s also clear that an automobile dealership and the manufacturer have a customer relationship. The regulations elaborate on this, stating that a contribution is not excluded under section 118 when money or property is transferred to the “...corporation in consideration for goods or services rendered.” Goods and services flow both ways between the manufacturer and the dealership. And, as described in the following case, a manufacturer that pays a dealer to construct facilities often expects to receive significant benefits in return.

The case of John B. White, Inc. v. Comm’r, 55 TC 729 (1971), addressed a situation similar to modern imaging payments. In White, Ford Motor Company (Ford) paid a dealership cash to induce the dealership to move its operations. Ford believed that moving the dealership to a more desirable location with a more attractive and better equipped building would increase the sales of Ford products and enhance Ford’s image.

The Tax Court ruled that the payment was includible in the dealership’s income and was not excludible as a contribution to capital under IRC section 118. The Court first cited IRC section 61 and noted that the payment from Ford enhanced White’s wealth and allowed the dealership to acquire improved facilities and at a more advantageous location.

The Court also addressed the potential for excluding the payment under IRC section 118 and concluded that Ford made the payment in expectation of enhanced promotional activities by White through the use of the new facilities. The Court noted that Ford anticipated increased sales of its products and enhancement of the Ford image from the new facilities; the benefits that Ford anticipated were neither indirect nor intangible. As a result, the Court concluded that the payment was not excludible from the dealership’s income.

Conclusion

In general, analysis of a number of legal authorities, some of which are cited above, lead to the conclusion that manufacturer payments to auto dealerships for facility and image upgrade payments should be reported in income. The White case in particular appears to be on point with the general facts surrounding the payments and should be considered carefully when evaluating the proper treatment of image upgrade payments. Additionally, each program must be evaluated individually and treatment determined based on the facts and circumstances of those facts.