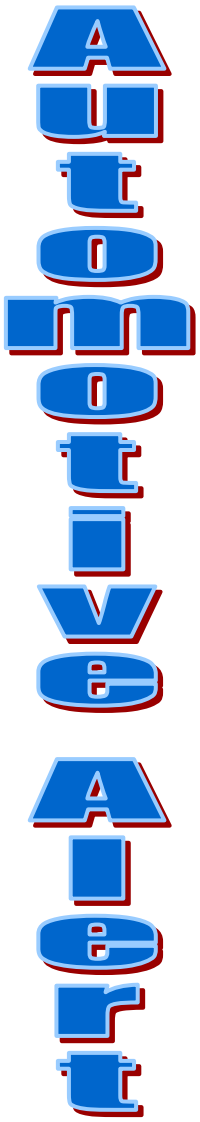
IRS

REVENUE PROCEDURE 2010-44 PROVIDES UNICAP RELIEF FOR MOTOR VEHICLE DEALERSHIPS



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Introduction

On November 9, 2010, the IRS issued formal UNICAP (Internal Revenue Code 263A) guidance to auto dealers and several other types of motor vehicle dealerships. Revenue Procedure (Rev. Proc.) 2010-44 provides two safe harbor methods of accounting that, if properly elected and applied, should simplify a dealership's UNICAP computations. Dealers properly changing to one or both of the safe harbor methods receive audit protection (as defined in section 7 of Rev. Proc. 2008-52) for years prior to the year of change.

Generally, taxpayers subject to UNICAP are required to capitalize rather than deduct certain direct and indirect costs allocable to property produced and/or acquired for resale. Indirect costs most often incurred by a reseller include purchasing, storage, and handling costs. However, a reseller is not required to capitalize handling and storage costs incurred at a retail sales facility.

Although the UNICAP provisions were originally enacted in 1986, the industry's focus on the issue increased in 2007 with the issuance of Technical Advice Memorandum (TAM) 200736026. The complex TAM addressed many auto dealership UNICAP issues and concluded that the dealership at issue had not properly applied the UNICAP rules. The TAM analyzed one specific dealership and cannot be used or cited as precedent. Nevertheless, the TAM provided insight as to how the Service would interpret similar facts for similarly situated taxpayers.

Many in the automobile industry expressed concern that complying with the legal authority outlined in the TAM would cause undue burden on both the industry and the IRS. The new safe harbors may provide motor vehicle dealerships an opportunity to alleviate that burden and change their method of accounting for UNICAP costs.

What are the Safe Harbors?

Effective November 9, 2010, Rev. Proc. 2010-44 provides that qualifying motor vehicle dealerships may elect either or both of the following safe harbor methods of accounting:

Retail sales facility safe harbor method – A qualifying dealer using this method may teat its entire sales facility as a retail sales facility. The dealer is not required to capitalize and may currently deduct handling and storage costs incurred at its facility provided that certain criteria are met.

The facility must be routinely visited by retail customers and the dealership must normally and routinely conduct on-site retail sales from the facility. A retail sales facility includes a vehicle lot that is a part of the sales facility and is routinely visited by customers.

Facts and circumstances and common understanding govern the definition of a retail sales facility for purposes of the retail sales facility safe harbor. Some dealerships operate their sales facility under one roof. Others have more than one building located on one piece of real estate. Still others have nearly all of their operations on one piece of real estate with a portion, such as a service shop or body shop, located elsewhere. A key component of any analysis is whether or not the locations are routinely visited by retail customers. For example, if the service or body shop located apart from the main dealership location is not visited by the retail customers, it is unlikely to be part of the retail sales facility, and UNICAP costs must be capitalized.

Reseller without production activities safe harbor method – A qualifying dealer electing this safe harbor method may treat itself as a reseller without production activities. The benefits of electing this method include classifying activities conducted by dealership employees and contractors working at the dealership location as handling costs rather than production costs. Handling costs incurred at a retail sales facility may be currently deducted rather than capitalized. Costs associated with outside contractor work performed away from the dealership still must be capitalized rather than deducted. The cost of parts must be capitalized on dealership-owned vehicles as an acquisition cost of the vehicle.

Most dealerships add the cost of both parts and labor, often including a profit margin, to the cost basis of the dealership owned vehicle. However, for tax purposes, the labor costs and internal profit are not required to be capitalized and may be currently deducted. A word of caution: dealers that currently include labor and internal profit in inventory for tax purposes may not stop including those costs without changing their method of accounting for those costs. The new revenue procedure provides that a dealer may make a corresponding change in method of accounting to remove those costs at the same time they elect the new safe harbors. (See below for more information on accounting method changes.)

Who Qualifies for the Safe Harbors?

The revenue procedure defines a qualifying motor vehicle dealership broadly as a dealership that primarily purchases and resells to retail customers one or more of the following categories of new or used vehicles:

- Automobiles,
- Light, medium, or heavy duty trucks
- Recreational vehicles
- Motorcycles
- Boats
- Farm or construction machinery and equipment

The new safe harbors do not require that a dealer analyze dealership transactions and categorize them as a retail sale or non-retail sale as the TAM required. To determine whether it qualifies for the safe harbors, the dealership should consider its typical operations and determine whether its primary activity is the acquisition and resale of vehicles to retail customers that visit the dealership facilities. A retail customer is defined as the final purchaser of the vehicle or equipment.

Determination of whether a dealership primarily purchases and resells to retail customers requires a fact and circumstances analysis. But it is anticipated that a typical dealership would be categorized as a qualifying motor vehicle dealership for purposes of this revenue procedure.

How Do I Adopt the New Safe Harbors?

A qualifying dealership that wants to take advantage of either or both of the new safe harbors must follow specific rules to change their method of accounting for UNICAP. In nearly all cases, the dealership does not need to secure advance permission from the IRS to make the accounting method change but rather may make the change by completing a Form 3115 (Application for Change in Method of Accounting). The completed form must be attached to their timely filed return for the year in which they make the change. A copy of the form must also be sent to the IRS National Office.

In most cases, a dealership can adopt the new safe harbors for its first or second year ending after November 9, 2010 without considering most of the restrictions sometimes imposed on automatic method changes. If a dealer chooses to adopt the method during a later period, they should refer to the scope limitations provided in the automatic change in method of accounting revenue procedure.

Some dealers may also decide that it is appropriate or necessary to change other UNICAP methods of accounting in conjunction with the change to the safe harbor(s). A dealer that files a Form 3115 to change to one or both of the safe harbors may also make other concurrent automatic changes, such as removing internal profit or labor, on the same form using the same method change designation number as the safe harbors.

Does the Revenue Procedure Include Audit Protection?

In most cases, a dealer that properly changes its method of accounting to a method consistent with the safe harbor methods will receive audit protection for prior year returns. In other words, the IRS will not require the dealer to change its method of accounting for the same item in a year prior to the year of change. That doesn't mean that the IRS cannot audit other issues at a dealership that changes to one or both of the new safe harbor methods. The examiner may also ask to review the Form 3115 and any computations made to change to one or both of the safe harbors to ensure that the change was properly made.

The audit protection attaches when the copy of the Form 3115 is filed with the National Office. But if the National Office copy is filed prior to year end, the dealership may be required to perfect the Form 3115 when the return is filed.

Does This Mean That Auto Dealerships are Not Subject to UNICAP?

No. Dealerships are still subject to IRC 263A (UNICAP). The revenue procedure is merely a set of safe harbors that may be elected. Dealers remain subject to UNICAP and should consider how all of the UNICAP rules could affect the dealership. For example, dealers must still consider whether they have off site storage requiring cost capitalization and purchasing activity for which they need to capitalize costs.

Additional Information

This Alert is intended to be a brief overview of the new safe harbor provisions and changes in method of accounting. To determine how these provisions apply to your dealership, please review Internal Revenue Code §263A and the accompanying regulations, Revenue Procedure 2010-44 and Revenue Procedure 2011-14.