

Dealership UNICAP Revenue Procedure 2010-44

Questions & Answers

On November 9, 2010, the IRS released the long-awaited capitalization (UNICAP) guidance that NADA has so diligently pursued for five years. The following questions and answers address many of the issues that dealers faced and how Revenue Procedure 2010-44 will apply.

Q – What is UNICAP?

A – The UNICAP provisions require taxpayers to capitalize additional costs to inventory in addition to the normal costs of acquiring parts and vehicles. For dealerships treated as resellers, these additional costs normally include costs of storage, handling, purchasing, and applicable overhead. These rules apply to all resellers with average annual gross receipts over \$10 Million.

Q – Why did the IRS issue the new rules?

A – Even though UNICAP is almost 25-years old, there had been no specific guidance for car and truck dealerships until 2007 when the IRS established several very harsh and burdensome positions in the case of one dealer. The IRS issued a Technical Advice Memorandum (TAM) stating these positions. In audits of other dealerships, IRS Agents applied the positions in the TAM, even to dealerships that had received IRS approval for a much more favorable way to determine UNICAP. The new rules essentially make the more favorable application of UNICAP, already used by many dealerships, available to all dealerships.

Q – What are the new rules?

A – Dealerships can now make two elections. The first is: dealerships can elect to deduct all handling and storage costs incurred at certain dealership sales facilities. The second is: dealerships can elect to be treated as resellers who are not producers and deduct the cost of all labor (handling costs) performed by the dealership on customer and dealership-owned vehicles. In making this election, a dealership is also allowed to make a correction for the amount of profit that may have been capitalized on parts added to dealership-owned vehicles.

Q – How does a dealership elect the new rules?

A – Dealerships elect one or both of the new rules by filing a Form 3115, Application for Change in Accounting Method, with the IRS. There is no filing fee for this form and a dealership may file it any time from the beginning of the year of change until the income tax return is timely filed for the year of change.

Q – My current UNICAP method appears to be consistent with the new rules. Do I still need to file a Form 3115 to elect the safe harbors?

A – Yes. While a dealership's current UNICAP method and the safe harbors may result in no UNICAP capitalization, every dealership needs to file Form 3115 to elect the specific new safe harbors. If the dealership does not file a Form 3115, a later IRS audit could subject the dealership to all of the UNICAP issues in the TAM.

Q – What happens if the IRS audits the dealership before the Form 3115 is filed?

A – The IRS will not challenge the dealership's treatment of handling and storage costs at the dealership's retail facility or handling costs for customer and dealership-owned vehicles for federal income tax returns filed before November 10, 2010 as long as the dealership's treatment is consistent with the new rules. Once a proper Form 3115 is filed, audit protection is provided for these items for tax returns filed for all prior years. Thus, most dealerships will want to elect the safe harbors for this year.

Q – What will the IRS do if a dealership does not file a Form 3115?

A – If a dealership does not file the Form 3115, the IRS could audit the dealership and apply the harsh positions in the TAM.

Q – Will the new rules result in any additional taxes?

A – Generally, no. In fact, many dealerships may get a one-time extra deduction. For dealerships that have all of their facilities connected to retail sales facilities, no storage and handling costs for the retail sales facility need to be capitalized. If a dealership had been capitalizing these costs, the filing of the Form 3115 will allow the dealership to deduct all of these costs that are incurred in the current year and, for any of these costs that were previously capitalized, they may also be deducted in the year for which the Form 3115 is filed. For dealerships that have been adding parts and labor to vehicles by charging them at or near retail prices on internal repair orders, the new rules may allow dealerships to remove all of the labor cost and all of the profit on parts. For most dealerships, this adjustment will reduce taxes in the year for which the Form 3115 is filed.

Q – Do the new rules eliminate the need to capitalize any UNICAP costs?

A – While dealerships generally may be able to deduct all storage and handling costs, the UNICAP rules for dealerships require them to consider the capitalization of purchasing costs. Also, a dealership may have facilities that do not qualify for the new rule. However, many dealerships may have no UNICAP cost to capitalize if they fit certain guidelines related to the new rules and existing special rules for purchasing costs.

Q – What are the special rules for purchasing costs?

A – Dealerships may use the special purchasing rules. Under these existing rules, the compensation of employees who spend less than 1/3 of their activities purchasing inventory is fully deductible. For employees who spend between 1/3 and 2/3 of their time purchasing inventory, their compensation is capitalized to the extent of their purchasing activities. All of the compensation of employees who spend more than 2/3 of their activities purchasing inventory is capitalized.

Q – What dealership facilities might not qualify for the new rules?

A – A dealership may have facilities that are not connected to a retail sales facility. The new rules appear to apply only to sales facilities that are routinely visited by retail customers. In some cases, a portion of the dealership's facilities may not qualify as a retail sales facility. If such a facility is used for storage and the new rule does not apply to the facility, a dealership would be required to capitalize handling and storage costs for the facility.

Q – If a dealership uses LIFO, how will the new rules apply?

When the application of the new rules eliminate all UNICAP costs for a dealership, it is very easy to determine what the one-time deduction should be. If UNICAP costs are not eliminated, the IRS has simplified UNICAP rules for dealerships that use LIFO. These rules allow a dealership to revise their UNICAP amount and project the revised amount for the last three years to all LIFO layers.

The foregoing summary of Revenue Procedure 2010-44 was prepared for NADA by Robert Zwiers and Joseph Magyar of Crowe Horwath LLP. It is not intended as legal or accounting advice. Dealers should consult their tax professional to determine the proper application of Revenue Procedure 2010-44 to their dealership.

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