

Truck Dealers, Beware of UNICAP Tax Issues

During the past couple of years, IRS has placed major focus on Uniform Inventory Capitalization (UNICAP). The entire motor vehicle industry, including heavy truck dealers, has been cited by IRS as being noncompliant with the UNICAP rules, and that message was reiterated at the recent ATD convention by IRS Motor Vehicle Technical Advisor, Terri S. Harris. IRS has classified this as a “Tier III” issue for auto and truck dealerships, meaning it will be closely scrutinized in every IRS examination. Truck dealers should now review their basic compliance with the UNICAP rules.

The complex UNICAP rules have been in effect since 1986 and are found in Internal Revenue Code section 263A and related regulations. The purpose of these rules is to capitalize certain inventory related expenses. That is, these expenses are treated as inventory and cannot be deducted currently as can other dealership expenses. As a consequence the dealership’s taxable income and income taxes are increased. Truck dealerships are subject to the UNICAP rules and may be required to capitalize certain inventory purchasing costs, inventory handling and storage costs, and related G&A expenses.

UNICAP recently became a controversial issue for the motor vehicle industry when in late 2007 IRS issued Technical Advise Memorandum (TAM) 200736026 that specifically addressed an auto dealership’s UNICAP calculations. It made interpretations of the UNICAP regulations that are adverse to all dealers, including truck dealers. The TAM’s conclusions would be costly from a tax perspective if implemented by dealers. The TAM subsequently seemed to become the basis for IRS’ pursuit of dealer UNICAP. A Technical Advise Memorandum (TAM) is a written opinion issued by the IRS National Office regarding the specific tax treatment of a specific taxpayer that is under IRS audit. The TAM has no precedential value and carries no authoritative weight as law. The TAM does, however, appear to represent the “official” IRS position and indicates how IRS would side on UNICAP issues. The TAM represented an interpretation of the regulations that would increase the amount of costs a dealership had to capitalize and as a consequence lose a current deduction for those costs.

The main issues in the TAM were as follows: The UNICAP rules do not require capitalization of inventory handling and storage costs related to on-site retail sales but do so for other sales. The TAM classifies as such other sales, certain sales to leasing companies, dealer trades, and the disposal of trade-ins and thus requiring capitalization of handling and storage related thereto. The TAM further suggests a dealer may be a producer with respect to installation of parts on new and used inventory vehicles owned by the dealership. A producer is generally someone engaged in a manufacturing activity including improvement or installation activities. Classification as a producer causes additional capitalization. The TAM also concluded that the repair/installation activity conducted on service customers’ vehicles constituted handling that potentially must be considered for capitalization. Many of conclusions reached in the TAM appeared to be based on little reasoning and are disputable.

A flurry of IRS examinations ensued based on the TAM. IRS agents however had a difficult time applying the complex rules as interpreted by the TAM to dealerships. In September 2009, IRS issued an internal directive to suspend examination of IRC 263A issues with respect to new and used auto dealers and medium/heavy duty truck dealers until 1/1/2011. The directive cited the following purpose ... “In order to

encourage compliance and to allow taxpayers in the auto dealership industry an opportunity to voluntarily change their methods of accounting to comply with the legal reasoning outlined in TAM 200736026.” The directive suggests that dealers adopt the interpretations made in the TAM, a controversial document that has no real legal authority. Doing so would appear to be an unwise route to take. The directive also gives IRS time to revisit their positions, develop new plans and tools and train agents.

For truck and other motor vehicle dealers, UNICAP issues remain in a state of flux. UNICAP issues have been slated for priority guidance for sometime indicating that a Revenue Ruling(s) would be issued to provide concrete guidance on the TAM’s issues. However none have been issued to date. There is indication that there is a pending Revenue Ruling on the TAM’s producer issue but no indication if or when it might be issued. There is also talk of modifying existing regulations but such change will be slow to come.

Despite the issues, truck dealers should address their UNICAP calculations considering the increased focus. Aside from the controversial interpretations of the TAM there are basic noncontroversial elements of the UNICAP rules that truck dealers must comply with. It is important that dealers have the proper elections and methodologies in place to make sure they are capitalizing an appropriate amount as necessary and such costs are minimized. Dealers should adopt and use the overall “simplified resale method” for their basic calculation, elect the 1/3-2/3 rule to minimize allocable purchasing costs, and elect to use certain de minimis 90/10 rules to minimize allocable handling and storage costs. These methods and elections represent tax accounting methods and generally require the filing of Change in Accounting Method with IRS. These changes are generally automatic and require no fee payments to IRS.

The Dixon Hughes Dealer Services Group will be working closely with ATD, the IRS and others to help clarify these matters to provide proper guidance for our heavy truck dealer clients.

If you have any questions relating to UNICAP tax issues, please contact your Dealer CPA or you may contact the author of this article, Jorg Kaltwasser, CPA at (901) 684-5642 or via e-mail at jkaltwasser@dixon-hughes.com.

For additional information regarding the Dixon Hughes Dealer Services Group, please contact us at dsg@dixon-hughes.com, (877) DLR-CPAs or visit us on the Web at www.dixon-hughes.com/dsg.

About the Dixon Hughes Dealer Services Group

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