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A Quarterly Update of Essential Tax Information

DEALER TAX WATCH

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DEALER TAX WATCH *OUT*

If you had called me personally to ask, "What's happening lately with IRS audits of dealers and dealerships that I need to know about?" ... Here's what I'd say:

#1. SECTION 263A ... IRS GUIDANCE ON COST CAPITALIZATION FOR AUTO DEALERSHIPS ... IT HAS ARRIVED & IT'S NOT GOOD NEWS. Section 263A applies to all dealerships with average annual gross receipts of $10 million or more. That attribute pretty much defines the majority of dealerships served by our readership. Accordingly, the focus of this issue of the *Dealer Tax Watch* is an analysis of recently issued Technical Advice Memorandum (TAM) 200736026.

I've also added my comments, interpretations and opinions, which you are smart enough, or should be, to take with at least a few proverbial grains of salt.

For over a year now, I've been warning you that the IRS would eventually publish something on this subject. On September 7, 2007, that guidance, in the form of TAM 200736026, finally became available to the public.

I also warned you to expect that the news would be "bad." Indeed, the news is generally bad. But, in my opinion, there really is some - make that a little - room for optimism.

In the June issue of the *DTW*, I said that I thought some of our readers would be incredulous once the IRS published its views and thinking about how Section 263A should be applied to auto dealerships. After reading the TAM, I'm certain that some of you will be in shock.

Make no mistake about it, there is going to be a lot of digging and detail work from now on if the IRS has its way and this TAM becomes the *gold standard* for IRS auditors in auto dealerships. Of course, that shouldn't happen if you believe what the TAM says in the Caveat on the last page... Section 6110(k)(3) of the Code provides that this TAM may not be used or cited as precedent.

WATCHING OUT FOR

Oh really? I have been told by several reliable sources that some agents have basically handed a copy of the TAM to a dealer under audit and said, "Let's take it from here...". Personally, I've read a few examining agent's reports, and, yes, they are coming up with proposed adjustments of several hundred thousand dollars for these dealerships based on spreadsheets that will make your eyes roll.

#2. BAD FACTS ... OR NO FACTS ... MAKE BAD LAW. As you read it, or read the discussion of the TAM here, you should pay careful attention to the lack of factual information presented by the dealership.

The IRS agent submitting the TAM obviously knew that he/she had a good thing here because, for that dealer, the facts were very unfavorable. Without factual information, we who are now reading the TAM at this later date, have no idea of how other, more

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conscientious attempts to apply Section 263A to dealerships might stand up to scrutiny by the IRS.

One inference from this lack of information could be that the taxpayer in the TAM might have spent considerable time and energy fulminating against the audacity of the IRS agent to challenge its long-standing practice of doing very little, if anything, to capitalize costs. On the other hand, the taxpayer's inability or unwillingness to provide critical factual information handed the IRS a great new "poster child" for Sec. 263A abuse. And, the IRS dressed up this taxpayer in its strained interpretations of the Section 263A Regulations.

Ultimately, the test of acceptability is whether or not the dealership's application of Section 263A results in a "clear reflection of income." The TAM literally gives the examining agent a free hand to select from a variety of approaches to use in changing the taxpayer's method. This "clear reflection" standard is not a new or unfamiliar one. It is, however, a very vague one.

#3. TAM ... MY PERSONAL ODYSSEY. Twenty years ago, after Section 263A came into the Code in 1986, I taught full-day seminars interpreting and explaining this Code Section as best as I could. Many of you readers may even remember attending my *Cost Cap* seminars back in the good old days.

After a few years, interest and attendance in these seminars on Section 263A dwindled because (I was told by many CPAs) IRS auditors examining dealerships never even looked at *Cost Cap* ... Or, if they did, they knew so little about the subject that they accepted whatever the CPA handed to them if the ink on the paper was dry.

Many CPAs came up with slick little worksheets that boiled the whole area down to a questionnaire with a few simple questions calling for little more than "Yes" or "No" answers. With appropriate coaching, the answers to these questions resulted in only a few (thousand) dollars, if anything at all, being capitalized as *additional Section 263A costs*.

A so-called "Zero UNICAP Method" eventually emerged, representing the epitome of arrogance by some CPAs who were unwilling to read the Regulations and/or to try to realistically apply the complexities of Section 263A to their dealership clients.

In contrast, in those early days ... the late '80s and the early '90s ... I even went so far as to prepare full studies of the application of Section 263A to dealerships. My analyses were done on a department-by-department basis, and I developed separate absorption ratios for new vehicle activities, for used vehicle activities and for parts and service activities. I applied these ratios to each department's ending inventories which were valued differently (some were on LIFO, and others were not).

The end result was that I was always coming up with several thousand dollars more to be capitalized under Section 263A than the amounts that the slick short-cutters came up with on their abbreviated worksheet questionnaires. Given the lack of IRS audit interest, the general sentiment seemed to be ... If the IRS accepted "it," keep on feeding "it" to them.

Eventually, even my own clients resisted spending the money for these studies. Alas, what I called the "*De Filipps Common Sense Approach to Cost Cap*" became as extinct as the do-do bird or the T-Rex.

I still believe that the method I applied many years ago (on a separate trade or business basis) that analyzed the "specific facts and circumstances" of the dealership's operations produced a result that clearly reflected income by capitalizing appropriate amounts to the ending inventories. Granted, with the insights now provided by TAM 200736026, some additional tweaking would need to be done ... but I don't think the results would necessarily be "disastrous" for dealers.

As a matter of fact, exactly 20 years ago, almost to the date, I took it upon myself to try to speak for auto dealers as a group when the Treasury held hearings on the Section 263A Regulations. Everything I said at that time, I still believe - with even more conviction after 20 years of experience. Although I included this in a previous *DTW* issue, I've reprinted on the following pages my testimony at that time which called for ***practical assistance***. Hopefully, this will have some impact now that you can see more clearly the impact of the Regulations as interpreted today by the IRS.

So, in concluding this recitation of my personal journey with the *Cost Cap* Regs., in all candor, I can't say that I am now surprised by the depth or the allegedly disastrous implications of this TAM. All I can really say is ... now that the IRS is finally awakened from its Rip Van Winkle-like slumber, you better look out (or take a closer look at what you've been doing).

#4. TAM ... QUO VADIS? TAM 200736026 now provides great incentive and opportunity for the IRS to obtain as much revenue as possible from the application of Section 263A to dealerships. Unless NADA and other organizations can successfully resist the IRS on this, any agent will be able to walk into a dealership - and within a few minutes - propose enormous deficiencies.

And, this could happen regardless of the passage of time ... Remember, ***there is no statute of limita-***

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tions preventing the IRS from overcoming all of the prior years' neglect of this provision which became part of the Internal Revenue Code in 1986.

By the way, the interest due on these deficiencies, all by itself, will be shocking.

This TAM is not the first time the IRS has interpreted technical Regulations in an extremely adverse way for dealerships. I don't believe that "working with the IRS on this" is the right approach now, just as I did not believe, several years ago, that working with the IRS on trying to resolve the parts replacement cost issue was the right approach.

You'll recall that in the replacement cost controversy, the IRS won a technical victory in the Tax Court in *Mountain State Ford Truck Sales.* However, in trying to apply it in the real world of auto dealerships, the IRS found that it had to back away from the ramifications of its technical victory. In the end, the IRS issued Rev. Proc. 2002-17 because the correct technical answer - if that's what it was - was unworkable.

In connection with the current TAM, I'm not suggesting that there shouldn't be any cost capitalization for auto dealerships. Nor am I suggesting that the result in the TAM is necessarily incorrect in many of its conclusions. I simply believe that the result(s) produced by the TAM is neither realistic, nor workable, nor what Congress intended in the enactment of Section 263A as it would be applied to smaller, closely-held businesses and particularly to automobile dealerships.

In my opinion, the Section 481(a) transitional rules and the change in method of accounting complexities will be well beyond the scope of the average general practitioner and/or dealership controller to understand or to fully comply with.

Apparently, there is now some discussion within the IRS that might result in the IRS putting the cost cap issue on its agenda for *further guidance* in 2008. This guidance could come in the form of a Revenue Procedure or a Revenue Ruling (probably with stilted facts in favor of the IRS). Remember Revenue Ruling 2005-52? It was based on made-up dealership "facts," all of which were unfavorable to the dealer. Heaven forbid.

Hopefully, more trade associations will come to the assistance of NADA in fighting to mitigate the impact of this TAM and in keeping it from spreading. My concluding opinion is that perhaps this matter should be brought to the attention of dealers' representatives in Congress for relief.

#5. THE IPIC LIFO METHOD IS NOT FOR AUTO DEALERS. Last year, at the AICPA Dealership Conference in Phoenix, at least one practitioner on the tax panel commented that perhaps more dealerships using LIFO ought to be using the IPIC LIFO Method. About the same time, RSM McGladrey's Newsletter (Sept./Oct. 2006) contained what I thought was a very confusing generalization about the potential advantages of the IPIC Method for dealers.

In response to these and other similar claims that the IPIC Method might be good for auto dealers, I devoted the entire June 2007 issue of the *LIFO Lookout* to the subject of the IPIC Method, in general, and in its particular application to automobile dealerships.

That issue of the *Lookout* included a significant study and comparison of the Inventory Price Index Computation (IPIC) LIFO Method with the Alternative LIFO Method for New Vehicles. In addition, it summarized detailed comparisons between the long-term inflationary indexes computed under the IPIC Method versus those under the Alternative LIFO Method for all manufacturers and franchises.

Bottom line... For auto dealerships, the results under the Alternative LIFO Method for New Vehicles were far, far better than they were under the IPIC Method. By this, I mean that the cumulative inflation rates and indexes computed under the Alternative LIFO Method greatly exceed the inflation indexes computed for the corresponding periods which would be derived from either Table 6 of the Producer Price Index (PPI) Reports or from Table 3 of the Consumer Price Index (CPI) Reports.

In the interest of keeping you informed in a general way about the IPIC LIFO Method and auto dealerships, I've included a brief summary from the *LIFO Lookout* on pages 6-7.

#6. DEALERSHIP FINED $500,000 FOR FAILURE TO FILE FORMS 8300. The September 26, 2007 *Brownsville Herald* reported that a Texas dealership group was convicted in Federal Court of failing to report a few cash transactions in excess of $10,000 in the years 2003 and 2005.

These failures involved only three vehicles ... a Mercedes Benz, a Toyota *Camry* and a BMW. But, the result was a significant penalty for the dealership. No individual employees were charged ... only the dealership was involved.

#7. ISSUES AFFECTING DEALER OBLIGORS, INSURERS AND REINSURERS OF F & I PRODUCTS. CreditRe will be presenting a tax and reinsurance conference that will address the tax issues of risk transfer on automobile finance and

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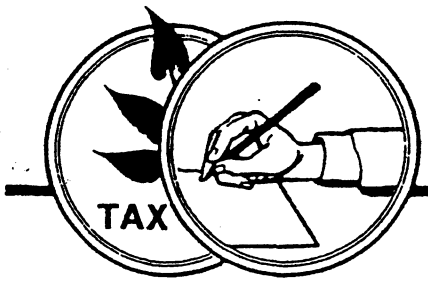

letters to the editor

SMALL BUSINESS NEEDS PRACTICAL ASSISTANCE FOR COST CAPITALIZATION RULES

To the Editor:

In following your coverage of the recent Treasury hearings on section 263A cost capitalization regulations, I found interesting the continued emphasis on the "practical capacity repeal" issue. Thanks to the well-intentioned and well-publicized planning strategy noted by a number of seminar speakers concerning practical capacity as a clever way around the section 263A rules, practical capacity indeed seems doomed at this stage...until it gets to Court.

As one of the 22 individuals presenting views at the Treasury hearings in Washington, D.C. on December 7th, I was neither an industry representative nor a lobbyist. I took it upon myself to speak for the *vast majority* of closely held businesses that have never heard of practical capacity, never will, and couldn't care less. But they are still stuck with the cost capitalization regulations and getting little practical assistance in the meantime.

A 'Form 263A' would protect many smaller businesses by forcing their accountants to affirmatively deal with the choices of various elections, especially those related to simplified methods.

For the possible benefit of your readers who might have smaller, closely held business clients, you might wish to publish the views I made before the Treasury and IRS representatives. Essentially, these were as follows:

1. For a broad range of fairly homogeneous taxpayers, essentially retailers such as automobile dealers and other retail and wholesale businesses, "safe harbor" ranges should be developed for use in allocating section 263A costs.

2. I pointed out that I had seen no evidence of trade associations attempting to develop prototypes or ranges, based on input from members' CPAs which could be used for the benefit of their entire membership. Most trade associations are narrowly concentrating on specific definitions and other technical interpretations, ignoring the broader problem faced by their smaller members' CPAs in actually coming up with figures in the very near future.

3. The technicalities of the section 481(a) transitional rules are far beyond the comprehension of the average generalist CPA practitioner who has to deal with them for smaller closely held business clients. Such things as the "expedited procedure" by which one determines the eligibility for a four-year, 25 percent pro rata spread simply causes confused looks in the seminars I teach on this subject. How in the world will this actually be implemented eventually? And Form 3115 is required to be filed with 1987 returns!

4. In my comments at the hearing, I pointed out that the section 481(a) adjustment in many cases probably could be paid in full so as to eliminate the necessary corollary computations in subsequent years to see if an acceleration of the section 481(a) adjustment were required. For many taxpayers, the amount of tax would be relatively small and far outweigh the nuisance-value in the next couple of years regardless of the possibility that rates might be lower.

5. If the regulations were amended to reflect acceptance of the use of "safe harbor" ranges by certain taxpayers who essentially had standardized or similar accounting systems and reported on a regular or monthly basis to a manufacturer or supplier, etc., then the same percentage could or should likely be used prospectively for several years, as well as for opening inventory restatement purposes, in an effort to achieve real *uniformity* in the application of the new rules.

6. The final point I attempted to stress was the need that a form (much like the Form 970 for initial LIFO elections) should be developed by which all of the important decisions being made in the first year under section 263A would be captured. My experience as a consultant over the years is that the IRS is not the party raising questions or issues in connection with LIFO or cost capitalization issues. In fact, the parties raising such questions are new accountants for closely held businesses who question the inventory practices of former accountants or CPAs when they take over a new account. Yes, many closely held businesses do change accountants frequently and they are seriously disadvantaged in instances where the former practitioner did not understand or adhere to the inventory

technicalities surrounding LIFO. The new cost capitalization rules may introduce similar pitfalls.

For example, a number of elections need to be affirmatively made in connection with the use of simplified methods available under section 263A. Where desired, if these methods are not properly elected, it will be the taxpayer who ultimately will be placed at a disadvantage if these issues are raised in the future. A "Form 263A" would protect many smaller businesses by forcing their accountants to affirmatively deal with the choices of various elections, especially those related to simplified methods. Although many might resist the notion of one more mandatory form, such a form would highlight these technical areas which otherwise might be unnoticed.

I went so far as to give the Treasury-IRS panel a copy of a "Form 263A" that I had developed for their consideration in this regard. I would be pleased to send a copy of it to any of your readers who might care to write me requesting a copy.

My written submission dealt with automobile dealers as representative of a homogeneous group of taxpayers who might significantly benefit from a "safe harbor" approach.

As a member of the American Institute of CPAs (AICPA), I find it most troubling that out of the thousands (?) of hours it devoted to practical capacity and fiscal year retention, no time could be found for thinking about the need to provide practical assistance to the closely held businesses which every accounting firm, whether small or large, has found to be the root of their own growth. It almost seems like no one seems to care any more about the small taxpayers....

Sincerely,

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Dealer Tax Watch Out

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insurance products and include practical suggestions for evaluating the effect of these issues on operations and for creating courses of action.

This Conference was not presented in 2006, so there is 2 years' worth of "catching up" to do. The Conference brochure states, "The IRS has a new theory regarding abusive reinsurers, namely, applying a transfer pricing analysis to judge whether the reinsurance transaction constituted an arm's-length transaction."

Apparently, this transfer pricing theory and other approaches are now being used by the IRS to question Section 501(c)(15) and Section 831(b) reinsurers. If the Service finds that a reinsurer was not an insurance company, then the reinsurer's election under Section 953(d) would be invalid, and the reinsurer would be deemed to be a controlled foreign corporation.

If you have dealers who are involved with these or similar reinsurance situations, you can check the CreditRe web site (www.creditre.net) for a Conference agenda and other information.

#8. PPC'S *GUIDE TO DEALERSHIPS* (2007) WILL HELP YOU STAY ON YOUR TOES. Over the summer, the PPC *Guide to Dealerships* was updated to reflect the new risk-assessment standards that were implemented by the Public Company Accounting Oversight Board's (PCAOB) publication of *Auditing Standards for Nonpublic Entities* (SAS Nos. 104-111).

These standards became effective for audits of financial statements for periods beginning on or after December 15, 2006. So, these standards are effective for 2007 financial statements.

After attending a full-day seminar on these new standards and looking over the information included in the PPC *Guide* update, it seems to me that this PPC update is a resource you'll want to review and consult. After all, SAS No. 109 is a major component of these new standards, and it requires that an understanding of entity environment, including internal control, be factored into the application of these standards.

Within a few days of attending this seminar, an article caught my eye on page 1 of the September 3, 2007 *Automotive News*. The title was *"Looted? Dealership Says CFO's Misdeeds Cost $20 Million and Forced Sale of Store."*

This article reported allegations of the overstatement of dealership profits (to increase performance-based pay), the improper diversion of dealership funds and vehicles for personal use and the overstatement of dealership inventories which resulted in out-of-trust positions with various floorplan lenders.

This is just one more example of what's going on in the jungle out there.

Even if you're not involved with auditing the financial statements of a dealership, any involvement with a dealership's financial statements should be handled with great care.

IPIC Considerations

General Considerations for Auto Dealerships in Evaluating the IPIC (Inventory Price Index Computation) LIFO Method

- ***The IPIC Method Is Not As "Simple" As Some Would Have You Believe ...*** The IPIC LIFO Method requires many choices and binding sub-elections, each with its own particular consequences and each constituting a method of accounting which cannot be changed without first obtaining permission from the IRS.

- ***Pooling alternatives raise difficult choices.*** IPIC taxpayers are required to make binding elections in setting up pooling arrangements for their inventories. Pooling rules involve either (1) the specific rules contained in the IPIC portion of the Regulations or (2) the more general pooling rules that apply to all Dollar-Value LIFO Methods. The question is ... what inventories are you going to put into your IPIC LIFO pools?

Many dealerships using the IPIC Method do not include (1) used vehicles or (2) parts and accessories inventories in their LIFO pool. Whether this omission or exclusion is permitted by the Regulations is uncertain, especially in light of a more recent IRS Letter Ruling (200603027).

- ***CPI vs. PPI ... Which Table should dealers select? Not an obvious choice.*** Dealerships electing the IPIC Method are permitted to elect to use either (1) Table 3 of the CPI or (2) Table 6 of the PPI. These tables produce different results because they have significantly different components, and each includes, excludes or treats differently certain transactions. The IRS has issued no guidance as to which table is more appropriate for automobile dealerships in their IPIC calculations.

- ***Link-Chain vs. Double-Extension IPIC Methods.*** As part of an overall IPIC election, taxpayers must decide whether the computations will be made using (1) a double-extension methodology, which always refers back to the first base-year, or (2) a link-chain methodology, which updates the calculations on a year-to-year basis. In most circumstances, electing to use the link-chain method would be the better choice, and this can be done without justifying why the double-extension method was not selected.

- ***Deflation under BLS indexes offsets the advantage of a single, broader pool under IPIC.*** Auto dealerships using the IPIC Method would have one pool (in which at least new automobiles and new light-duty trucks would be combined). This is in contrast with dealerships using the Alternative LIFO Method which would divide their new vehicles into two pools ... one pool for new automobiles and a separate pool for new light-duty trucks.

The ability to have a single pool for new vehicles under the IPIC Method is an advantage because fluctuations in different segments of the new vehicle inventory (i.e., new automobiles vs. new light-duty trucks) do not affect the overall total dollar level for that pool and this tends to mitigate the severity of the LIFO recapture reserves due to decrements if separate pools for these two classes of goods had been maintained instead.

In recent years, this theoretical advantage of using a single pool has been significantly, if not totally, offset by the fact that price change indexes under either the CPI or the PPI for these inventories reflect cumulative deflation.

- ***Alternative LIFO inflation indexes are much higher than IPIC indexes.*** We have made a study of the differences in cumulative inflation indexes from both the CPI and the PPI over the 3, 5 and 7-year time periods ending with 2006.

Our analysis shows that dealerships using the Alternative LIFO Method would have reflected significantly more inflation in their LIFO reserves by computing their indexes internally over the period from 2000 through 2006 than if the IPIC Method had been used. In fact, if a dealership were using the IPIC Method, it would have been foolish for the dealership to remain on LIFO because the BLS Tables showed deflation, rather.than inflation, for these years.

Alt. LIFO vs. IPIC ... How to Read Our Survey Results

Chevrolet ... Pool #1. Using ***Chevrolet*** as an example, Table G shows that, for the 7-year period ending with 2006, the cumulative inflation index under the one-of-each-item-category *SuperLIFO™* database used in connection with the Alternative LIFO Method for Pool #1, New Automobiles, would have reflected ***inflation*** of almost 13% (12.63%).

For the corresponding 7-year time period, the applicable PPI Table 6 would have reflected cumulative ***deflation*** of slightly less than 5% (-4.86%) ... a difference of 18 percentage points. Alternatively, for the same 7-year period, the applicable CPI Table 3 would have reflected cumulative ***deflation*** of slightly more than 2% (-2.28%) ... a difference of 15 percentage points.

Chevrolet ... Pool #2. Similarly, over the same 7-year time period, the cumulative index under the one-of-each-item-category *SuperLIFO™* database used in connection with the Alternative LIFO Method for Chevrolet's Pool #2, New Light-Duty Trucks, would have reflected ***inflation*** of 12% (11.99%).

Correspondingly, the applicable PPI Table 6 would have reflected cumulative ***deflation*** of slightly more than 6% (-6.31%) ... a difference of 18 percentage points for that pool. Alternatively, for that same period, the applicable CPI Table 3 would have reflected cumulative ***deflation*** of almost 8% (-7.58%) ... a difference of almost 20 percentage points.

Table G

ALT. LIFO VS. IPIC RESULTS COMPARISON STUDY

Pools #1 & 2 ... 7-Year Summary Listed Alphabetically by Make

SUMMARY OF COMPARISON OF CUMULATIVE INFLATION / DEFLATION RATES
SUPERLIFO™ ONE-OF-EACH INDEXES FOR USE WITH THE ALTERNATIVE LIFO METHOD FOR NEW VEHICLES
vs. BLS PPI TABLE 6 & CPI TABLE 3 FOR USE WITH THE IPIC METHOD
FOR THE 7-YEAR PERIOD 2000 THROUGH 2006

	Pool #1 New Automobiles Cumulative 7 Years ... 2000-2006			Pool #2 New Light-Duty Trucks Cumulative 7 Years ... 2000-2006		
	Alt. LIFO	BLS - IPIC Method		Alt. LIFO	BLS - IPIC Method	
	SuperLIFO™	PPI Table 6	CPI Table 3	SuperLIFO™	PPI Table 6	CPI Table 3
ACURA	3.76%	-4.86%	-2.28%	8.58%	-6.31%	-7.58%
AUDI	8.89%	-4.86%	-2.28%	0.00%	-6.31%	-7.58%
BMW	8.94%	-4.86%	-2.28%	8.47%	-6.31%	-7.58%
BUICK	14.83%	-4.86%	-2.28%	3.03%	-6.31%	-7.58%
CADILLAC	12.19%	-4.86%	-2.28%	8.70%	-6.31%	-7.58%
CHEVROLET	12.63%	-4.86%	-2.28%	11.99%	-6.31%	-7.58%
CHRYSLER	9.86%	-4.86%	-2.28%	3.98%	-6.31%	-7.58%
DODGE	9.91%	-4.86%	-2.28%	13.46%	-6.31%	-7.58%
FORD	10.63%	-4.86%	-2.28%	14.51%	-6.31%	-7.58%
GMC TRUCKS	0.00%	-4.86%	-2.28%	10.35%	-6.31%	-7.58%
HONDA	7.35%	-4.86%	-2.28%	8.24%	-6.31%	-7.58%
HUMMER	0.00%	-4.86%	-2.28%	46.69%	-6.31%	-7.58%
HYUNDAI	9.38%	-4.86%	-2.28%	10.05%	-6.31%	-7.58%
INFINITI	10.98%	-4.86%	-2.28%	9.70%	-6.31%	-7.58%
ISUZU	0.00%	-4.86%	-2.28%	-3.52%	-6.31%	-7.58%
JAGUAR	13.08%	-4.86%	-2.28%	0.00%	-6.31%	-7.58%
JEEP	0.00%	-4.86%	-2.28%	12.01%	-6.31%	-7.58%
KIA	14.63%	-4.86%	-2.28%	16.79%	-6.31%	-7.58%
LAND / RANGE ROVER	0.00%	-4.86%	-2.28%	4.79%	-6.31%	-7.58%
LEXUS	3.74%	-4.86%	-2.28%	10.41%	-6.31%	-7.58%
LINCOLN	7.45%	-4.86%	-2.28%	9.10%	-6.31%	-7.58%
MAZDA	7.02%	-4.86%	-2.28%	15.10%	-6.31%	-7.58%
MERCEDES	9.02%	-4.86%	-2.28%	8.14%	-6.31%	-7.58%
MERCURY	11.89%	-4.86%	-2.28%	-1.17%	-6.31%	-7.58%
MITSUBISHI	10.83%	-4.86%	-2.28%	8.67%	-6.31%	-7.58%
NISSAN	6.86%	-4.86%	-2.28%	9.20%	-6.31%	-7.58%
OLDSMOBILE	11.40%	-4.86%	-2.28%	9.29%	-6.31%	-7.58%
PONTIAC	11.39%	-4.86%	-2.28%	2.79%	-6.31%	-7.58%
PORSCHE	7.27%	-4.86%	-2.28%	1.32%	-6.31%	-7.58%
ROLLS ROYCE	5.16%	-4.86%	-2.28%	0.00%	-6.31%	-7.58%
SAAB	3.53%	-4.86%	-2.28%	1.70%	-6.31%	-7.58%
SATURN	1.17%	-4.86%	-2.28%	5.89%	-6.31%	-7.58%
SUBARU	6.89%	-4.86%	-2.28%	6.24%	-6.31%	-7.58%
SUZUKI	8.83%	-4.86%	-2.28%	7.71%	-6.31%	-7.58%
TOYOTA	6.29%	-4.86%	-2.28%	7.96%	-6.31%	-7.58%
VOLKSWAGEN	7.14%	-4.86%	-2.28%	-5.03%	-6.31%	-7.58%
VOLVO	5.98%	-4.86%	-2.28%	5.59%	-6.31%	-7.58%

AN OVERVIEW & SOME COMMENTS ON TAM 200736026

The long-awaited guidance on the application of the Section 263A inventory cost capitalization rules to an automobile dealership was issued by the IRS on September 7, 2007. This guidance is in the form of a Technical Advice Memorandum to which the IRS' standard disclaimer is attached: "... (This TAM) may not be used or cited as precedent."

Although the TAM lists 12 basic issues (questions) for which it provides conclusions (answers), in reality, it addresses more than a dozen questions. In some instances, the final answers are not definitive, but they are expressed as depending on the outcome of further findings of fact by the examining agent.

As the Table of Contents on the facing page indicates, we have arbitrarily divided our analysis of the TAM into 3 parts. Hopefully, this will make it easier to digest the conclusions (i.e., holdings) that the IRS National Office reached on certain issues.

In this TAM, the National Tax Office was faced with what many practitioners would consider to be a very poor, or a very bad, fact pattern. This "poor fact pattern" is further compounded by what appear to be certain deficiencies in the presentation of the facts by the Taxpayer. In several instances, the TAM states that the Taxpayer provided little or no information, even though given the opportunity to do so in the form of a post-conference submission after the Taxpayer's conference of right in the National Office.

As a result, for some of the questions posed, the National Office could only conclude that it was unable to reach a critical determination "based on this lack of information." One overall result is that the TAM has left unaddressed many real-world practical problems because of the fact pattern presented by the dealership in the TAM.

DEALERSHIP'S METHODS FOR VALUING INVENTORIES

The TAM describes the inventory methods used by the Taxpayer as LIFO for new vehicles and FIFO for used vehicles and for parts.

It is surprising that, with all of the pin-point accuracy in quoting specific sections of the Regulations, the TAM would be somewhat careless in describing the non-LIFO inventory valuation methods used by the dealership. No dealership in the country accounts for its used vehicles on FIFO ... every dealership in the country uses specific identification as its method, and this may or may not approximate a FIFO cost ordering.

With respect to the dealership's parts inventories, the wording of the TAM seems careless again in referring to the use of FIFO. After all of the attention that the IRS gave the matter of dealership valuation of parts inventories in litigating ... and winning ... the *Mountain State Ford Truck Sales* case and, subsequently in backing away from its victory in Rev. Proc. 2002-17, one would have expected a more accurate description to refer to the dealership's valuing its parts and accessories inventories using replacement cost, which may or may not approximate the results of a FIFO cost ordering.

DEALERSHIP'S COST CAP METHOD

The TAM refers to the dealership's method for capitalizing additional Section 263A costs to ending inventory as being a ***"self-developed method."*** However, the Taxpayer did not explain how it initially determines the amount of additional Sec. 263A costs attributable to new vehicle inventory or parts inventory.

The TAM states the following regarding the Taxpayer's self-developed method ... "Other than a limited amount of mixed service costs, the Taxpayer does not capitalize any other indirect costs to new vehicles or to parts."

With respect to ***new vehicle inventory***, the TAM states only that "Additional Section 263A costs are capitalized by dividing (1) additional Sec. 263A costs attributable to new vehicles by (2) current-year purchases and then multiplying the result (i.e., the absorption ratio for new vehicles) by the LIFO increment, if any."

With respect to ***used vehicle inventory***, the dealership did not capitalize any additional Sec. 263A costs. To many practitioners, common sense would suggest that at least some amount of cost should have been capitalized with respect to the used vehicles in ending inventory.

With respect to the dealership's ***parts inventory***, the TAM states, "Additional Section 263A costs are capitalized by dividing (1) additional Sec. 263A costs attributable to parts by (2) current-year purchases of parts and then multiplying the result (i.e., the absorption ratio for parts) by the Sec. 471 parts costs in ending inventory."

PART I ISSUES ... PRODUCTION & HANDLING ACTIVITIES

The first part of the TAM deals with "production and handling" issues. The IRS lists major six issues and some of these are divided into multiple parts.

The overall conclusion is that, with respect to vehicles that the dealership owns, various activities within the service department constitute production

see **TAM 200736026**, page 10

Section 263A

APPLICATION OF INVENTORY COST CAPITALIZATION RULES TO AUTOMOBILE DEALERSHIPS TAM 200736026 ... ISSUED SEPT. 7, 2007

(Continued from page 8)

activities, and the costs associated with those activities are handling costs.

However, the TAM does not specifically state how the dealership should treat these costs. The TAM hedges here by using "either" ... "or" language in its conclusion.

PART II ISSUES ... RETAIL SALES FACILITIES

The second part of the TAM deals with "retail sales facility" issues and it addresses on-site and off-site sales and dual-function storage facility questions. Here, there are three major issues; however, some of these are split into sub-issues.

Overall, many of the dealership's sales of vehicles and of parts are identified as meeting the definition of "off-site" sales. From this, it follows that expenses or costs allocable to those "off-site" sales must be capitalized.

The analysis of sales made by the dealership's parts department will require considerably more work (or documentation) in order to support a determination of what percent of the parts department sales are really on-site sales to "end user retail customers."

The specific facts for the dealership in this TAM are that its activities are conducted at two locations, and that there is a geographic separation of one-half mile between these two locations.

Another important fact is that the second location does not have any identification to indicate that the vehicles on the property there are owned by, or available for sale by, the dealership conducting business at the first location. Furthermore, the dealership does not have a sales office at this second location, nor are any sales activities conducted there.

For many dealerships whose activities are conducted on more than one plot of land, their facts will significantly differ from facts of the dealership in the TAM. In other words, other dealerships may conduct business on several locations that are much closer to each other geographically (although, not necessarily across the alley from each other as in the Regulation example).

Also, for these dealerships, there may be considerable or significant dealership identification (signage, etc.) and sales activity conducted at the second or other location(s). Depending on the facts and circumstances in each individual case, the result for these dealers with multiple locations could be that considerably fewer dollars would be capitalized as additional Section 263A costs.

PART III ISSUES ...
IDENTIFICATION & ALLOCATION OF COSTS

The third part of the TAM addresses "identification and allocation of cost" issues. However, the basic holdings are that purchasing, storage and handling costs are not mixed service costs under either the simplified production method or under the simplified resale method.

The TAM identifies many expenses which are to be treated as mixed service costs for purposes of the simplified service cost method. The financial impact of this conclusion will be severe for many dealerships.

Most significantly, the TAM acknowledges that the standard to be applied to the method used by a taxpayer to capitalize costs under Section 263A is whether that method "clearly reflects income."

In this part of the TAM, the IRS does not mention anything in connection with the fact that different inventory valuation methods are involved for different classes of dealership inventory. Accordingly, there was no way of knowing whether dealers may be able to have a favorable advantage by taking the position that, for Section 263A purposes, their activities should be considered as separate trades or businesses.

USE OF THE LIFO METHOD

Several very practical points arise in connection with how the holdings in this TAM would apply to dealers using the LIFO method to value their (new vehicle) inventories.

The Service avoids a direct discussion of the interrelationship between the Section 263A adjustments called for by the TAM and the fact that the dealership under audit was using LIFO for a (significant?) portion of its inventory.

The Regulations provide that where LIFO is involved as the inventory valuation method, additional Section 263A costs are only to be capitalized with respect to the LIFO increment ... and not with respect to the overall dollar amount of the actual cost of that inventory.

In a given year, ***this could make LIFO extremely more attractive to any dealership*** because it would result in significantly smaller costs being capitalized, regardless of which (extremely complicated) method under Section 263A the IRS might pressure the dealer into adopting. But, for purposes of newly minted IRS audit situations occurring today, a dealership's use of the LIFO Method will not blunt the impact of the initial adjustment under Section 481(a) to capitalize additional Section 263A costs.

In other words, the fact that a dealership may be using LIFO to value its new vehicle inventories will not

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help any dealer to avoid the rather harsh impact of this TAM. This is evident from the fact that the IRS applied the absorption ratio against the dealership's total inventories (regardless of whether or not they are valued using LIFO).

There are several further implications and complications that result from the technicalities of Section 481(a) adjustments when changes in accounting methods involve the application of the cost capitalization rules to inventories that are valued using LIFO. We'll save those discussions for another time and place.

"GUIDANCE" TO BE DERIVED FROM TAM 200736026

The TAM contains a thorough analysis of many of the complex technical issues addressed in the Regulations under Section 263A. These detailed Regulations have been applied to the dealership under audit, based on the limited facts presented and in the context of the nature of the dealership's specific activities.

The authors of the TAM in the National Office conclude ... "The examining agent may require Taxpayer to use ***any permissible method***, including a reasonable method under Reg. Sec. 1.263A-1(f)(4), the simplified production method, or the simplified resale method ***if*** Taxpayer's production activities are *de minimis*." That's quite a wide range of choices ***(any)*** and it includes a big ***"if"***.

The TAM further states, "If the examining agent requires Taxpayer to use one of the simplified methods and Taxpayer is not satisfied with the results of that method, ***it may request*** to change its method of accounting to a facts-and-circumstances allocation method." So there's another option.

Overall, the TAM is a disappointment to anyone who was expecting that the TAM would provide a specific blueprint or format that auto dealerships and their advisors could use in applying Section 263A to their dealerships.

To some practitioners, TAM 200736026 seems to lay the groundwork so that Agents can basically nitpick ... or negotiate ... or use the TAM as a threat against ... dealerships in audit situations.

If a dealership is not represented by a CPA more fully versed in both the technical and practical refinements underlying Section 263A, that dealership might expect the worst in the form of the now-anecdotal "hundreds of thousands of dollars" of IRS audit adjustments.

On the other hand, where a dealership is represented more competently in these matters, it would appear that facts-and-circumstances reasonable allocation methods (including estimates) can be developed ... and justified. If this can be done in a manner acceptable to the IRS, the result for the dealership should be exposure to considerably smaller proposed adjustments for the capitalization of additional Section 263A costs.

But, to secure this result, the dealership will have to be willing to commit a considerable expenditure of time, effort and compliance cost dollars to the process.

TAM 200736026 ... Questions & Ramifications

- How should the Sec. 263A Regulations relating to "separate trades or businesses" be applied in the dealership context?
- If a dealership previously has considered itself to be ***a reseller*** (or reseller with *de minimis* production activities), what are the procedural mechanics relating to the IRS' change of the dealership's method of accounting?
  - Will Forms 3115 be required to be filed in connection with these cost cap method changes?
  - Will these changes be made under an expedited procedure? Will they be automatic changes?
  - Procedurally, how many copies ... when, where and with whom ... need to be filed?
  - What about Section 481(a) adjustments? Under what circumstances might there be a 4-year spread?
- What are the ramifications of cost cap changes in methods for auto dealers using LIFO to value their inventories? How will the Section 481(a) adjustments be handled? Will they be embedded in LIFO layers, etc.?
- What's next? ... Depends on who you talk to and what you believe.
  - Possible consideration of Sec. 263A issues as an Industry Issue Resolution topic.
  - Possible Revenue Ruling.
  - NADA intervention and possible intervention by other trade associations whose members will be significantly and adversely affected.
  - Possible Revenue Procedure in the form of a settlement document. (Something similar to Rev. Proc. 97-44 that was issued when almost all automobile dealers using the LIFO method were taken by surprise by the IRS' interpretation of the application of the LIFO financial statement conformity requirement.)
  - Possible relief under Revenue Procedure 2002-18?
  - Can dealers lobby with their representatives in Congress for relief?

Facts & Activities	*DESCRIPTION OF DEALERSHIP ACTIVITIES & OPERATIONS TAM 200736026*
Scope of Activities	• The Taxpayer is a franchised dealership that sells new and used vehicles. • The Taxpayer also sells vehicle parts. • Total gross receipts (sales) annually are in excess of $10 million. Therefore, the Taxpayer does not qualify for the small retailer exception to the application of Section 263A. • The Taxpayer's service department repairs and installs parts on ◆ Vehicles owned by customers (customer-owned vehicles) and ◆ New and used vehicles owned by the Taxpayer (Taxpayer-owned vehicles).
Two Locations	• The Taxpayer stores vehicles at its main sales facility, Location 1. • The Taxpayer also stores vehicles at Location 2. This location is one-half mile from Location 1. ◆ There is no sign at Location 2 indicating that it is owned by the Taxpayer. ◆ There is no sales office at Location 2.
Executive & Administrative Activities & Duties	• The Taxpayer has executive and administrative departments that perform various duties. • ***Executive activities.*** ◆ The executives oversee the purchasing activities of new and used vehicles, the parts and service departments' activities, financial reporting, financing, employee benefits and payroll. ◆ Executives also are involved in general planning and policy decisions. • ***Administrative department.*** This department performs various tasks, including... ◆ Reconciliation of the weekly parts invoices to the monthly statements ◆ Reconciliation of vehicle inventory ◆ Preparation and maintenance of all financial records for the new vehicle sales, used vehicle sales via retail and wholesale, parts department sales via retail and wholesale and service department activity ◆ Accounts payable ◆ Accounts receivable ◆ Payroll and (employee) benefit functions ◆ Various support functions of all the Taxpayer's activities
Various Types of Sales	• As is typical of an automobile dealership, the Taxpayer has numerous sales of automobiles (that are made directly) to retail customers. • ***Lease sales.*** If a retail customer prefers to lease a vehicle, the Taxpayer facilitates the lease. In a lease transaction, the Taxpayer leases the vehicle to the customer and simultaneously or immediately thereafter sells the vehicle, subject to the lease, to [*Credit*, i.e., the company that is purchasing the lease paper]. • ***Trade-ins.*** To facilitate sales of new and used vehicles, the Taxpayer allows its customers to trade in their used vehicles in exchange for a reduction in the price of a new or used vehicle that the customer is purchasing from the Taxpayer. • ***Wholesale sales.*** ◆ If the Taxpayer determines that a particular trade-in is not suitable for retail sale by the Taxpayer, it sells the trade-in on a wholesale basis. ◆ Also, the Taxpayer sells, on a wholesale basis, (1) some trade-in vehicles that it originally intended to sell on a retail basis and (2) some vehicles that it purchased at auction. • ***Dealer trades.*** If a customer wants to purchase a vehicle that the Taxpayer does not have in stock (e.g., a specific model in a particular color), the Taxpayer will arrange to acquire the vehicle from another dealership. ◆ Dealers usually accommodate each other in these transactions and sell such vehicles to each other at the dealer's cost. When the Taxpayer sells new vehicles to other automobile dealers, it does so at its cost. • ***Fleet sales.*** The Taxpayer also sells multiple new vehicles in fleet sales.
Subcontractor Activities	• ***Sublet repairs.*** In addition to its service department activities described on the facing page, the Taxpayer also has "sublet repairs." ◆ These are repair/installation activities performed by a subcontractor hired by the Taxpayer. ◆ These may be done with respect to Taxpayer-owned vehicles and/or to customer-owned vehicles. ◆ Sublet repair activities may include the installation of alarm systems and/or the replacement of transmissions by subcontractors for the Taxpayer.

Facts & Activities	*DESCRIPTION OF DEALERSHIP ACTIVITIES & OPERATIONS TAM 200736026*
Service Department ... a.k.a. Repair / Installation Activity	• The TAM refers to the activities of the service department as its "repair/installation activity." ◆ In industry parlance, an automobile dealership has a "service" department that "repairs" automobiles, most of which involves installation of new or replacement automobile parts. ◆ Tax accounting terminology often distinguishes between a ***service*** and a ***sale*** of goods. ◆ Under tax accounting principles, the activities of a dealership's service department would include (1) providing services to customers, (2) sales of goods to customers and (3) production of goods for sale to customers. ◆ Also, many of the "repairs" performed by a dealership's service department would qualify as "improvements" for which tax accounting requires a different treatment (i.e., repairs can be expensed ... but, improvements must be capitalized).
Work on Customer-Owned Vehicles	• The Taxpayer's repair/installation activity involves many vehicles that the Taxpayer does not own (customer-owned vehicles). When a customer brings his or her vehicle to the service department, a service advisor prepares a repair order on an estimation form. Once a formal diagnosis is made, the customer is contacted and authorizes the work. The work typically involves removal of old, worn or defective parts and installation of new parts. ◆ In most cases, customers pay for service parts and labor when they pick up their vehicle. ◆ The execution of a repair order activates a mechanic's lien on the customer's vehicle to the extent of the value of the parts and repair services (labor and other costs) provided. The mechanic's lien encumbers the customer's title/ownership of the vehicle. In general, customers cannot retrieve repaired vehicles without prior payment being made for the repair, nor can they dispose of the vehicle with a clean title until or unless the lien is satisfied. On occasion, when a customer defaults, the Taxpayer can sell the encumbered vehicle in satisfaction of the liability incurred for the cost of parts and services rendered.
Other Installation Activities	• The service department also installs certain options such as running boards, alarm systems, plow packages, towing packages, air conditioning, stereo equipment and entertainment systems on new vehicles. ◆ Some of these options are installed prior to the sale of the new vehicle being consummated, and some are installed subsequent to the sale transaction being completed. ◆ Whether the option is installed before or after the sales transaction is completed depends on the dollar value of the option being installed. If the cost of any option is above $200, the Taxpayer will not install the option until the customer completes the sales transaction.
Used Vehicle Repairs	• The service department may also install parts on used vehicles to correct defects or to make them more suitable for sale. ◆ The Taxpayer obtains most of its used vehicles from auction. On these vehicles, it may install new or replacement parts, if needed, and before reselling the vehicles. ◆ The Taxpayer obtains other used vehicles as trade-ins when a customer purchases a new vehicle or a different used vehicle. Many of the vehicles taken in trade are immediately sold, but some need new or replacement parts installed first. The extent of the work done on a vehicle depends on the Taxpayer's judgment and the "retail merit" of the vehicle which includes its mileage, condition, model year and amount of work required to make it ready for resale.
Parts Sales Activity	• ***Parts sales at Location 1*** ... are made via the Taxpayer's repair/installation activity. ◆ Some parts are sold to automobile repair shops that install the parts in retail customers' vehicles. The parts are either picked up at the Taxpayer's parts counter or an employee of the Taxpayer delivers the part to the repair shop. ◆ Other part sales are made to end users. These sales are also made at the Taxpayer's parts counter or the Taxpayer's employees deliver the parts to the end users. • ***2003 activities.*** In 2003, the Taxpayer's service department used 80% of the parts purchased ... 14% were recorded as wholesale sales and 6% were recorded as retail sales. • ***2004 activities.*** In 2004, the Taxpayer's service department used 74% of the parts purchased ... 21% were recorded as wholesale sales and 5% were recorded as retail sales. • The parts department sales counter generated approximately 5% of the Taxpayer's parts department sales. Approximately 12% in 2003 and 17% in 2004 of the sales made by the Taxpayer's parts department were recorded as wholesale sales. Some of these sales are to end users, but because sales were made at a discount, the Taxpayer recorded them as wholesale sales.

Part 1 Summary	***PRODUCTION & HANDLING ACTIVITIES ... ISSUES & HOLDINGS***

Six Major Issues (#1-6)	*IRS Holdings*
1. Under the following circumstances, whether the Taxpayer's installation activities constitute production activity... a. Installation of parts by the Taxpayer's service department personnel on i. Customer-owned vehicles ii. New vehicles owned by Taxpayer iii. Used vehicles owned by Taxpayer b. Sublet Repairs/Installation of parts by subcontractors on i. Customer-owned vehicles ii. New vehicles owned by Taxpayer iii. Used vehicles owned by Taxpayer	1. ***Customer-owned vehicles.*** With respect to customer-owned vehicles, when the Taxpayer or a subcontractor installs parts to customer-owned vehicles, the installation activity ***does not*** constitute production activity for purposes of Section 263A. This is because the Taxpayer does not hold the underlying benefits and burdens of ownership of the vehicle. • ***Taxpayer-owned vehicles.*** With respect to new and/or used vehicles owned by the taxpayer, when the Taxpayer or a subcontractor installs parts to new and/or used vehicles owned by the Taxpayer, the installation of parts ***may*** constitute production activities. • Applicable Regulation is Reg. Sec. 1.263A-2(a)(1).
2a. Whether auto repair/installation activity constitutes service activity with respect to customer-owned vehicles. 2b. Whether the parts provided in the auto repair/installation activity constitute property provided in the provision of services with respect to customer-owned vehicles.	2. Because the Taxpayer accounts for the parts as inventory, the Taxpayer does not qualify for the "property provided incident to services" exception set forth in the Regulation. • Applicable Regulation is Reg. Sec. 1.263A-1(b)(11).
3. Whether the Taxpayer is eligible for the *de minimis* exception.	3. Because the Taxpayer's total indirect costs exceed $200,000, the Taxpayer does not qualify for the *de minimis* rule/exception. • Applicable Regulation is Reg. Sec. 1.263A-1(b)(12).
4a. Whether the Taxpayer is a reseller with production activities. 4b. If the Taxpayer is a reseller with production activities, whether those activities qualify as *de minimis* production activities.	4. The National Tax Office ***cannot determine whether the Taxpayer qualifies*** for the *de minimis* production presumption test. • If the examining agent applies a facts and circumstances test, taking into account volume, the Taxpayer's production activities relating to property subject to Section 263A ***may be de minimis.*** • Applicable Regulation is Reg. Sec. 1.263A-3(a)(2)(iii)(A).
5. Whether the Taxpayer's repair/installation activities are handling costs.	5. Costs attributable to repair/installation activities with respect to customer-owned vehicles are handling costs. • Costs attributable to certain ***minor*** repair/installation activities with respect to Taxpayer-owned vehicles are also handling costs. • Applicable Regulation is Reg. Sec. 1.263A-3(c)(4).
6. If the Taxpayer is permitted to use the simplified resale method because it has *de minimis* production, how are the production costs accounted for in the formula? *Note: This conclusion makes little practical difference because under the simplified resale method, the combined absorption ratio is defined as the sum of both of these absorption ratios. (Reg. Sec. 1.263A-3(d)(3)(i)(C))*	6. Under the simplified resale method, the materials and labor costs presently capitalized to inventory are Section 471 costs. ◆ These costs are included in (both) the denominator of the formula as well as in the multiplicand. • The indirect costs relating to production activities are treated as additional Section 263A costs. ◆ These costs are included in ***either*** (1) the storage and handling costs absorption ratio ***or*** (2) the purchasing costs absorption ratio.

Part 2 Summary	*RETAIL SALES FACILITY ... ISSUES & HOLDINGS*

Three Major Issues (#7-9)	*Holdings*
7. Do the following sales constitute on-site sales to retail customers? a. Vehicles taken in trade or purchased at auction and subsequently resold at wholesale, b. Vehicles sold to another dealership at cost, c. Vehicles leased, d. Vehicles sold as part of a fleet sale, and e. Wholesale sales of parts to purchasers who are, or are not, end users where the parts are picked up at the Taxpayer's parts department by the purchaser or delivered to the purchaser by a driver from the Taxpayer's parts department.	7. The following ***are not*** (considered to be) on-site sales ... ◆ Vehicles resold at wholesale ◆ Vehicles sold to another dealership at cost ◆ Leased vehicles • Some parts sales are not on-site sales to retail customers. • The following ***are*** (considered to be) ***on-site sales*** ... ◆ Parts sales made at Location 1 to end user retail customers ◆ Fleet sales to retail customers
8. Is the Taxpayer's storage facility at Location 1 an on-site, off-site, or dual-function storage facility? ◆ [i.e., How should this storage facility be classified?]	8. The Taxpayer's storage facility at Location 1 is a ***dual-function*** storage facility.
9. Is the Taxpayer's storage facility at Location 2 an on-site, off-site, or dual-function storage facility? ◆ [i.e., How should this storage facility be classified?]	9. The Taxpayer's storage facility at Location 2 is an ***off-site*** storage facility.

Specific Facts Regarding Dealership's Two Locations	
Two Locations	• The Taxpayer stores vehicles at its main sales facility, Location 1. • The Taxpayer also stores vehicles at Location 2. This location is one-half mile from Location 1. ◆ There is no sign at Location 2 indicating that it is owned by the Taxpayer. ◆ There is no sales office at Location 2.

Capitalization as Inventory Costs vs. Immediate Deduction ... and Cost Allocations

For sales that are not on-site sales ... (in other words, for sales that are off-site sales) ... all allocable expenses must be capitalized. Accordingly, the Taxpayer must capitalize expenses allocable to

1. Vehicles resold at wholesale
2. Vehicles sold to another dealership at cost
3. Leased vehicles
4. Parts sales made at Location 1 to purchasers who are not the end user retail customers

For sales that are on-site sales, all allocable expenses may be deducted. Thus, the Taxpayer may deduct expenses allocable to

1. Fleet sales to retail customers
2. Parts sales made at Location 1 to end user retail customers

Parts sales analysis. A proper analysis separating on-site from off-site sales of parts will require a determination of whether the purchaser is actually the end user. Accordingly, a sale by the taxpayer's parts department to another dealership's parts department (even if that dealership's employee may physically come to the taxpayer's parts department to pick up the parts purchased) would be considered to be an off-site sale because the "end user retail customer" would be the individual customer of the purchasing dealership, rather than the purchasing dealership entity.

Since the storage facility at Location 2 is an off-site storage facility, all expenses allocable to that facility must be capitalized.

Since the TAM concludes that the storage facility at Location 1 is a dual-function storage facility, that means that a determination must be made that allocates the costs related to the storage function to arrive at how much of these costs may be expensed and how much must be capitalized. For this purpose, the allocation between the off-site storage function and the on-site storage function is made by 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 and purchasing merchandise stored therein); to
- ***Total gross sales*** of the facility. For this purpose, the total gross sales of the facility include the value of items shipped to other facilities of the taxpayer.

For example, if the on-site sales at a dual-function facility are 40% of the total gross sales of the facility, then 40% of the facility's storage costs are allocable to the on-site storage function and are not required to be capitalized.

Note: See Selected Purchasing, Handling & Storage Definitions, Allocation Rules & De Minimis Exceptions *on page 26.*

Part 3 Summary	*IDENTIFICATION & ALLOCATION OF COSTS ... ISSUES & HOLDINGS*

Three Major Issues (#10-12)	*Holdings*
10a. Whether purchasing, storage and handling costs are mixed service costs under the ***simplified production method.***	10a. Purchasing, storage and handling costs are not mixed service costs under the simplified production method. • This TAM conclusion is qualified by the language... "Under the circumstance described below..." apparently referring to the detailed discussion of the Taxpayer's facts and the TAM's analysis. • Applicable Regulation is Reg. Sec. 1.263A-3(c)
10b. Whether purchasing, storage and handling costs are mixed service costs under the ***simplified resale method.***	10b. Purchasing, storage and handling costs are not mixed service costs under the ***simplified resale method.*** • This TAM conclusion is qualified by the language... "Under the circumstance described below..." apparently referring to the detailed discussion of the Taxpayer's facts and the TAM's analysis. • Applicable Regulation is Reg. Sec. 1.263A-3(c)
11. Which costs are mixed service costs for purposes of the ***simplified service cost method***?	11. The following costs are mixed service costs for purposes of the simplified service cost method: ◆ Salaries - executive costs including payroll taxes and employee benefits ◆ Salaries - administrative costs including payroll taxes and employee benefits ◆ Rent, real estate taxes, utilities, repairs and office supplies allocable to administrative departments ◆ Data processing costs ◆ Legal and audit costs • This TAM conclusion is qualified by the language... "Under the circumstance described below..." apparently referring to the detailed discussion of the Taxpayer's facts and the TAM's analysis.
12. Provided that the Taxpayer's ***self-developed*** method for capitalizing additional Section 263A costs is not a proper method, ***what method of accounting can the examining agent use*** in order to compute the Taxpayer's taxable income?	12. The Commissioner may require the Taxpayer to use ***any method that*** (in his opinion) ***clearly reflects income.*** • Permissible methods suggested by the TAM include... ◆ A reasonable method under Reg. Sec. 1.263A-1(f)(4). ◆ The simplified production method ◆ The simplified resale method *if* Taxpayer's production activities are *de minimis*." ◆ A facts-and-circumstances allocation method. • *Note:* Although the "clear reflection of income" standard seems to leave the door wide open for the examining agent, the "facts and circumstances" and "other reasonable methods" would seem to open another door for the taxpayer.

Customer-Owned Vehicles ... Taxpayer-Owned Vehicles ... Production Activities

- In addressing the first issue included in the "production and handling" category, the TAM held that with respect to ***customer-owned vehicles***, when the Taxpayer (or a subcontractor working for the Taxpayer) installs parts to customer-owned vehicles, the installation activity ***does not*** constitute production activity for purposes of Section 263A. This is because the Taxpayer does not hold the underlying benefits and burdens of ownership of the vehicle.
- With respect to new and/or used vehicles owned by the taxpayer (i.e., ***taxpayer-owned vehicles***), when the Taxpayer (or a subcontractor working for the Taxpayer) installs parts to new and/or used vehicles owned by the Taxpayer, the installation of parts ***may*** constitute production activities.

Background	• Section 263A(g) defines the term "produce" very broadly. The term "produce" includes "construct, build, install, manufacture, develop, or improve." • The examining agent argues that "install" and "improve" are within the definition of produce, and therefore, any installation or improvement, whether to Taxpayer-owned vehicles or to customer-owned vehicles, are production activities under Reg. Sec. 1.263A-2(a)(1)(i).
Customer-Owned Vehicles ***(Taxpayer Does Not Have Title to Customers' Vehicles)***	• The examining agent argues that for customer-owned vehicles, the production activity is "install" and the parts are the Section 263A property. • Although an activity may qualify as production under the broad definition at Section 263A(g)(1) and the Regulations thereunder, a taxpayer is not considered to be producing property ... unless it is also an owner of the property for Federal income tax purposes. *See* Reg. Sec. 1.263A-2(a)(1)(ii)(A). • The examining agent argues that when all of the facts and circumstances, including the various benefits and burdens of ownership vested with the Taxpayer, are examined, the Taxpayer has ownership of the installed parts until it is fully compensated. ◆ The examining agent argues that the Taxpayer has the benefit of ownership based on the rights conveyed to it by the execution of the mechanic's lien to the extent of the amount charged for the parts and services provided. ◆ The examining agent also argues that the cost of the parts and services to the Taxpayer constitute a burden of ownership in the respect that the Taxpayer has invested its resources, parts, and labor in order to repair the customer's vehicle. • In the instant case, we believe that the vehicle is the property being produced, not the parts. ◆ The parts are not otherwise produced (e.g., manufactured or developed) by the Taxpayer. ◆ The parts do not retain their character as separate pieces of property for any other significant Federal income tax purpose(s), e.g., depreciation, after they are installed into vehicles. ◆ These and other factors lead us to the conclusion that ***the Section 263A analysis should be focused on the vehicles.*** • Although the Taxpayer holds a mechanic's lien on customer-owned vehicles, the customers continue to possess the benefits and burdens of ownership. A mechanic's lien secures payment for labor or materials supplied. It encumbers the property but does not transfer an ownership interest in the vehicle to the Taxpayer. Therefore, ***the Taxpayer is not considered a producer of customer-owned vehicles*** under Reg. Sec. 1.263A-2(a)(1)(ii)(A).
Taxpayer-Owned Vehicles ***(Dealership Has Title to Its Own Vehicles)***	• The examining agent argues that for taxpayer-owned vehicles, there are two production activities and two types of Section 263A property. ◆ The first production activity as defined by statute is "install" and the corresponding Section 263A property is the parts being installed. ◆ The second production activity is "improve" and the corresponding Sec. 263A property is the vehicle. • The Taxpayer is the tax owner of the new and used vehicles. See Reg. Sec. 1.263A-2(a)(1)(ii)(A). ◆ Therefore, ***to the extent the Taxpayer has production activities*** relating to new and used vehicles, ... ***the Taxpayer-owned vehicles are Sec. 263A produced property.*** ◆ ***The installed parts are direct material costs*** to the extent production activities are involved because they either become an integral part of the property produced (the vehicle) or they are consumed in the ordinary course of production and can be identified or associated with a particular vehicle. See Reg. Sec. 1.263A-1(e)(2)(i)(A).

Customer-Owned Vehicles ... Taxpayer-Owned Vehicles ... Production Activities

Service Department Activities Are Either... ***Production Activities or Handling Activities***	• In new vehicles, the Taxpayer installs options such as air running boards, alarm systems, plow packages, towing packages, air conditioning, stereo equipment and entertainment systems. • In used vehicles, the Taxpayer also repairs and installs parts in order to place the vehicles into a saleable condition. • The Taxpayer's accounting system adds the costs of parts and direct labor to the inventory cost of the specific used or new vehicle, but it does not add any related indirect costs to the vehicles. ◆ The Taxpayer tries to capture as much cost as possible into the basis of the vehicle. However, certain costs, such as car washes, are not charged to a specific vehicle ... rather, the costs are expensed as incurred. • ***Production vs. handling.*** Whether the Taxpayer's activities in servicing new and used vehicles constitute production (under Reg. Sec. 1.263A-2) or handling (under Reg. Sec. 1.263A-3(c)(4)) ***depends on the specific facts.*** ◆ Some of the repair/installation activities improve the vehicles and place them in a minimally saleable or more saleable condition. The installation of certain parts makes the property more readily marketable and/or adds utility to the product. For example, a dealership may install air conditioning to make a vehicle more saleable, or a dealership may replace defective parts on used vehicles to place the vehicle into a saleable condition. ◆ ***Production costs*** are costs that make property more readily marketable and/or add utility to a product, making it more suitable for use and consumption. • The Taxpayer is producing tangible personal property within the meaning of Section 263A when it replaces or installs some parts on some new and used vehicles. • The Taxpayer is required to capitalize all direct material costs, direct labor costs, and indirect costs properly allocable to this inventory. See Reg. Secs. 1.263A-1(e)(2)(i) and 1.263A-1(e)(3). • ***Certain minor activities performed by the Taxpayer may not constitute production of property.*** ◆ Replacing fluids and/or minor cleaning on used vehicles may or may not constitute production under Section 263A, depending on the specific facts. ◆ ***To the extent the repair/installation activities are not production activities ... these activities are handling activities.*** See Issue 5 for a discussion concerning handling costs. • Items that were accounted for as inventory in the parts department and "sold" to the service department for installation into a taxpayer-owned vehicle must be included in the cost of the vehicle, even if certain activities performed by the Taxpayer are not considered to be production activities. ◆ For example, if the parts department sells floor mats to the service department, the floor mats are still capitalized as an inventoriable cost when placed in a taxpayer-owned vehicle. The cost of the floor mats can not be expensed.
Subcontractor Activities Are Attributed to the Taxpayer	• The Taxpayer hires subcontractors to perform certain repair/installation activities to the taxpayer-owned vehicles and to customer-owned vehicles. • Generally, property produced for the taxpayer under a contract with another party is treated as property produced by the taxpayer to the extent the taxpayer makes payments or otherwise incurs costs with respect to the property. See Reg. Secs. 263A(g)(2) and 1.263A-2(a)(1)(ii)(B)(1). Although an exception is made for routine purchase orders, the contracts that the Taxpayer is involved with are not routine purchase agreements. • Having concluded previously that the Taxpayer is a producer with regard to new and used vehicles, we also conclude that ***work performed by subcontractors on new and used vehicles is property produced by the Taxpayer.*** ◆ Certain minor activities performed by the subcontractor attributable to the Taxpayer may not constitute production of property under Section 263A, depending on the specific facts.
"Marcor" Is Not Applicable	• These conclusions are based on the definitions of, and the distinctions between, the terms "production" and "handling" that are made in the Regulations under Section 263A. ◆ No reliance is placed on either the decision in *Marcor, Inc. v. Comm.* (89 T.C. 181 (1987)) or the IRS nonacquiescence to that decision in Action on Decision (nonacq 1990-2 CB 1).

Issues #2 & #3 Discussion	*THE NATIONAL TAX OFFICE'S ANALYSIS PRODUCTION & HANDLING ... ISSUE #2 & #3*	*TAM 200736026*

Taxpayer's Activities Are Not Merely "Service" Activities

- In addressing the second issue in the "production and handling" category, the TAM concluded that the Taxpayer's repair/installation activities conducted in the dealership's service department could not be regarded as merely *service* activities.

Issue #2

Inapplicability of Safe Harbor Exception for Certain Services

- The activities of an automobile dealership's service department with respect to customer-owned vehicles would qualify as providing services to customers as well as sales of goods to customers.
  - There is an exception to the requirement to capitalize costs under Section 263A in the case of property provided to the client (customer) incident to providing service. (Reg. Sec. 1.263A-1(b)(11))
  - To qualify for this exception, the service provider must satisfy two requirements.
    - The property provided must be de minimis in amount. [Reg. Sec. 1.263A-1(b)(11)(i)(A)]
    - The property provided must not be inventory in the hands of the service provider. [Reg. Sec. 1.263A-1(b)(11)(i)(B)]
- Although the Taxpayer does not produce the parts it installs into customer-owned vehicles, the Taxpayer is reselling the parts in conjunction with the repair/installation activity that it performs. The vehicle parts are accounted for as inventory in the hands of the Taxpayer.
  - Because the Taxpayer accounts for these parts as inventory, it is not necessary to evaluate whether the parts satisfy the *de minimis* test or whether the auto repair/installation activity constitutes the provision or providing of services.
  - The exception in Reg. Sec. 1.263A-1(b)(11) does not apply to the Taxpayer.
  - ***However, the mere fact that the exception does not apply does not mean that the Taxpayer is engaged in a production activity subject to Section 263A.***
    - *Comment: Note ... This is a very important caveat.*

Another *de minimis* Exception Does Not Apply to the Taxpayer

- In the third issue included in the "production and handling" category, the TAM analyzed another *de minimis* exception that is favorable to certain small producers because it would treat their costs as being too small to warrant any further consideration.
- The TAM concluded that the Taxpayer in the TAM is unable to qualify for this favorable treatment.

Issue #3

Inapplicability of Safe Harbor Exception for Small Producers

- Certain producers may be eligible for the application of a *de minimis* exception rule to their activities.
  - If a producer using the simplified production method incurs $200,000 or less of total indirect costs in a taxable year, the additional Sec. 263A costs allocable to eligible property (i.e., inventory) remaining on hand at the close of the taxable year are deemed to be zero. [See Reg. Sec. 1.263A-1(b)(12) which cross-references Reg. Sec. 1.263A-2(b)(3)(iv).]
- In applying the $200,000 rule, the indirect costs included in the calculation are
  - All costs other than direct material costs and direct labor costs (in the case of property produced) or
  - Acquisition costs (in the case of property acquired for resale) that are properly allocable to property produced or property acquired for resale. [Reg. Sec. 1.263A-1(e)(3)(i)]
- A taxpayer's total indirect costs are broader than a taxpayer's additional Section 263A costs.
  - In explanation of this, the Regulations state, "Solely for purposes of this determination, taxpayers are permitted to exclude any category of indirect costs (listed in Reg. Sec. 1.263A-1(e)(3)(iii)) that is not required to be capitalized (for example, marketing, selling, advertising and distribution costs) in determining total indirect costs."
- The Taxpayer is not eligible for this *de minimis* exception for two reasons.
  - The Taxpayer's total indirect costs exceed $200,000, and
  - The Taxpayer is not using the simplified production method.

Reseller with Production Activities ... Maybe "Yes" ... Maybe "No"

- In the fourth issue included in the "production and handling" category, the National Office said that it could not decide whether the Taxpayer's production activities were *de minimis*. Regrettably, the Taxpayer, the Taxpayer's representative and/or the IRS examining agent had not provided enough factual information to the National Office.
- Although the taxpayer failed to satisfy a *de minimis* activity presumption included in the Regulations, the National Office did state that ...
  - Other facts and circumstances could result in a favorable interpretation for the Taxpayer, even though it did not satisfy the presumption.
- In this area, it would appear that if the Taxpayer is able to compile and present additional information, that information could result in a favorable holding for the Taxpayer (i.e., a holding that its installation activity did not rise to a sufficient level to require application of the producer rules).

In General	• A reseller producing property must capitalize the additional Section 263A costs associated with any inventoriable property it produces unless the taxpayer is a small reseller. [Reg. Sec. 1.263A-3(a)(2)] • The Taxpayer is not a small reseller. Therefore, the Taxpayer must capitalize additional Section 263A costs associated with produced inventoriable property.
If Level of Production Activity Is Small Enough, Taxpayer Can Use the Simplified Resale Method	• ***A reseller with de minimis production activities may use the simplified resale method.*** [Reg. Sec. 1.263A-3(a)(4)(ii)] • The *de minimis* production activity test is based on all the facts and circumstances, including the volume of the production activities in the Taxpayer's trade or business. [Reg. Sec. 1.263A-3(a)(2)(iii)] • Production activities are presumed to be *de minimis* if ... ◆ The gross receipts from the sale of property produced by the reseller are less than 10% of the total gross receipts of the trade or business, ***and*** ◆ The labor costs allocable to the trade or business' production activities are less than 10% of the reseller's total labor costs allocable to its trade or business. [Reg. Secs. 1.263A-3(a)(2)(iii)(A)(1)(i) and (ii)]
Taxpayer Fails the Presumptive Test	• The examining agent provided information for the presumptive test which consists of two parts. • ***The first part of the presumptive test*** compares gross receipts from the sale of property produced to total gross receipts of the trade or business. ◆ As explained above, the TAM concludes that the vehicle is the property produced. ◆ Therefore, the (first part of the) test takes into account the gross receipts from the sale of the entire vehicle, not just the value of the production added by the Taxpayer. ◆ ***The Taxpayer agrees that it does not meet the first part of the presumptive test.*** • ***The second part*** of the test compares labor costs allocable to the production activities to total labor costs. ◆ The Taxpayer's labor costs attributable to the service department solely associated with the activity of repairing/installing to total labor is over 40% for both tax years under examination. ◆ Given the conclusion of the TAM regarding customer-owned vehicles (in Issue #1), the labor cost for the second part of the test should not include labor attributable to customer-owned vehicles. ◆ *Note: The examining agent had taken the position that based on labor cost alone, the Taxpayer did not meet both parts of the two-part test described above.* *The National Office did not agree with the agent on his/her position because the holding in one of the previous issues was that only the installation/repair activities related to taxpayer-owned vehicles should be regarded as "production activity."* *In other words, the labor cost for the second part of the test should only include labor cost attributable to taxpayer-owned vehicles.*

Reseller with Production Activities ... Maybe "Yes" ... Maybe "No"

Alternative Test Based on Facts & Circumstances	• A taxpayer's production activities may still be considered *de minimis* based on a consideration of all of the facts and circumstances of the case. [Reg. Sec. 1.263A-3(a)(2)(iii)(A)(1)] ◆ This would apply even though the taxpayer fails the presumptive test described in the Regulations. • The examining agent provided information for a test using the gross receipts from the service department. The gross receipts from selling parts and labor from the service department are 10.39% and 8.51% of total gross receipts for the two years under examination. ◆ The gross receipts include parts and labor used in servicing both taxpayer-owned vehicles and customer-owned vehicles. ◆ The National Office observed that if only parts and labor used to service taxpayer-owned vehicles were included, the corresponding percentages would be reduced.
The Taxpayer Could Have Provided More Information, But Didn't ***The TAM Concluded that No Determination Could Be Made***	• The Taxpayer did not provide information to the National Tax Office showing which costs and gross receipts are attributable to (1) taxpayer-owned vehicles and to (2) customer-owned vehicles. • According to the examining agent, this information was requested, but the Taxpayer did not provide the data during the examination. The Taxpayer's representative indicated at the conference of right that the data is available. • At the conference of right, the Taxpayer's representative indicated that the Taxpayer uses internal work orders to track parts and labor costs for each vehicle serviced, regardless of whether the vehicle is (taxpayer-owned) new or used or customer-owned. ◆ The Taxpayer's representative indicated work performed on used and new vehicles is insignificant when compared to the acquisition cost of the vehicle. ▪ For example, in 2004, the Taxpayer had 21 used vehicles in ending inventory and only $2,800 total costs were attributable to those vehicles. ▪ The Taxpayer's representative stated that in most cases, the costs incurred in getting the vehicles ready for resale are minor and incidental compared to the acquisition costs of the vehicles. ▪ The Taxpayer's representative indicated that these costs are usually around three to five percent of the acquisition cost of the vehicle. • The Taxpayer's statement and information submitted with this request for technical advice takes the position that it does not produce any inventory. • The Taxpayer did not provide any written arguments concerning the *de minimis* test for production activities. • The Taxpayer did not provide any further information in a post-conference submission even though alternative *de minimis* tests were discussed at the Taxpayer's conference of right. • Based on this lack of information, the National Office concluded, ***"We cannot determine whether the Taxpayer's production activities are de minimis."***
Further Information Could Be Favorable to the Taxpayer on this Issue	• ***More work ahead for the agent if the Taxpayer can provide the data.*** The National Office stated that the examining agent should look at all the facts and circumstances to determine whether the production activities of the Taxpayer could/should be considered to be *de minimis*. • Factors to be considered include ... ◆ The relative material and labor costs added to ***the particular vehicle*** compared to the cost of the particular vehicle and ◆ The relative material and labor costs added to ***all the vehicles*** compared to the cost of all vehicles. ◆ The value added to the vehicle by the production activity. ◆ *Note: There could be others ... These 3 are the only that were listed in the TAM.* ◆ *For example, often it takes just a few minutes for a technician to add a $300 item to a $50,000 vehicle. This is where the Regulations may provide some relief.* • On a definitely optimistic note, the TAM concluded ... ***"We believe these factors may demonstrate that the Taxpayer's production activities are de minimis."***

Issue #5 Discussion	*THE NATIONAL TAX OFFICE'S ANALYSIS PRODUCTION & HANDLING ... ISSUE #5*	*TAM 200736026*

Costs Attributable to Repair/Installation Activities

- In addressing the fifth issue in the "production and handling" category, the National Office concluded that costs attributable to repair/installation activities with respect to customer-owned vehicles are handling costs.
- Costs attributable to certain minor repair/installation activities with respect to Taxpayer-owned vehicles are also handling costs.

In General	• In Issue #1, the TAM concluded that the installation of parts to taxpayer-owned vehicles ***could be*** production activities under Section 263A depending on the specific facts and circumstances. • Parts installed in customer-owned vehicles are property acquired for resale and are subject to the capitalization rules under Reg. Sec. 1.263A-3. • This is true notwithstanding the TAM's conclusion that the parts installed in customer-owned vehicles are not Section 263A property ***produced*** by the Taxpayer.
Handling Costs	• Handling costs include costs attributable to ... [Reg. Sec. 1.263A-3(c)(4)(i)] ◆ Processing, ◆ Assembling, ◆ Repackaging, ◆ Transporting, and ◆ Other similar activities with respect to property acquired for resale. • This will be the result only if the Taxpayer's activities do not come within the meaning of the term "produce" as defined in Reg. Sec. 1.263A-2(a)(1). • ***Handling costs must be capitalized unless they are incurred at a retail sales facility (and they are incurred) with respect to property sold to retail customers at the facility.*** [Reg. Sec. 1.263A-3(c)(4)(i)] ◆ *Note: The converse of the above statement is that* ***handling costs are deductible if they are incurred at a retail sales facility with respect to property that is sold to retail customers at the facility.***
Application to Taxpayer	• ***Costs attributable to installing parts in customer-owned vehicles are handling costs.*** ◆ When a customer brings a vehicle to the Taxpayer's service department, service technicians disassemble a component or components of the vehicle in order to remove defective parts. Subsequently, they install new parts and re-assemble the component(s). ◆ This activity is similar to the bicycle assembly example described at Reg. Sec. 1.263A-3(c)(4)(iii). The bicycle is sold to customers. The customers can buy the bicycle in a box and assemble it themselves. Alternatively, the customers can pay a fee and have the bicycle assembled. ◆ Taxpayer's customers have the same choice; they can buy and install the parts themselves, or they can pay a fee and have the Taxpayer install the parts. ▪ *Comment: Given the increasing modular designs, assemblies and generally increasing inability to diagnose what's causing a vehicle to operate inefficiently or improperly without computer diagnostics and software, the analogy made by the National Tax Office here seems to be very strained, especially with respect to later model vehicles.* • Certain minor activities with respect to taxpayer-owned vehicles do not come within the meaning of the term "produce" as defined in Reg. Sec. 1.263A-2(a)(1). ◆ Activities such as washing vehicles and adding fluids to taxpayer-owned vehicles are handling costs. • If a subcontractor does handling-type activities to customer-owned or taxpayer-owned vehicles, those costs are also capitalizable as handling costs under Reg. Sec. 1.263A-3(c)(4).

Issue #6 Discussion	*THE NATIONAL TAX OFFICE'S ANALYSIS PRODUCTION & HANDLING ... ISSUE #6*	*TAM 200736026*

Treatment of Production Costs in the Simplified Resale Method Combined Absorption Ratio

- The last issue in the "production and handling" category involves the question of how production costs should be reflected in the computation of the combined absorption ratio formula that is used in the simplified resale method.
- This discussion assumes that the Taxpayer would be permitted to use the simplified resale method because any production activity that it engaged in was *de minimis*.
- The TAM concluded that the indirect costs relating to production activities are to be treated as additional Section 263A costs. As such, they should be included ***either*** in (1) the storage and handling costs absorption ratio ***or*** (2) the purchasing costs absorption ratio.

In General	• A taxpayer that uses the simplified resale method and has *de minimis* production activities incident to its resale activities or property produced under contract must capitalize all costs allocable to eligible property produced using the simplified resale method. [Reg. Sec. 1.263A-3(a)(4)(iv)] • Costs allocable to eligible property produced include [Reg. Sec. 1.263A-1(a)(3)(i)] ◆ Direct material costs, ◆ Direct labor costs, and ◆ Indirect costs properly allocable to property produced. • The ***combined absorption ratio*** under the simplified resale method is: $\frac{\text{Current year's storage and handling costs}}{\text{Beginning inventory plus current year's purchases}} + \frac{\text{Current year's purchasing costs}}{\text{Current year's purchases}}$ • The combined absorption ratio (as determined above) is then multiplied by "Section 471 costs remaining on hand at year end" to determine the additional Section 263A costs allocable to eligible property remaining on hand at the close of the taxable year. [Reg. Sec. 1.263A-3(d)(3)] • *Note: The TAM makes no clarification with respect to the multiplication of the ratio by the current- year's increment (and not the much greater ending inventory at cost) where the LIFO method is being used to value the inventory. But, see Reg. Sec. 1.236A-3(d)(3)(ii).*
The Question	• Where should the reseller's *de minimis* production costs be reflected in the simplified resale method formula (since there seems to be no "place" for those costs in the formula)?
Application to Taxpayer	• The Taxpayer accumulates the cost of parts and labor on internal repair orders, which are generated for each new and used vehicle serviced. ◆ The total amount from the repair order is added to the inventory cost of the new or used vehicle. ◆ Since the Taxpayer already capitalizes these costs under its present method of accounting, these costs would be Section 471 costs for purposes of the Regulations under Section 263A. [Reg. Secs. 1.263A-1(d)(2)(i) and (ii)] • Current year's purchases used in the denominator of the combined absorption ratio generally mean the Taxpayer's Section 471 costs incurred with respect to purchases of property acquired for resale during the current taxable year. [Reg. Sec. 1.263A-3(d)(3)(i)(E)(2)] ◆ Taxpayer's costs of parts and labor are incurred with respect to the purchases of property acquired for resale ... Accordingly, those costs ... belong in the denominator of the formula. ◆ The costs of parts and labor also are included in the Section 471 costs remaining on hand at year end. [Reg. Sec. 1.263A- 3(d)(3)(i)(C)(2)] • In addition to direct material costs and direct labor costs, the Taxpayer must also allocate indirect costs to property produced. ◆ Since the indirect costs properly allocable to property produced were not previously capitalized, they are additional Section 263A costs. [Reg. Sec. 1.263A-1(d)(3)] ◆ Additional Section 263A costs are (to be included) in the numerator of the storage and handling costs absorption ratio and the purchasing costs absorption ratio.
Conclusion ... Put These Costs in One Place or in the Other	• The ***indirect costs*** properly allocable to property produced ***are similar to handling costs.*** ◆ The indirect costs allocable to property produced ***could be*** added to the other additional Section 263A costs included in numerator of the storage and handling costs absorption ratio. ◆ In the alternative (however), ***it is not unreasonable*** to include the indirect costs allocable to property produced in the purchasing costs absorption ratio [since that ratio is similar to the simplified production method described at Reg. Sec. 1.263A-2(b)(3)].

Form 4564	Department of the Treasury Internal Revenue Service Information Document Request	Request Number

To:	Subject:
	Submitted to:
Description of Documents Requested:	Dates of Previous Requests:

Subject: Resale of Vehicles for 200x tax year

- Provide the dollar amount of revenues related to adding accessories and different options to new vehicles at the customer request at the time of sale.
  - For example, running boards to SUV's, alarm systems, special tires, special equipment, video and stereo systems.
  - How is this revenue accounted for?
    - What account numbers?
    - Is it considered part of the new vehicle revenue or a separate item?
- How many used vehicles (cars & trucks) were taken in on trade in 200x?
- How many used vehicles (cars & trucks) were taken in through remarketed account, via auction and other sources?
- How many used vehicles (cars & trucks) taken in as trade-in were sold in 200x?
- How many used vehicles (cars & trucks) taken in from other sources, remarketed were sold in 200x?
- When repairs and maintenance are required to vehicles received as trade-ins and from other sources (remarketed):
  - Provide documentation to show the costs of improvements to at least ____ (10-20, etc.) vehicles that required work to get to good operating condition prior to being sold retail as a used car?
  - How are these amounts treated?
    - Provide treatment of the expenses incurred.
    - How are they tracked with the used vehicle?
    - Include account numbers
- Who buys cars from auctions and other sources included in the remarketed account?
  - Provide name, position, salary and commissions, and percent of time allocated to these functions.

Subject: Floor Plan and New Car Inventory Ordering

- Provide a detailed explanation of how the floor plan works.
- Provide a detailed analysis of how the ordering process works.
- Provide the names, position, salary (including commissions) and time percentage allocated to the following:
  - Person who performs ordering
  - Person who reconciles purchase orders inventory
  - Person who tracks inventory
  - Person who resolves disputes
- How are new vehicles shipped to the location?
- What is the minimum inventory level required?
- Provide the internal controls inventory paper work.

Information Due By _____ **At Next Appointment** ☐ **Mail In** ☐

FROM	Name and Title of Requestor	Date:
	Office Location: Phone: Voice Fax	Page 1

Form 4564

Form 4564	Department of the Treasury Internal Revenue Service Information Document Request	Request Number

To:	Subject:
	Submitted to:
	Dates of Previous Requests:

Description of Documents Requested:

Subject: Purchasing, Handling and Storage Cost

Provide an explanation to the following questions for calendar year 200x:

1. Who does the purchasing of new vehicles?
   - Who decides what to purchase?
   - Who establishes and maintains supplier contracts?
   - Who actually places the orders?
   - Provide the total salaries of the individuals performing these tasks and the percent of time allocated to these tasks.
2. Who does the purchasing of used vehicles?
   - Provide the total salaries of the individuals performing these tasks and the percent of time allocated to these tasks.
3. Who values the trade in vehicles?
   - Provide the total salaries of the individuals performing these tasks and the percent of time allocated to these tasks.
4. How much is the annual rent where cars are stored at the offsite facility?
   - How much is the insurance related to the cars insured at this facility?
   - How many vehicles can this lot store?
   - Is there any security at this lot? If so, what type and how much?
5. What percent of new car sales are related to Internet sales for tax years 200x?
   - Who is responsible for these sales?
   - Provide the total salaries of the individuals performing these tasks and the percent of time allocated to these tasks.
6. Are customers allowed to browse vehicles in all areas of the various lots owned and/or leased by the taxpayer?
7. What is the square footage of the facility?
   a. What is the square footage of the building?
   b. What is the square footage of the show room?
   c. What is the square footage of the office area?
   d. What is the square footage of the service area, waiting area and parts department including on-site storage?

Information Due By _____ **At Next Appointment** ☐ **Mail In** ☐

FROM	Name and Title of Requestor	Date:
	Office Location: Phone: Voice Fax	Page 1

Form 4564

P, H & S	SELECTED DEFINITIONS, ALLOCATION RULES & DE MINIMIS EXCEPTIONS
Purchasing Activities ***-3(c)(3)(ii)(A)***	• The determination of whether an employee is engaged in purchasing activities is based upon the activities performed by the employee, and not upon his or her title or job classification. • ***1/3 - 2/3 Rule for Allocation Labor Costs.*** A taxpayer may elect to apply the following rule for allocating labor costs in connection with employees who perform both purchasing and non-purchasing activities. Under this rule, which is based on the person's ***activities*** relate to purchasing ◆ ***If less than 1/3 ... none*** of that person's labor cost is allocated to purchasing activities. ◆ ***If more than 2/3 ... 100% or all*** of that person's labor cost is allocated to purchasing activities. ◆ ***If 1/3 or more or less than 2/3 ... a reasonable allocation*** must be made between activities. • Note: This determination is made on an employee-by-employee basis (not on an overall departmental basis).
Handling Activities ***-3(c)(4)(i)***	• Handling costs incurred at a retail sales facility with respect to property sold to retail customers at the facility are ***not*** required to be capitalized. ◆ Thus, handling costs incurred at a retail sales facility to unload, unpack, mark and tag goods sold to retail customers at the facility are ***not*** required to be capitalized. • Handling costs incurred at a dual-function storage facility with respect to property sold to customers from the facility are ***not*** required to be capitalized ***to the extent that the costs are incurred with respect to property sold in on-site sales. Handling costs allocable to off-site sales are required to be capitalized.*** • Handling costs attributable to property sold to customers from a dual-function storage facility in on-site sales are determined by applying the sales ratio computation found in Reg. Sec. 1.263A-3(c)(5)(iii)(B).
Storage Costs, In General ***-3(c)(5)(i)***	• Generally, storage costs are required to be capitalized to the extent they are attributable to the operation of an ***off-site*** storage or warehousing facility. • Storage costs attributable to the operation of an ***on-site*** storage facility are not required to be capitalized ... i.e., they can be expensed. • Storage costs attributable to a ***dual-function facility*** must be capitalized to the extent that the facilities costs are allocable to off-site storage.
On-Site Off-Site Sales/Facilities Definitions ***-3(c)(5)(ii)***	• An ***on-site storage facility*** is a storage or warehousing facility that is physically attached to, and an integral part of, a retail sales facility. • A ***retail sales facility*** is a facility where the taxpayer sells merchandise exclusively to retail customers in ***on-site sales***. Special rules apply to various situations and portions of specific retail sites. ◆ Two lots of an automobile dealership physically separated by an alley or an access road would generally be considered to be one retail sales facility, provided that customers routinely shop on both of the lots in order to select the specific automobile(s) they wish to purchase. (Reg. Sec. 1.263A-3(c)(5)(ii)(B)(2)). • ***On-site sales*** are sales made to ***retail customers*** physically present at the facility. ◆ Mail order and catalog sales are made to customers not physically present at the facility, and thus, they are not considered to be on-site sales. (Note: Certain purchases over the internet would fall into this category.) • ***Retail customers*** are the final purchasers of the merchandise. ◆ A "retail customer" does not include a person who resells the merchandise to others, such as a contractor or manufacturer that incorporates the merchandise into another product for sale to customers. ◆ Special rules apply which may treat a non-retail customer as a retail customer under certain conditions. • ***Off-site storage facility*** is defined as "a storage facility that is not an on-site storage facility."
Dual Function Storage Facility & Sales Ratio ***-3(c)(5)(iii)(B)***	• Storage costs associated with a dual-function storage facility must be allocated between ◆ The **off-site** storage function (i.e., these costs must be capitalized), and ◆ The **on-site** storage function (i.e., these costs can be expensed - they do not have to be capitalized). • ***Allocation ratio (based on sales) for dual-function storage facilities.*** These costs must be 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 and purchasing merchandise stored there in) ***to*** ◆ ***Total gross sales*** of the facility. ▪ The total gross sales of the facility includes the value of items shipped to other facilities of the taxpayer. • Note: This sales ratio computation is also the ratio to be used for the allocation of handling costs.
90%-10% de minimis Rule ***-3(c)(5)(iii)(C)***	• For dual-function storage facilities, there is a special *de minimis* rule. • ***If 90% or more*** of the costs of the facility are attributable to the on-site storage function, then the entire storage facility is ***deemed to be an on-site*** storage facility ... and thus, no costs need to be capitalized. • ***If 10% or less*** of the costs of the storage facility are attributable to the on-site storage function, then the entire storage facility is ***deemed to be an off-site*** storage facility ... and thus, all costs are required to be capitalized. • If the 10% sales test *de minimis* is not met (i.e., the wholesale and other non-retail sales of parts exceeds 10% of the parts department's total sales), then some amount should be capitalized as handling costs. An analysis of only these departments' activities (justified under a specific allocation/facts and circumstances approach) might yield a more "reasonable" result consistent with the principles of Section 263A.

Issues #7, 8 & 9 Discussion	***THE NATIONAL TAX OFFICE'S ANALYSIS PRODUCTION & HANDLING ... ISSUES #7 - #8 - #9***	*TAM 200736026*

On-Site Sales ... Off-Site Sales ... Dual-Function & Off-Site Storage Facilities

- The second part of the TAM combines three issues concerning the nature of the dealership's storage facilities and sales for cost capitalization purposes. These areas are examined in order to determine whether any portion of certain dealership costs are required to be capitalized instead of expensed.
- The key determinant is whether various sales, and the storage facilities from which they originate, constitute on-site sales to retail customers.
- For sales that do not satisfy the Regulation's obtuse definition as being "on-site," all related, allocable expenses are required to be capitalized as additional Section 263A costs. [See facing page for various definitions, etc.]
- For dealerships, on-site sales are "good" because all associated costs are immediately and fully deductible as expenses. On the other hand, off-site sales are "bad," because all associated costs are required to be capitalized.
- Query: How should "*Internet sales*" be treated? Apparently, the dealership in the TAM was not selling via the Internet.

On-Site & Off-Site Definitions	• ***On-site sales*** are defined as sales made to retail customers physically present at a facility. [Reg. Sec. 1.263A-3(c)(5)(ii)(D)] • ***Retail customer*** is defined as the final purchaser of the merchandise. ◆ Any person/customer who resells (the) merchandise to others is, by definition, excluded from being treated as a retail customer. [Reg. Sec. 1.263A-3(c)(5)(ii)(E)] • The TAM states, "...Under this definition it appears that few of the sales under consideration constitute on-site sales to retail customers."
Off-Site Sales ... Bad News	• ***Most vehicles sold at wholesale*** are not sold to the final purchaser of the merchandise. • ***Vehicles sold to other dealerships*** (i.e., "dealer trades") are not sold to the final purchaser of the merchandise. • ***Leased vehicles*** are sold to Credit [unrelated party purchasing lease], and accordingly, are not on-site sales because Credit (i.e., the entity that purchases the lease paper) does not purchase the vehicles at one of the Taxpayer's sales locations. • ***Some parts sales*** by the dealership are wholesale sales, and therefore, are not made to a retail customer.
On-Site Sales ... Good News	• ***Some parts sales*** (including parts sold to the Taxpayer's service department) made to end users ***do appear to qualify as retail sales*** where they are on-site sales made to final purchasers. • ***Fleet sales*** appear to qualify as on-site retail sales since presumably the customer purchases the vehicles at one of the Taxpayer's sales facilities.
Location 1 ... Some Costs Must Be Capitalized (Based on Sales Ratio)	• On-site sales are defined as sales made to retail customers physically present at a facility. [Reg. Sec. 1.263A-3(c)(5)(ii)(D)] • From the analysis of the nature of the Taxpayer's sales, it is clear that the Taxpayer engages in both on-site and off-site sales at Location 1. • The Taxpayer's storage facility at Location 1 meets the definition of being a ***dual-function storage facility***. • Therefore, the Taxpayer must determine storage and handling costs capitalizable under Section 263A ***by applying the dual function storage facility allocation ratio*** in Reg. Sec. 1.263A-3(c)(5)(iii)(B). [Reg. Secs. 1.263A-3(c)(4)(i) and 1.263A- 3(c)(5)(iii)]
Location 2 ... Some Costs Must Be Capitalized	• An off-site storage facility is defined as a storage facility that is not an on-site storage facility. [Reg. Sec. 1.263A-3(c)(5)(ii)(F)] • 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. Sec. 1.263A-3(c)(5)(ii)(A)] • The Taxpayer engages in no sales to retail customers at Location 2. ◆ The Taxpayer asserted that Location 2 was commonly known as the Taxpayer's overflow lot and that retail customers would go to Location 2 to look at vehicles. ◆ No retail sales were alleged to have taken place at Location 2. ◆ Location 2 is too far from Location 1 (one-half mile) to be considered as part of one retail sales facility under Reg. Sec. 1.263A-3(c)(5)(ii)(B)(2) ... i.e., two lots physically separated by an alley or an access road. • Therefore, the Taxpayer's storage facility at Location 2 is an off-site storage facility.

Issue #10 Discussion	*THE NATIONAL TAX OFFICE'S ANALYSIS PRODUCTION & HANDLING ... ISSUE #10*	*TAM 200736026*

Purchasing, Storage & Handling Costs ... Are Not Mixed Service Costs

- In addressing the first issue included in the "identification and allocation of costs" category, the TAM concluded that the dealership's purchasing, storage and handling costs are not mixed service costs under either the simplified production method or under the simplified resale method.

In General	• The examining agent asserts that ***if the Taxpayer is a producer*** and is required to use the simplified production method, then the Taxpayer's purchasing, storage and handling costs are mixed service costs (in accordance with Reg. Sec. 1.263A-1(e)(4)(ii)(C) and the applicable examples in Reg. Secs. 1.263A-1(e)(4)(iii) and (iv)). • Alternatively, ***if the Taxpayer is a reseller*** and is required to use the simplified resale method, then the examining agent asserts that the purchasing, storage and handling costs are not mixed service costs according to Reg. Sec. 1.263A-1(e)(4). • The classification of purchasing, storage and handling costs as mixed service costs does not depend on whether the Taxpayer uses the simplified production method or the simplified resale method. ◆ Nor does the classification of a cost (as a mixed service cost) depend on whether the Taxpayer is a producer or a reseller. • The TAM concluded that the Taxpayer's purchasing, storage and handling costs are not mixed service costs. The detailed analysis is below.
Rules for Classifying Indirect Costs	• The types of costs that must be capitalized by taxpayers are described in Reg. Sec. 1.263A-1(e). ◆ Resellers must capitalize the acquisition cost of property as well as indirect costs described in Reg. Sec. 1.263A-1(e)(3). ◆ The indirect costs most often incurred by resellers are purchasing, handling and storage costs. [Reg. Sec. 1.263A-3(c)(1)] ◆ The rules provided in Reg. Sec. 1.263A-3(c) also apply to producers incurring purchasing, handling and storage costs. • Taxpayers must capitalize all indirect costs properly allocable to property produced or property acquired for resale. [Reg. Sec. 1.263A-1(e)(3)(i)] ◆ ***Indirect costs*** are properly allocable to property produced or property acquired for resale when the costs ***directly benefit or are incurred by reason of the performance of production or resale activities***. • Service ***costs*** are defined as indirect costs (e.g., general and administrative costs) that can be identified specifically with a service department or function or that directly benefit or are incurred by reason of a service department or function. [Reg. Sec. 1.263A-1(e)(4)(i)(A)] ◆ Service ***departments*** are defined as administrative, service or support departments that incur service costs. [Reg. Sec. 1.263A- 1(e)(4)(i)(B)] ◆ The facts and circumstances of the taxpayer's activities and business organization control whether a department is a service department. ◆ The mere title or activity of a department or function does not determine whether the department or function constitutes a service department. • Service costs are segregated into three separate categories: ◆ ***Capitalizable*** service costs ... Service costs that directly benefit or are incurred by reason of the performance of a production or resale activity. [Reg. Sec. 1.263A-1(e)(4)(ii)(A)] ◆ ***Deductible*** service costs ... Service costs that do not directly benefit or are not incurred by reason of the performance of a production or resale activity. [Reg. Sec. 1.263A-1(e)(4)(ii)(B)] ◆ ***Mixed*** service costs ... Service costs that are partially allocable to production or resale activities and partially allocable to non-production or non-resale activities. [Reg. Sec. 1.263A-1(e)(4)(ii)(C)]
Cost Accounting Principles Re: Producers	• Cost accounting has traditionally distinguished between operating departments and service departments. ◆ An ***operating*** department (also called a production department for a manufacturer) adds value to a product or service. ◆ A ***service*** department is a department that assists or supports other internal departments so that its costs are allocable to such departments. These service departments are necessary to facilitate a company's core activities, but the core activities themselves are not performed in these departments. ◆ *Note: Two accounting texts are cited in the TAM; these citations are not included here.*

Purchasing, Storage & Handling Costs ... Are Not Mixed Service Costs

Cost Accounting Principles Re: Producers (continued)	• *In the context of a manufacturer*, the purchasing, storage and handling departments are often service departments because such departments do not directly engage in the production of the manufacturer's products; rather, they only assist or support the production departments. • *In the context of a reseller*, the purchasing, storage and handling departments are generally akin to the manufacturer's production departments. These departments directly act on the products and goods that will be sold to the retailer's customers. ◆ Accordingly, ***resellers' purchasing, storage and handling departments*** generally are not service departments, and therefore, they ***cannot be treated as mixed service departments***. • The examining agent refers to examples at Reg. Secs. 1.263A-1(e)(4)(iii)(C) and (D) to show that purchasing operations and materials handling and warehousing costs can be incurred in service departments. ◆ Although these examples provide that purchasing and warehousing costs can be service costs, they do not conclude that they are always service costs. Further, the examples do not conclude that if they are service costs, they are mixed service costs. The costs could be fully capitalizable service costs or fully deductible service costs.
Analysis Based on Taxpayer's Functions ***P, S & H Costs Are Indirect Costs, Not Service Costs***	• The Taxpayer is a reseller with production activities. ◆ The activities performed in the Taxpayer's purchasing, storage and handling functions are the same regardless of whether the Taxpayer uses the simplified production method or the simplified resale method. ◆ The facts and circumstances of the Taxpayer's activities and business organization must be looked at in order to determine whether the functions are incurred in a service department. • The Taxpayer's ***purchasing costs related to the retail activity*** include sales managers' wages and associated payroll taxes benefits and demonstrator vehicle expense (an employee benefit) attributable to the purchasing activity of purchasing new vehicles and used vehicles obtained from trade-in, auction and other dealers. ◆ The Taxpayer has an off-site storage facility dedicated to storing overflow vehicles. The Taxpayer incurs handling costs at its sales facility. • The purchasing, storage and handling costs incurred by the Taxpayer are the traditional types of costs incurred by resellers in connection with their core activity of acquiring merchandise for resale. ◆ These costs directly benefit or are incurred by reason of the performance of production or resale activities. They can not be identified specifically with a service department or function and do not directly benefit or are incurred by reason of a service department or function. • The Taxpayer's ***purchasing, storage and handling costs are indirect costs*** of its resale activity. They are not service costs. • To the extent that the Taxpayer's purchasing, storage and handling costs are not fully allocable to resale or production activities, ***the Taxpayer can make a reasonable allocation between capitalizable activities and deductible activities***. [Reg. Sec. 1.263A-1(e)(3)(i)] ◆ For example, if a person performs both purchasing and non-purchasing activities, the Taxpayer must reasonably allocate the person's labor costs between these activities. [Reg. Sec. 1.263A- 3(c)(3)(ii)] ◆ Storage costs are capitalized to the extent they are attributable to an off-site storage facility. [Reg. Sec. 1.263A-3(c)(5)(i)] ◆ Handling costs generally are required to be capitalized to the extent they are not incurred at a retail sales facility. [Reg. Sec. 1.263A-3(c)(4)] • ***If the Taxpayer is required to use the simplified production method***, the allocable purchasing, storage and handling costs are additional Section 263A costs, and they are included in the numerator of the absorption ratio. [Reg. Sec. 1.263A-2(b)(3)(ii)(A)] • ***If the Taxpayer is required to use the simplified resale method***, the allocable purchasing costs are included in the numerator of the purchasing costs absorption ratio and the allocable storage and handling costs are included in the numerator of the storage and handling costs absorption ratio. [Reg. Sec. 1.263A-3(d)(3)(i)]

Issue #11 Discussion	*THE NATIONAL TAX OFFICE'S ANALYSIS PRODUCTION & HANDLING ... ISSUE #11*	*TAM 200736026*

Mixed Service Costs for Purposes of the Simplified Service Cost Method

- In addressing the second issue included in the "identification and allocation of costs" category, the TAM produced a list of costs that are mixed service costs for purposes of determining the capitalizable portion of mixed service costs under the simplified service cost method.

In General	• At issue is whether certain costs incurred in the Taxpayer's executive and administrative departments are mixed service costs. • The discussion of mixed service costs and departments in Issue #10 applies equally here. • Service ***costs*** are defined as indirect costs (e.g., general and administrative costs) that can be identified specifically with a service department or function or that directly benefit or are incurred by reason of a service department or function. [Reg. Sec. 1.263A-1(e)(4)(i)(A)] ◆ Service ***departments*** are defined as administrative, service or support departments that incur service costs. [Reg. Sec. 1.263A- 1(e)(4)(i)(B)] ◆ The facts and circumstances of the taxpayer's activities and business organization control whether a department is a service department. ◆ The mere title or activity of a department or function does not determine whether the department or function constitutes a service department. • Service costs are segregated into three separate categories: ◆ ***Capitalizable*** service costs ... Service costs that directly benefit or are incurred by reason of the performance of a production or resale activity. [Reg. Sec. 1.263A-1(e)(4)(ii)(A)] ◆ ***Deductible*** service costs ... Service costs that do not directly benefit or are not incurred by reason of the performance of a production or resale activity. [Reg. Sec. 1.263A-1(e)(4)(ii)(B)] ◆ ***Mixed*** service costs ... Service costs that are partially allocable to production or resale activities and partially allocable to non-production or non-resale activities. [Reg. Sec. 1.263A-1(e)(4)(ii)(C)]
Application to Taxpayer	• The Taxpayer has executive and administrative departments that perform various duties. • The executive and administrative departments are administrative, service or support departments incurring both capitalizable service costs and deductible service costs. ◆ Accordingly, the departments are mixed service departments, and the costs (listed below) incurred in those departments are mixed service costs. • The Taxpayer may use the ***simplified service cost method*** for determining capitalizable mixed service costs incurred during the taxable year. [Reg. Sec. 1.263A-1(h)] [See below]
Mixed Service Costs Include ...	• The following costs are mixed service costs for purposes of determining the capitalizable portion of mixed service costs under Reg. Secs. 1.263A-1(h) and 1.263A-3(d)(3)(i)(F) ... (i.e., under the simplified service cost method): ◆ Salaries - executive costs including payroll taxes and employee benefits ◆ Salaries - administrative costs including payroll taxes and employee benefits ◆ Rent, real estate taxes, utilities, repairs and office supplies allocable to administrative departments ◆ Data processing costs ◆ Legal and audit costs
Simplified Service Cost Method ***Definition of Total Mixed Service Costs***	• ***Total mixed service costs*** are defined as the total costs incurred during the taxable year in all departments or functions of the taxpayer's trade or business that perform mixed service activities. ... In determining the total mixed service costs of a trade or business, the Taxpayer must include all costs incurred in its mixed service departments and cannot exclude any otherwise deductible service costs. ◆ For example, if the accounting department within a trade or business is a mixed service department, then in determining the total mixed service costs of the trade or business, the Taxpayer cannot exclude the costs of personnel in the accounting department that perform services relating to non-production activities (e.g., accounts receivable or customer billing activities). Instead, the entire cost of the accounting department must be included in the total mixed service costs. [Reg. Sec. 1.263A-1(h)(6)] • ***Costs allocable to more than one business.*** To the extent that mixed service costs, labor costs, or other costs are incurred in more than one trade or business, the Taxpayer must determine the amounts allocable to the particular trade or business for which the simplified service cost method is being applied by using any reasonable allocation method consistent with Reg. Sec. 1.263A-1(f)(4). [Reg. Sec. 1.263A-1(h)(7)]

What Method of Accounting for Determining Section 263A Costs Will Be Acceptable?

- The final issue, as phrased in the TAM, is "... What method of accounting can the examining agent use in order to compute Taxpayer's taxable income?"
- The answer is that ultimately, the Commissioner may require the Taxpayer to use ***any method that*** (in his opinion) ***clearly reflects income.***

Taxpayer's Present Method	• The Taxpayer uses a ***self-developed method*** for allocating additional Section 263A costs to new vehicles and parts. ◆ The Taxpayer includes some, but not all, mixed service costs in the calculation. ◆ The Taxpayer does not allocate any additional Section 263A costs to used vehicle inventory. • The Taxpayer's self-developed method allocates its additional Section 263A costs using two absorption ratios. ◆ The first absorption ratio is the ratio of the Taxpayer's additional Section 263A costs incurred during the taxable year related to new vehicles to current year purchases of new vehicles. ▪ The Taxpayer applies this ratio to the LIFO increment, if any. ▪ The Taxpayer liquidates additional Section 263A costs (capitalized in a previous year) when it invades a LIFO layer (for that year). ◆ The second absorption ratio is the ratio of the Taxpayer's additional Section 263A costs incurred during the taxable year related to parts to current year purchases of parts incurred during the taxable year. ▪ The Taxpayer applies this ratio to the Section 471 costs in ending inventory. ▪ The Taxpayer's Section 471 costs in ending inventory are the acquisition costs of the parts remaining on hand at the end of the taxable year. • ***The Taxpayer did not provide documentation showing how it determined the percentage of costs attributable to new vehicles or to parts.***
The IRS Agent's Approach	• The examining agent calculated the amount of additional Section 263A costs required to be capitalized using two approaches ◆ The simplified production method as described at Reg. Sec. 1.263A-2(b) ◆ The simplified resale method as described at Reg. Sec. 1.263A-3(d). • The Taxpayer's self-developed method resulted in the capitalization of a smaller amount of additional Section 263A costs than would be capitalized under either of the examining agent's recomputation methods (i.e., under the simplified production method and/or the simplified resale method). • IRS agent's position ... the Taxpayer's self-developed method of accounting (for Section 263A costs) does not provide for a clear reflection of income. • The National Tax Office agreed with the examining agent that the Taxpayer's present method of allocating additional Section 263A costs is not proper. ◆ Aside from the fact that the Taxpayer's method is a modification of the simplified methods, the Taxpayer is required to allocate all costs required to be capitalized under Section 263A and the Regulations thereunder to all inventory, ***including used vehicles.*** ◆ The Taxpayer's method is similar to the simplified production method. The simplified production method is applied on a trade or business basis. ▪ Unless new vehicles and parts are separate trades or businesses, the Taxpayer is incorrectly applying the simplified production method to those inventories. ▪ The Taxpayer has not allocated any indirect costs to used vehicles. ▪ Also, the Taxpayer has not included all required costs. ◆ *Comment: The Taxpayer in the TAM did not pursue the separate trades or businesses line of reasoning or analysis in (further?) support defense of its self-developed cost cap method.*

What Method of Accounting for Determining Section 263A Costs Will Be Acceptable?

Commissioner's Discretion in Changing Taxpayer's Methods	• If the Taxpayer's method of accounting does not clearly reflect income, the computation of taxable income shall be made under such method as, in the Commissioner's opinion, does clearly reflect income. [Section 446(b) and Reg. Sec. 1.446-1(a)(2)] • The Commissioner "has broad powers in determining whether accounting methods used by a taxpayer clearly reflect income." See *Comm. v. Hansen*, 360 U.S. 446, 467 (1959), 1959-2 C.B. 460. • Once the Commissioner determines that a taxpayer's method does not clearly reflect income, he may select a method which, in his opinion, does clearly reflect income. ◆ The Taxpayer carries the burden of showing that the method selected by the Commissioner is incorrect, and such burden is extremely difficult to carry. (Citations omitted) • The courts have consistently held that the Commissioner's authority under Section 446(b) permits him to select the method of accounting the Taxpayer must use once he has determined that a taxpayer's method does not clearly reflect income. (Citations omitted) • Accordingly, the TAM concluded that ***the examining agent may compute the Taxpayer's taxable income using any method that clearly reflects the Taxpayer's taxable income.***
Permissible Methods – General Rules	• The Regulations provide two simplified methods for allocating additional Section 263A costs to ending inventory and other eligible property. ◆ ***Producers*** may elect to use the ***simplified production method*** to determine the additional Section 263A costs properly allocable to ending inventories of property produced and other eligible property on hand at the end of the taxable year. [Reg. Sec. 1.263A-2(b)(1)] ◆ ***Resellers*** may elect to use the ***simplified resale method*** to determine the additional Section 263A costs properly allocable to property acquired for resale and other eligible property on hand at the end of the taxable year. [Reg. Sec. 1.263A-3(d)(1)] ◆ The simplified methods are permissible methods for taxpayers eligible to use them. • In general, a taxpayer may elect the simplified production method if engaged in both production and resale activities with respect to items of eligible property. [Reg. Sec. 1.263A- 3(a)(4)] ◆ However, generally, the simplified resale method is only available to a trade or business exclusively engaged in resale activities. [Reg. Sec. 1.263A-3(d)(2)] ◆ Therefore, as a general rule, if a ***reseller is engaged in both*** production and resale activities with respect to the items of eligible property, then ***the reseller may only elect the simplified production method*** and is not allowed to elect the simplified resale method. [Reg. Sec. 1.263A-3(a)(4)] • There are two exceptions to the general rule prohibiting resellers engaged in production activities from using the simplified resale method. Resellers engaged in both production and resale activities are permitted to elect to use the simplified resale method under the following circumstances [Reg. Sec. 1.263A-3(a)(4)] ... ◆ First, a reseller otherwise permitted to use the simplified resale method may use the simplified resale method if its production activities with respect to the items of eligible property are *de minimis* and incident to its resale of personal property. [Reg. Sec. 1.263A-3(a)(4)(ii)] ◆ Second, a reseller otherwise permitted to use the simplified resale method may use the simplified resale method even though it has personal property produced for it (e.g., private label goods) under a contract with an unrelated person if the contract is entered into incident to its resale activities and the property is sold to its customers. [Reg. Sec. 1.263A-3(a)(4)(iii)] • ***In addition to the simplified methods, a taxpayer may use ...*** ◆ ***Specific identification methods*** and/or burden rates described in Reg. Secs. 1.263A-1(f)(2) or (3) if they are reasonable allocation methods within the meaning of Reg. Sec. 1.263A-1(f)(4). ◆ ***Any other reasonable allocation method*** to properly allocate direct and indirect costs among units of property produced or property acquired for resale during the taxable year. [Reg. Sec. 1.263A-1(f)(4)]

What Method of Accounting for Determining Section 263A Costs Will Be Acceptable?

Allocation Methods Available to the Examining Agent	• ***The examining agent's conclusions and options.*** ◆ If the Taxpayer is a reseller with more than *de minimis* production activities, then the Taxpayer must allocate additional Section 263A using the simplified production method. ◆ If the Taxpayer is a reseller with *de minimis* production, the Taxpayer may use the simplified resale method. ◆ If the Taxpayer has more than *de minimis* production activities, then the agent can require the Taxpayer to use the simplified production method in order to capitalize all additional Section 263A costs to both production and resale property that remain on hand at year end. • If the Taxpayer's production activities are determined to be *de minimis*, the Taxpayer can be required to use the simplified resale method to capitalize additional Section 263A costs. [Reg. Secs. 1.263A-3(a)(4)(ii) and 1.263A-3(a)(4)(iv)] • Because the Taxpayer has *de minimis* production costs incident to its resale activities and property produced under contract, it is required to capitalize all costs allocable to eligible property produced using the simplified resale method. ◆ The Taxpayer must include any *de minimis* production costs, subcontractor's costs, as well as handling costs incurred in servicing taxpayer-owned vehicles, in the storage and handling costs absorption ratio or in the purchasing costs absorption ratio of the simplified resale method to the extent these costs are not capitalized to the basis of the vehicles. • Even if the Taxpayer's production activities are *de minimis*, the examining agent can require the Taxpayer to use the simplified production method. ◆ See Reg. Sec. 1.263A-3(a)(4) which provides that resellers may elect the simplified production method if engaged in both production and resale activities with respect to items of eligible property. • Another alternative is that the examining agent can require the Taxpayer to use any other method that is a reasonable method within the meaning of Reg. Sec. 1.263A-1(f)(4).
Taxpayer's Arguments	• The Taxpayer argued that even if it were a producer, the simplified production method does not clearly reflect income. • Due to the nature of its activities, the Taxpayer has little inventory on hand at year-end that is produced. Therefore, income is distorted if production costs are allocated to inventory that was not produced. • The Taxpayer's position is that it should be entitled to use a method that capitalizes only necessary preproduction costs (as provided in Reg. Sec. 1.263A-2(a)(3)(ii)) and whatever small amount would apply to the vehicles in process at the body shop.
The TAM's Conclusions	• Although they may produce results that differ from a facts-and-circumstances method, the simplified production method and the simplified resale method clearly reflect income when properly applied by an eligible taxpayer. [See T.D. 8482, 1993-2 C.B. 77, 83-4] • As explained above, the examining agent may require the Taxpayer to use any permissible method, including a reasonable method under Reg. Sec. 1.263A-1(f)(4), the simplified production method, or the simplified resale method if the Taxpayer's production activities are *de minimis*. • If the examining agent requires the Taxpayer to use one of the simplified methods and the Taxpayer is not satisfied with the results of that method, the Taxpayer may request to change its method of accounting to a facts-and-circumstances allocation method. • Bottom line: The Commissioner may require the Taxpayer to use ***any method that*** (in the Commissioner's opinion) ***clearly reflects income***.

Simplified Resale Method	***SIMPLIFIED RESALE METHOD WITHOUT HISTORIC ABSORPTION RATIO ELECTION*** ***Reg. Sec. 1.263A-3(d)(3)(i) ...(ii) ... (iii)*** Page 1 of 2
	General Allocation Formula ... Reg. Sec. 1.263A-3(d)(3)(i)
(A) In General	• Under the simplified resale method, the additional Section 263A costs allocable to eligible property remaining on hand at the close of the taxable year are computed as follows: Combined absorption ratio* x Section 471 costs remaining on hand at year end
(B) Effect of Allocation	• The resulting product under the general allocation formula is the additional Section 263A costs that are added to the taxpayer's ending Section 471 costs to determine the Section 263A costs that are capitalized.
(C) Definitions	• ***Combined absorption ratio.**** The combined absorption ratio is defined as the sum of the storage and handling costs absorption ratio [as defined below in (D)] and the purchasing costs absorption ratio [as defined below in (E)]. • ***Section 471 costs remaining on hand at year end.*** Section 471 costs remaining on hand at year end mean the Section 471 costs that the taxpayer incurs during its current taxable year, which remain in its ending inventory or are otherwise on hand at year end. [Section 471 costs are defined in Reg. Sec. 1.263A-1(d)(2).] ◆ For LIFO inventories of a taxpayer, the Section 471 costs remaining on hand at year end means the increment, if any, for the current year stated in terms of Section 471 costs. (See paragraph (d)(3)(ii) of this Section for special rules applicable to LIFO taxpayers.) ◆ Additional Section 263A costs that are allocated to inventories on hand at the close of the taxable year under the simplified resale method of this paragraph (d) are treated as inventory costs for all purposes of the Internal Revenue Code.
(D) Storage & Handling Costs Absorption Ratio	• The ***storage and handling costs absorption ratio*** (i.e., fraction) is determined as follows: Current year's storage and handling costs / 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 taxpayer's property acquired for resale and other eligible property. • Storage and handling costs must include the amount of allocable mixed service costs (as determined in (F) below). • Beginning inventory in the denominator of the storage and handling costs absorption ratio refers to the Section 471 costs of any property acquired for resale or other eligible property held by the taxpayer as of the beginning of the taxable year. • Current year's purchases generally mean the taxpayer's Section 471 costs incurred with respect to purchases of property acquired for resale during the current taxable year. • In computing the denominator of the storage and handling costs absorption ratio, a taxpayer using a dollar-value LIFO method of accounting, must state beginning inventory amounts using the LIFO carrying value of the inventory and not current-year dollars.
(E) Purchasing Costs Absorption Ratio	• The ***purchasing costs absorption ratio*** (i.e., fraction) is determined as follows: Current year's purchasing costs / 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 taxpayer's property acquired for resale and eligible property. • Purchasing costs must include the amount of allocable mixed service costs (as determined in (F) below). • Current year's purchases generally mean the taxpayer's Section 471 costs incurred with respect to purchases of property acquired for resale during the current taxable year.
Combined Absorption (CA) Ratio = Storage & Handling Costs (CA) Ratio + Purchasing (CA) Ratio	

Simplified Resale Method	***SIMPLIFIED RESALE METHOD WITHOUT HISTORIC ABSORPTION RATIO ELECTION Reg. Sec. 1.263A-3(d)(3)(i) ...(ii) ... (iii)***
(F) Allocable Mixed Service Costs	• In general, if a taxpayer allocates its mixed service costs to purchasing costs, storage costs and handling costs using a method described in Reg. Sec. 1.263A-1(g)(4), the taxpayer is not required to determine its allocable mixed service costs under this paragraph (d)(3)(i)(F). • However, if the taxpayer uses the simplified service cost method, the amount of mixed service costs allocated to and included in purchasing costs, storage costs, and handling costs in the absorption ratios above is determined as follows: $\frac{\text{Labor costs allocable to activity}}{\text{Total labor costs}} \times \text{Total mixed service costs}$ • ***Labor costs allocable to activity*** are defined as the total labor costs allocable to each particular activity (i.e., purchasing, handling and storage), excluding labor costs included in mixed service costs. • ***Total labor costs*** are defined as the total labor costs (excluding labor costs included in mixed service costs) that are incurred in the taxpayer's trade or business during the taxable year. (See Reg. Sec. 1.263A-1(h)(6) for the definition of total mixed service costs.)
LIFO Taxpayers Electing Simplified Resale Method ... Reg. Sec. 1.263A-3(d)(3)(ii)	
(A) In General	• Under the simplified resale method, a taxpayer using a LIFO method must calculate a particular year's index (e.g., under Reg. Sec. 1.472-8(e)) without regard its additional Section 263A costs. • Similarly, a taxpayer that adjusts current-year costs by applicable indexes to determine whether there has been an inventory increment or decrement in the current year for a particular LIFO pool must disregard the additional Section 263A costs in making that determination.
(B) LIFO Increment	• If the taxpayer determines there has been an inventory increment, the taxpayer must state the amount of the increment in current-year dollars (stated in terms of Section 471 costs). ◆ The taxpayer then multiplies this amount by the combined absorption ratio. ◆ The resulting product is the additional Section 263A costs that must be added to the taxpayer's increment for the year stated in terms of Section 471 costs.
(C) LIFO Decrement	• If the taxpayer determines there has been an inventory decrement, the taxpayer must state the amount of the decrement in dollars applicable to the particular year for which the LIFO layer has been invaded. • The additional Section 263A costs incurred in prior years that are applicable to the decrement are charged to cost of goods sold. • The additional Section 263A costs that are applicable to the decrement are determined by multiplying the additional Section 263A costs allocated to the layer of the pool in which the decrement occurred by the ratio of the decrement (excluding additional Section 263A costs) to the Section 471 costs in the layer of that pool.
Permissible Variations of the Simplified Resale Method ... Reg. Sec. 1.263A-3(d)(3)(iii)	
(A) & (B) Permitted Variations of the Simplified Resale Method	• The exclusion of beginning inventories from the denominator in the storage and handling costs absorption ratio formula in paragraph (d)(3)(i)(D) of this section; or • Multiplication of the storage and handling costs absorption ratio [in paragraph (d)(3)(i)(D) of this Section] by the total of Section 471 costs included in a LIFO taxpayer's ending inventory (rather than just the increment, if any, experienced by the LIFO taxpayer during the taxable year) for purposes of determining capitalizable storage and handling costs. ◆ *Comment: This is what was done in TAM 200736026.* ◆ *Note: The language above does not include the purchasing costs absorption ratio ... i.e., only the storage and handling costs absorption ratio would be multiplied by the total Section 471 costs.*

FIFO ... Example 1	***SIMPLIFIED RESALE METHOD WITHOUT HISTORIC ABSORPTION RATIO ELECTION*** ***FIFO Inventory Method ... Reg. Sec. 1.263A-3(d)(3)(iv)***
(i)	• Taxpayer S uses the FIFO method of accounting for inventories. ◆ S's beginning inventory for 1994 (all of which was sold during 1994) was $2,100,000 (consisting of $2,000,000 of Sec. 471 costs and $100,000 of additional Sec. 263A costs). • During 1994, S makes purchases of $10,000,000. • S incurs purchasing costs of $460,000, storage costs of $110,000, and handling costs of $90,000. • S's purchases (Section 471 costs) remaining in ending inventory at the end of 1994 are $ 3,000,000.
(ii) ***Mixed Service Costs***	• In 1994, S incurs $400,000 of total mixed service costs and $1,000,000 of total labor costs (excluding labor costs included in mixed service costs). • In addition, S incurs the following labor costs (excluding labor costs included in mixed service costs): ◆ Purchasing .....$100,000 ◆ Storage.....$200,000 ◆ Handling .....$200,000 • Accordingly, the following ***mixed service costs*** must be included in purchasing costs, storage costs and handling costs as capitalizable mixed service costs: ◆ Purchasing .....$40,000 ([$100,000 divided by $1,000,000] multiplied by $400,000) ◆ Storage.....$80,000 ([$200,000 divided by $1,000,000] multiplied by $400,000) ◆ Handling .....$80,000 ([$200,000 divided by $1,000,000] multiplied by $400,000)
(iii) ***Computation of Purchasing Costs Absorption Ratio***	• S computes its ***purchasing costs absorption ratio*** for 1994 as follows: $\frac{\text{1994 purchasing costs}}{\text{1994 purchases}} = \frac{\$460,000 + \$40,000}{\$10,000,000}$ $= \frac{\$500,000}{\$10,000,000} = 5.0\%$
(iv) ***Computation of Storage & Handling Costs Absorption Ratio***	• S computes its ***storage and handling costs absorption ratio*** for 1994 as follows: $\frac{\text{Storage and handling costs}}{\text{Beginning inventory plus 1994 purchases}} = \frac{(\$110,000 + \$80,000) + (\$90,000 + \$80,000)}{\$2,000,000 + \$10,000,000}$ $= \frac{\$190,000 + \$170,000}{\$12,000,000}$ $= \frac{\$360,000}{\$12,000,000} = 3.0\%$
(v) ***Additional Costs to Be Capitalized***	• S's combined absorption ratio is 8.0%, or the sum of the purchasing costs absorption ratio (5.0%) and the storage and handling costs absorption ratio (3.0%). • Under the simplified resale method, S determines the additional Section 263A costs allocable to its ending inventory by multiplying the combined absorption ratio by its Section 471 costs with respect to current year's purchases remaining in ending inventory: ***Additional Section 263A costs = 8.0% x $3,000,000 = $240,000***
(vi)	• S adds this $240,000 to the $3,000,000 of purchases remaining in its ending inventory to determine its total ending FIFO inventory of $3,240,000.

LIFO ... Example 2	*SIMPLIFIED RESALE METHOD WITHOUT HISTORIC ABSORPTION RATIO ELECTION* *LIFO Inventory Method ... Reg. Sec. 1.263A-3(d)(3)(iv)*
(i)	• Taxpayer T uses a dollar-value LIFO inventory method. • T's beginning inventory for 1994 is $2,100,000 (consisting of $2,000,000 of Section 471 costs and $100,000 of additional Section 263A costs). • During 1994, T makes purchases of $10,000,000. • In addition, T incurs purchasing costs of $460,000, storage costs of $110,000, and handling costs of $90,000. • T's 1994 LIFO increment is $1,000,000 ($3,000,000 of Section 471 costs in ending inventory less $2,000,000 of Section 471 costs in beginning inventory).
(ii) *Mixed Service Costs*	• In 1994, T incurs $400,000 of total mixed service costs and $1,000,000 of total labor costs (excluding labor costs included in mixed service costs). • In addition, T incurs the following labor costs (excluding labor costs included in mixed service costs): ◆ Purchasing .....$100,000 ◆ Storage.....$200,000 ◆ Handling .....$200,000 • Accordingly, the following ***mixed service costs*** must be included in purchasing costs, storage costs, and handling costs as capitalizable mixed service costs: ◆ Purchasing .....$40,000 ([$100,000 divided by $1,000,000] multiplied by $400,000) ◆ Storage.....$80,000 ([$200,000 divided by $1,000,000] multiplied by $400,000) ◆ Handling .....$80,000 ([$200,000 divided by $1,000,000] multiplied by $400,000)
Absorption Ratio	• Based on these facts, T determines that it has a combined absorption ratio of 8.0%. • This computation is the same as the computation for the FIFO example *(Example 1)*.
Computation of Purchasing Costs Absorption Ratio	• T computes its ***purchasing costs absorption ratio*** for 1994 as follows: $\frac{\text{1994 purchasing costs}}{\text{1994 purchases}} = \frac{\$460,000 + \$40,000}{\$10,000,000}$ $= \frac{\$500,000}{\$10,000,000} = 5.0\%$
Computation of Storage & Handling Costs Absorption Ratio	• T computes its ***storage and handling costs absorption ratio*** for 1994 as follows: $\frac{\text{Storage and handling costs}}{\text{Beginning inventory plus 1994 purchases}} = \frac{(\$110,000 + \$80,000) + (\$90,000 + \$80,000)}{\$2,000,000 + \$10,000,000}$ $= \frac{\$190,000 + \$170,000}{\$12,000,000}$ $= \frac{\$360,000}{\$12,000,000} = 3.0\%$
(iii) *Multiplication of Absorption Ratio by Current Year Increment*	• To determine the additional Section 263A costs allocable to its ending inventory, T multiplies its combined absorption ratio (8.0%) by the $1,000,000 LIFO increment. • T's additional Section 263A costs allocable to its ending inventory are $80,000 ($1,000,000 multiplied by 8.0%). • This $80,000 is added to the $1,000,000 to determine a total 1994 LIFO increment of $1,080,000. • T's ending inventory is $3,180,000 (its beginning inventory of $2,100,000 plus the $1,080,000 increment).
(iv) *LIFO Decrement In Next Year*	• In 1995, T sells one-half of the inventory in its 1994 LIFO increment. ◆ In other words, T has a decrement of $500,000 in 1995. • T must include $40,000 in its cost of goods sold for 1995. This is the amount of additional Section 263A costs relating to this inventory decrement (i.e., one-half of the $80,000 additional Section 263A costs capitalized in 1994 ending inventory, or $40,000).

Practice Guide	*CAN YOUR DEALERSHIP GET A BETTER COST CAP RESULT? TAM LANGUAGE THAT COULD BE HELPFUL TO THE TAXPAYER*
Is the TAM All that Bad? ***Can You Find Better Alternatives?***	• The TAM is a very long document, and our analysis divided it so that the overview and the summary portion (pages 8-16) could be read on a stand-alone basis. • The detailed issue-by-issue analysis (pages 17-33) includes supplementary information and other observations. • This *Practice Guide* may be helpful as a review to focus on those TAM conclusions where, with a combination of better facts or more detailed information, a dealership might be able to end up with a lesser amount of additional Section 263A costs being capitalized if its CPAs are willing and able to crunch the numbers and think creatively.
	Production & Handling Activities
Issue #1	• With respect to new and/or used vehicles owned by the taxpayer (i.e., ***taxpayer-owned vehicles***), when the Taxpayer (or a subcontractor working for the Taxpayer) installs parts to new and/or used vehicles owned by the Taxpayer, the installation of parts ***may*** constitute production activities. ◆ The word "may" is conditional ... What are the conditions? • ***Production vs. handling.*** Whether the Taxpayer's activities in servicing new and used vehicles constitute production (under Reg. Sec. 1.263A-2) or handling (under Reg. Sec. 1.263A-3(c)(4)) ***depends on the specific facts.***
Issue #2	• The TAM concluded that the Taxpayer's repair/installation activities conducted in the dealership's service department could not be regarded as merely *service* activities. ◆ The TAM added ... ***However, the mere fact that the exception does not apply does not mean that the Taxpayer is engaged in a production activity subject to Section 263A.***
Issue #3	• This issue seems to be pretty straight-forward, leaving very little room for alternatives.
Issue #4	• Given the conclusion of the TAM regarding customer-owned vehicles (in Issue #1), the labor cost for the second part of the presumptive test should not include labor attributable to customer-owned vehicles. ◆ In other words, the labor cost for the second part of the test should only include labor cost attributable to taxpayer-owned vehicles. • A taxpayer's production activities may still be considered *de minimis* based on a consideration of all of the facts and circumstances of the case. [Reg. Sec. 1.263A-3(a)(2)(iii)(A)(1)] This would apply even though the taxpayer fails to satisfy the presumptive test described in the Regulations. • The Taxpayer did not provide information to the National Tax Office showing which costs and gross receipts are attributable to (1) taxpayer-owned vehicles and to (2) customer-owned vehicles. ◆ Based on this lack of information, the National Office concluded, ***"We cannot determine whether the Taxpayer's production activities are de minimis."*** ◆ Further information could be favorable to the Taxpayer on this issue, and there's more work ahead for the agent if the Taxpayer can provide the data. ◆ The National Office stated that the examining agent should look at all the facts and circumstances to determine whether the production activities of the Taxpayer could/should be considered to be *de minimis*. • Factors to be considered include ... ◆ The relative material and labor costs added to ***the particular vehicle*** compared to the cost of the particular vehicle and ◆ The relative material and labor costs added to ***all the vehicles*** compared to the cost of all vehicles. ◆ The value added to the vehicle by the production activity. ◆ *Note: There could be other factors to be considered ... The 3 above are the only that were listed in the TAM.* ◆ *For example, often it takes just a few minutes for a technician to add a $300 item to a $50,000 vehicle. This is where the Regulations may provide some relief.* • On a definitely optimistic note, the TAM concluded ... ***"We believe these factors may demonstrate that the Taxpayer's production activities are de minimis."***
Issue #5	• Costs attributable to certain ***minor*** repair/installation activities with respect to taxpayer-owned vehicles are handling costs. ◆ How far can the adjective "minor" be stretched? (continued)

Practice Guide	CAN YOUR DEALERSHIP GET A BETTER COST CAP RESULT? TAM LANGUAGE THAT COULD BE HELPFUL TO THE TAXPAYER
Issue #5 (continued...)	• With respect to the TAM's holding that ***costs attributable to installing parts in customer-owned vehicles are handling costs,*** the TAM states ... "Taxpayer's customers ... can buy and install the parts themselves, or they can pay a fee and have the Taxpayer install the parts. ◆ *Given the increasing modular designs, assemblies and generally increasing inability to diagnose what's causing a vehicle to operate inefficiently or improperly without computer diagnostics and software, the analogy made by the National Tax Office here seems to be very strained, especially with respect to later model vehicles.*
Issue #6	• This issue seems to be pretty straight-forward, leaving very little room for alternatives.
	Retail Sales Facilities
Issues #7-#9 Sales	• ***Some parts sales*** (including parts sold to the Taxpayer's service department) made to end users ***do appear to qualify as retail sales*** where they are on-site sales made to final purchasers. • The analysis of sales made by the dealership's parts department will require considerably more work (or documentation) in order to support a determination of what percent of the parts department sales are really on-site sales to "end user retail customers." This will require detailed review of sales records and, possibly, resort to reasonable estimates.
Issues #7-#9 Location Differences	• ***Specific facts for the dealership in this TAM.*** The dealership's activities are conducted at two locations. These locations are one-half mile apart. The TAM concluded that the Taxpayer's storage facility at Location 2 is an off-site storage facility because it is too far from Location 1 (one-half mile) to be considered as part of one integrated retail sales facility. ◆ The dealership's second location does not have any identification to indicate that the vehicles on the property there are owned by, or available for sale by, the dealership conducting business at the first location. In addition, the dealership does not have a sales office at this second location, nor are any sales activities conducted there. • ***Other dealerships may have location and activity facts that can be distinguished.*** For many dealerships whose activities are conducted on more than one plot of land, their facts will significantly differ from facts of the dealership in the TAM. ◆ Other dealerships may conduct business on several locations that are much closer to each other geographically (although, not necessarily across the alley from each other as in the Reg. example). ◆ Also, for these dealerships, there may be considerable or significant dealership identification (signage, etc.) and sales activity conducted at the second or other location(s). • Depending on the facts and circumstances in each individual case, the result for these dealers with multiple locations could be that considerably fewer dollars would be capitalized as additional Section 263A costs if these locations are dual-function storage facilities.
	Identification & Allocation of Costs ... & Methods
Issue #10	• To the extent that the Taxpayer's purchasing, storage and handling costs are not fully allocable to resale or production activities, ***the Taxpayer can make a reasonable allocation between capitalizable activities and deductible activities.*** [Reg. Sec. 1.263A-1(e)(3)(i)] ◆ For example, if a person performs both purchasing and non-purchasing activities, the Taxpayer must reasonably allocate the person's labor costs between these activities. ◆ Storage costs are capitalized to the extent they are attributable to an off-site storage facility. ◆ Handling costs generally are required to be capitalized to the extent they are not incurred at a retail sales facility.
Issue #11	• This issue seems to be pretty straight-forward, leaving very little room for alternatives.
Issue #12	• The TAM concluded that ***the examining agent may compute the Taxpayer's taxable income using any method that clearly reflects the Taxpayer's taxable income.*** • Permissible methods suggested by the IRS National Office in the TAM include... ◆ A reasonable method under Reg. Sec. 1.263A-1(f)(4). ◆ The simplified production method ◆ The simplified resale method ***if*** the Taxpayer's production activities are *de minimis*." ◆ A facts-and-circumstances allocation method. • The "separate trades or businesses" line of reasoning may prove helpful under certain circumstances. • Where LIFO is used to value inventories, the results may be less drastic than under FIFO.

SELECTED PRIOR ARTICLES
ON THE APPLICATION OF SECTION 263A TO AUTOMOBILE DEALERSHIPS

DTW Articles

The *De Filipps' Dealer Tax Watch* newsletter is a quarterly publication of essential tax information by Willard J. De Filipps, CPA, P.C., 317 West Prospect Avenue, Mt. Prospect, IL 60056. It is intended to provide accurate, general information on tax matters and it should not be construed as offering accounting or legal advice or accounting or legal opinion on any specific facts or circumstances. The contents are intended for general information purposes only. Readers should consult their certified public accountant, attorney and/or other competent advisors to discuss their own situations and specific income, gift and estate tax questions. Mechanical or electronic reproduction or photocopying is prohibited without permission of the publisher. Annual subscription: $475 plus shipping and handling. Back issues available for $80 each. Not assignable without consent. Any quoted material must be attributed to *De Filipps' Dealer Tax Watch* published by Willard J. De Filipps, CPA, P.C. Editorial comments and article suggestions are welcome and should be directed to Willard J. De Filipps at (847) 577-3977; FAX (847) 577-1073 or by email to cpawjd@aol.com.

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De Filipps' DEALER TAX WATCH

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