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DEALER TAX WATCH

A Periodic Update of Essential Tax Information

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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. 2012 IS CERTAINLY OFF TO AN INTERESTING START. In the Year-End 2011 Edition, we said a not-too-fond goodbye to "old" Section 263A ... the inventory cost capitalization rules that the IRS interpreted so grotesquely for so long. In that Edition, I included several articles that you may want to keep for future reference if your dealership clients conduct activities and operations that do not fall within the safe harbors.

On the other hand, if your dealerships are securely "docked" in the harbors, all you need to think about is capitalizing purchasing costs which should be almost inconsequential, in most cases. Until there is some new guidance from the IRS ... so long, farewell, goodbye.

So, what's now taking the top spot on our list of critical dealership tax issues? That's easy... The tax treatment of the receipt by dealerships of payments from manufacturers under their image upgrade programs. As discussed below, that is the new #1.

Timelines. The Timeline for 2011 that was included on page 5 of the Year-End Edition of the *DTW* seemed to stop abruptly with the entry for July 26. In fact, nothing much occurred after July until late in the year (after we went to press with the Year-End Edition).

On December 27, 2011, the IRS published Temporary Regulations which provide guidance on the application of Sections 162(a) and 263(a) to amounts paid to acquire, produce, or improve tangible property. These Regulations became effective January 1, 2012 and are extremely important to all dealerships, and most other businesses, as well.

Accordingly, on page 5, you'll find a revised Timeline for 2011.

Most of what is included in the 2012 year-to-date Timeline (on pages 6-7) relates to developments and activities bearing on (1) dealership treatment of manufacturer upgrade payments, (2) the new Section 263(a) Regulations, and/or (3) the potential repeal of the LIFO method.

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WATCHING OUT FOR

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#2. TAX ISSUES WORKSHOP AT NADA CONVENTION. The 2012 NADA Convention *Dealer Tax Issues* Workshop covered many issues of importance to dealerships. The article (beginning on page 8) brings you up-to-date on the topics covered by the Panel which consisted of the IRS Motor Vehicle Technical Advisor (Ms. Terri Harris) and representatives from three prominent CPA firms that have significant dealership clientele.

The Workshop allocated a considerable amount of time to the discussion of manufacturer assistance payments to dealerships for facility improvements. The consensus of the panelists (although, there seemed to be one very strong dissent) was that these payments received by dealerships would be includable (i.e., taxable as ordinary income) upon receipt.

However, the Panelists emphasized that the adverse tax impact resulting from immediate taxability could be significantly minimized if dealers and their advisors carefully considered the appropriate use of several techniques. Among the major considerations in this regard are the provisions in the new Regulations under Section 263(a).

#3. UPDATE ON TAX TREATMENT OF MANUFACTURE UPGRADE PAYMENTS. As indicated above, this is the new major tax issue confronting the dealership industry. In the Year-End 2011 Edition of the *Dealer Tax Watch*, I included a lengthy discussion of manufacturer upgrade payments and related tax issues.

Beginning on page 16, I've included an update of this material. This doesn't repeat the specifics on Section 118 and/or the case law, but it concentrates on more recent developments and reflects a number of conversations with practitioners in the meantime. It also sets forth my analysis of why I believe the controlling precedent in this area is the *John White* case and why reliance on certain other case law is misplaced.

So far this year, there hasn't been any specific precedential guidance from the IRS on this subject. It would appear, however, that the position of the IRS (Motor Vehicle Technical Advisor) was clarified in her statements at the 2012 NADA Workshop.

The *Automotive Alert* issued in February by the Motor Vehicle Technical Advisor "is not an official IRS pronouncement and may not be cited as authority." However, it does state the following in its concluding paragraph... "The *White* case in particular appears to be on point with the general facts surrounding the payments [from the automobile manufacturers] and should be considered carefully when evaluating the proper treatment of image upgrade payments." The full text of this *Alert* begins on page 26.

A note of caution and concern for many practitioners ... although not widely discussed yet ... is that the IRS may not consistently or uniformly across-the-board monitor (or police, if you wish) those dealerships and their advisors who are trying to fly below the radar on this issue of current taxability of the payments. I've had several discussions with CPAs who have lost their dealership clients to other CPA firms that are apparently willing to attempt to justify the immediate non-taxability of the payments under one rationale or another.

Regrettably, this is reminiscent of the situation arising many years ago in the context of the compliance of dealership financial statements with the LIFO conformity issue when some dealers buckled under and voluntarily paid a penalty for conformity violations, while other dealers - on the advice of their CPAs - did not. Gresham's Law ... in the context of bad advice driving out good advice ... caused many CPAs to lose dealership clients. And, in the final analysis, the IRS never followed up, and those dealerships and their advisors who took their chances made those who complied voluntarily look like saps.

#4. THE TREASURY'S "NEW" SECTION 263(a) PARADIGM SHIFT. As indicated in the discussion of the 2011 Timeline, in late December 2011, the IRS published Temporary Regulations which provide guidance on the application of Sections 162(a) and 263(a) to amounts paid to acquire, produce, or improve tangible property.

In this Edition, beginning on page 36, I've included an overview of the new Regulations. I've also analyzed the specific provisions and examples in the Regulations which directly relate to dealership facility expansion, modernization and upgrade activities. The specific examples were cited by Ms. Terri Harris during the 2012 NADA Tax Issues Workshop as warranting dealers' attention.

In addition, the Motor Vehicle Technical Advisor released an *Automotive Alert* addressing these Regulations in February. This *Alert* appears on pages 50-53.

Needless to say, this new shift in the way the IRS and the Treasury view capitalization versus repair expense issues necessitates a shift in our own thinking on these matters, too.

#5. IRS UPDATES INSTRUCTIONS FOR FORM 3115 FOR AUTOMATIC ACCOUNTING METHOD CHANGES. Form 3115 is the form that taxpayers must file when they are changing most methods of accounting. The IRS recently updated the Instructions for this Form by a revision dated March 2012. This supersedes the previous revision of the Instructions dated December 2009.

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This revision updates all references relating to automatic changes to refer to Revenue Procedure 2011-14 (which superseded Rev. Proc. 2008-52) as the controlling document. For a summary of this update to the Instructions, see page 11.

The total of the automatic changes that do not require advance permission from the IRS is now 180. (But that includes several "automatics" that are now obsolete.) The Automatic Change List will continue to grow over time.

The revised Instructions also include many new automatic changes in methods which may be made in connection with the new Temporary Regulations under Section 263(a) and other Sections which concern the proper treatment of expenditures for repairs and improvements to tangible property and related matters.

For a summary of these automatic changes, see pages 42-43 and pages 58-59.

#6. *DE FILIPPS UNIVERSITY* AUDIO SEMINARS. So far this year, I have presented 3 more audio seminars to supplement this publication and various speaking engagements. These audio seminars (listed below) were 2 hours in length. I plan to continue to offer additional audio seminars throughout the year. Please call or e-mail me with any suggestions you might have for future seminar topics.

Complete information about *De Filipps University* and each audio seminar is available on our web site (www.defilipps.com). If you missed any of our 2011 and 2012 seminars listed below, On Demand Audio Recordings (which include all of the presentation materials for that seminar) can be purchased at www.krm.com/wjd (on the "Recordings" tab).

Participants find these audio seminars to be practical and cost efficient because there is no limit on the number of individuals who can listen to a presentation at one registration site. In addition, no travel time, expenses or other inconvenience are incurred. Also, some firms use the information and materials from these seminars to develop, enrich and customize their own in-house training programs.

To facilitate CPE credits for participants, we are registered as a sponsor of continuing education with the National Association of State Boards of Accountancy (NASBA).

#7. UPDATE ON CLASS ACTION "TAKINGS" SUITS. In the Watch Out #9 of the Year-End 2011 Edition of the *DTW*, one of the items discussed under the Section "Manufacturer Bankruptcies & Dealership Closings" was the "takings" suits filed by dealerships. Briefly, on February 17, 2011, a group of

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Chrysler dealers affected by Chrysler's bankruptcy in 2009 filed a class action suit against the United States of America in the U.S. Court of Federal Claims.

A few days later (Feb. 21, 2011), a group of General Motors dealers affected by GM's bankruptcy in 2009 filed a class action suit against the United States of America in the U.S. Court of Federal Claims.

In this litigation, dealers are suing the U.S. Government for the alleged unconstitutional taking of their dealerships (in violation of the 5th Amendment to the Constitution) without fair and just compensation.

Recently, the Government's attorneys were rebuffed in the motions they filed to have the suits dismissed. Accordingly, these suits are now in the pre-trial discovery phase, and as reported in the *Wall Street Journal* recently, "The dealers' lawyers are seeking government documents that they hope will show that automakers had to eliminate some dealerships as a condition of receiving funds from the government's Troubled Asset Relief Program."

These cases are expected to move slowly through the system and may end up before the Supreme Court.

#8. STATUS OF LIFO ... WILL LIFO BE AROUND NEXT YEAR? The answer is that no one can really be sure.

Earlier this year, the Obama Administration again included a proposal to eliminate the use of LIFO as part of its 2013 Revenue Proposals. The Administration's proposal - if it were to come to pass - at least would provide a 2-year stay of execution if broad repeal were to be the fate of LIFO.

Also, in the meantime, there has been one bill introduced to immediately repeal the use of LIFO by certain major integrated oil companies.

There has been a lot of speculation over the possibility that the blending of International Financial Reporting Standards (IFRS) and U.S. Generally Accepted Accounting Principles (GAAP) would automatically result in the "effective repeal" of the use of the LIFO method for U.S. businesses.

Many who lobbied Congress to repeal LIFO have argued that, as a practical matter, the repeal of LIFO was inevitable as soon as U.S. GAAP reporting standards (which permit LIFO) were absorbed and eliminated via "convergence" with global or European-style IFRS.

The "inevitability" of the demise of LIFO based on this assumption is now in considerable doubt. This doubt has arisen because of recent expressions of interest by the SEC in evaluating a new approach for the more gradual, and less all-inclusive, integration of U.S. GAAP and IFRS. This new approach would not, per se, either directly or indirectly prohibit the use of LIFO by U.S. companies reporting to the SEC.

Accordingly, there are several factors bearing on the retention - repeal status of LIFO, and these factors change in ways that no one can really measure.

#9. WORSE YET ... POSSIBLE REPEAL OF LCM METHODS. Whenever Administration or legislative proposals have been set forth to eliminate the use of LIFO, these proposals have also included - almost as a "throw-away" - the elimination of two other significant inventory methods of accounting ... namely the use of the lower-of-cost-or-market (LCM) method and the subnormal goods method.

Elimination of the ability to write used vehicles down to lower-of-cost-or-market values would significantly hurt all automobile dealers. The Administration's current proposal would take effect in 2014 and allow dealers only a 4-year spread period.

These important matters are fully discussed in the Mid-Year 2012 Edition of the *LIFO Lookout*.

#10. SURVEY OF DEALERSHIP LIFO RESERVES. In the Mid-Year 2012 Edition of the *LIFO Lookout*, I also included the results of a survey that show the inventory levels and corresponding LIFO reserves for almost 100 dealerships for whom we do LIFO calculations covering the four-year period 2008-2011.

This information (current as of Dec. 31, 2011) shows how heavily these dealerships not only use LIFO but rely on LIFO for increased cash flow (as generated by the reduction of their income tax liabilities) to replace their inventories so that they can stay in business and finance other pressing obligations and challenges.

#11. UPDATED INDEX OF *DEALER TAX WATCH* ARTICLES ... 18 YEARS. We have updated our Index of all articles appearing in the *Dealer Tax Watch* from our first issue, June 1994, through December 2011.

This electronically searchable and user-friendly Index is available on our web site (www.defilipps.com) for your reference purposes. As with last year's Index, you can search the Index by keyword(s), and you can also save the 70-page Index on your computer for handy reference and printing.

The ten sections of our Index of Articles are listed 60.

DTW 2011 Timeline	*JAN. 1 TO DEC. 31, 2011 ... THE YEAR IN REVIEW*
January 10	• ***Revenue Procedure 2011-14*** revised and updated the procedures, including those for filing Forms 3115, for taxpayers making designated ***automatic*** changes in accounting methods. ◆ This Revenue Procedure included the Section 263A safe harbor elections for motor vehicle dealerships that can be made as automatic changes #150 and #151. ◆ This Revenue Procedure superseded Rev. Proc. 2008-52. • Rev. Proc. 2011-14 is effective for the filing of Forms 3115 on or after January 10, 2011.
January	• IRS Motor Vehicle Technical Advisor published an *Automotive Alert ... "Rev. Proc. 2010-44 Provides UNICAP Relief for Motor Vehicle Dealerships."*
February 17	• A group of Chrysler dealers affected by Chrysler's bankruptcy in 2009 filed a class action against the United States of America in the U.S. Court of Federal Claims.
February 21	• A group of General Motors dealers affected by GM's bankruptcy in 2009 filed a class action against the United States of America in the U.S. Court of Federal Claims.
March 18	• In Field Attorney Advice 20111101F, the IRS held that a dealer was not permitted to deduct goodwill that was associated with two franchises that had been purchased as part of a larger acquisition involving several other franchises. The dealer unsuccessfully claimed that goodwill assigned to these franchises became worthless when the manufacturer notified the dealer that it was terminating his rights to sell vehicles under his franchise agreements.
March 18	• In TAM 201111004, the IRS held that a taxpayer may defer the gain on an involuntary conversion of inventory if the business is in a Federally-declared disaster area. • This guidance emphasizes that the provisions of Code Section 1033(h)(2) should not be overlooked by dealerships located in disaster areas. • The broader application of this TAM is that Section 1033(h)(2) could allow a dealership (in a Federally-designated disaster area) to defer reporting gain if (or when) it reinvests insurance or salvage proceeds in other assets used in the business.
March 18	• In ILM 201120021, the IRS held that an employee tool reimbursement plan failed to meet the business connection requirement (i.e., the first requirement of the three-requirement test that plans must satisfy in order to be accountable plans under Section 62(c)).
June 24	• President Obama's Administration included the repeal of LIFO as a tax break to be eliminated as part of the negotiations to reach a deal on the debt limit increase impasse. • Apparently, this is a follow-up to the President's proposal at the beginning of this year - as part of his "Greenbook" proposals - when he had included the repeal of LIFO after the year 2012 ... with a 10-year spread period for the recapture of the LIFO reserve into taxable income.
July 26	• The Tax Court's decision in *Recovery Group, Inc.* (see April 15 - 2010 Timeline ... T.C. Memo 2010-76) was upheld by the U.S. Court of Appeals for the First Circuit (Docket No. 10-1886). • Both Courts held that a covenant not to compete is 15-year amortizable property under Sec. 197 and that "an interest in a trade or business" under Sec. 197 means ***any portion of the trade or business*** rather than its entirety.
September 15 and/or October 15	• These are the latest extended due dates (depending on the entity) for calendar year 2010 dealership income tax returns electing to be covered under the Section 263A inventory cost capitalization safe harbor rules provided by Rev. Proc. 2010-44. • Also, these are the dates for filing the duplicate copies of Forms 3115 making these elections with the IRS National Office in Washington, DC.
December	• On December 27, 2011, the Treasury published temporary Regulations (T.D. 9564) that provide guidance on the application of Sections 162(a) and 263(a) to amounts paid to acquire, produce, or improve tangible property. ◆ Correlative amendments were also made to Regulations under Sections 167 and 168 with respect to depreciation and disposition of MACRS assets. ◆ Collectively, these Regulations are referred to as the ***new Tangibles Regulations***. • These Regulations became effective January 1, 2012 and also serve as proposed Regulations. • These Regulations have a significant bearing on the extent to which dealerships might be able to reduce the tax impact otherwise associated with having to report manufacturer assistance payments for facility improvements as ordinary income when received. • See January 2012 for issuance of related Revenue Procedures 2012-19 and 2012-20 which provide procedures for automatic changes in accounting methods under these Regulations.

JANUARY 1, 2012 TO DATE

January	• ***New Tangibles Regulations.*** In January 2012, the IRS issued two Revenue Procedures which provide procedures by which taxpayers may make automatic changes in accounting methods (CAMs) under these Regulations. ◆ These CAMs are for taxable years beginning on or after January 1, 2012. • Rev. Proc. 2012-19 is for CAMs involving ... ◆ Materials and supplies ... Under Reg. Secs. 1.162-3T & -4T ◆ Capital expenditures in general ... Under Reg. Sec. 1.263(a)-1T ◆ Transaction costs ... Under Reg. Sec. 1.263(a)-2T ◆ Improvements ... Under Reg. Sec. 1.263(a)-3T • Rev. Proc. 2012-20 is for CAMs involving ... ◆ Leased property ... Under Reg. Sec. 1.167(a)-4T ◆ General asset accounts ... Under Reg. Sec. , 1.168(i)-1T ◆ MACRS (Modified Accelerated Cost Recovery System) property ... Under Reg. Sec. , 1.168(i)-7T ◆ Dispositions of MACRS property ... Under Reg. Sec. 1.168(i)-8T.
January	• ***Request for relief from LIFO recapture due to natural disasters in 2011.*** On January 13, 2012, NADA sent a letter to the Treasury/IRS requesting expedited Section 473 relief for certain franchised auto and truck dealers (Honda, Subaru and Toyota/Scion). • These dealers experienced significant decreases in their new vehicle year-end Dec. 31, 2011 LIFO inventories as a result of the earthquake and tsunami that occurred in Japan in march 2011 and/or the flooding that occurred in Thailand in July 2011. • In March, the Treasury's Office of Tax Policy responded by stating its position that ... ◆ Section 473 cannot be used to provide relief in situations that do not involve a "politically motivated" inventory disruption. ◆ The inventory disruptions caused by (these) natural disasters do not rise to the level of urgency that would justify granting relief under Section 473
February	• ***Repeal of LIFO and other inventory accounting methods.*** President Obama's Administration again included the repeal of the use of the LIFO method as a tax break to be eliminated as part of the fiscal year 2013 revenue proposals. • The repeal of LIFO would start in the first taxable year beginning after the December 31, 2013. ◆ This, in effect, is a 2-year postponement of the repeal advocated by the Administration in prior years' revenue proposals. ◆ The recapture of the LIFO reserve into taxable income would occur ratably over a 10-year spread period. • The Administration's revenue proposals for 2013 would also prohibit the use of (1) the lower-of-cost-or-market method and (2) the subnormal goods method for valuing inventories. ◆ The repeal of these methods would start in the first taxable year beginning after the December 31, 2013. ◆ The Sec. 481(a) adjustments would be taken into income ratably over a 4-year spread period.
February	• ***IRS issues* Automotive Alerts** ◆ *"Factory Image Upgrade Payments"* ◆ *"IRS Issues New Regulations ... Deduction and Capitalization of Expenditures Related to Tangible Property,"* which includes Addendum. ▪ *"Regulation Examples #6,-7 and -8 re: Store Remodels and Refreshes"* ... Addendum to IRS *Automotive Alert*
February	• ***Issuance of "Factory Facilities Programs:*** *An NADA Research Project"* by Glenn Mercer. • This *Report* summarizes the findings of the NADA Factory Facilities Programs Research Project which began in August, 2011 in response to significant expressions of concern and frustration by dealers over how the various manufacturers facility programs were being designed and implemented.
February	• ***2012 NADA Convention Dealer Tax Issues Workshop*** includes significant discussion by panelists of manufacturer assistance payments to dealerships for facility improvements. • Consensus of panelists is that generally, these payments received by dealerships would be includable (i.e., taxable as ordinary income) upon receipt. However, this adverse tax impact can be minimized by the consideration and appropriate use of several techniques.

Timeline	JANUARY 1, 2012 TO DATE (Page 2 of 2)
March	• ***Moratorium on raising Sec. 263(a) issues.*** On March 15, 2012, the LB&I (Large Business & International) Directive stated that for taxpayers who had adopted a method of accounting (change) relating to the conversion of capitalized assets to repair expense under Section 263(a), examining agents should discontinue any current exam activity with regard to these issues and not begin any new exam activity with regard to these issues. • Also, if the taxpayer under exam files a Form 3115 with regard to these issues on or after December 23, 2011, the examining "should risk assess the Form 3115 and determine (in consultation with the *Change in Accounting Method Issue Practice Group*)" whether to examine the Form 3115. ◆ In effect, this is a 2-year "moratorium" or a "stand-down order" on auditing these issues.
March	• ***Form 3115 Instructions.*** The IRS revised the Instructions for Form 3115 (to be used with the December 2009 revision of Form 3115). • This revision of the Form 3115 Instructions lists all of the changes in accounting methods that might be made in connection with the new Tangibles Regulations under Sections 162, 167, 168 and 263(a). ◆ These changes in accounting method may be made under Rev. Procs. 2012-19 or 2012-20.
April	• ***April 15 tax return filings.*** For the first time, some dealers may be required to file Form 8938 ... *Statement of Specified Foreign Financial Assets* with their 2011 income tax returns. • This new annual filing disclosure requirement applies to individuals if they own "specified foreign financial assets" and the value of those assets exceeds the threshold for their filing status. ◆ Specified foreign financial assets include: accounts maintained at foreign financial institutions, stock or security issued by a foreign corporation, any financial instrument held for investment, etc. ◆ The married filing jointly value threshold for filing Form 8938 is met if the aggregate value of all *specified foreign financial assets* exceeds \$100,000 at Dec. 31st or \$200,000 at any point during the tax year (\$50,000 or \$100,000 respectively for individuals filing as single taxpayers). ◆ Failure to comply with these new requirements can result in an extension of the statute of limitations, fines starting at \$10,000 and additional related penalties. • From an automobile dealer perspective, *specified foreign financial assets* may include stock ownership in an offshore reinsurance company. ◆ These disclosures are not required for shareholders of offshore reinsurance companies with valid IRC Section 953(d) elections.
May	• ***Sec. 263(a) Regulations public hearings.*** On May 9, 2012, the IRS held a public hearing at which interested parties presented comments on the Temporary and Proposed Regulations regarding deduction and capitalization of expenditures related to tangible property.
June	• ***Limited potential LIFO repeal.*** On June 7, 2012, a bill was introduced in the House of Representatives (H.R. 5906) that would repeal the use of the LIFO inventory method by integrated oil companies (as defined in Section 167(h)(5)(B)) effective for taxable years beginning after December 31, 2011. ◆ The Section 481(a) adjustment to recapture the LIFO reserve into the income must be taken into account ratably over a period not greater than 8 taxable years, beginning with the first such year.
Schedule UTP Reminder for 2012	• If a dealership files a corporate income tax return (i.e., ***Form 1120***), it will be required to file Schedule UTP *(Uncertain Tax Position Statement)* with its 2012 income tax return if ... ◆ The dealership, or an entity related to the dealership, issues an audited financial statement, ***and*** ◆ The dealership has total assets in excess of \$50 million. • Disclosure(s) on Schedule UTP should be considered by dealerships if they do not report manufacturer assistance payments for facility improvements as ordinary income when received.

NADA CONVENTION TAX ISSUES WORKSHOP COVERS THE WATERFRONT

This year, the 2012 National Automobile Dealers Convention was held in Las Vegas, Nevada in February. For auto dealers and their advisors, a special 75-minute workshop entitled, *"Exploring 2012 Tax Issues with Industry Experts"* addressed many issues of significance.

I attended the first of two presentations of this workshop. I also have watched the DVD of the second presentation of this workshop (which was given two days after the first) which is available directly from www.nadauniversity.com. This article is based upon both experiences.

The workshop was moderated by Paul Metrey, Chief Regulatory Counsel for NADA, and was presented by a Panel consisting of (1) Terri Harris, the IRS Motor Vehicle Technical Advisor/Specialist - Grand Rapids, MI, (2) Joe Magyar, Partner in Crowe Horwath, LLP - Tampa, Florida, (3) Wayne Robbins, Partner in Dixon Hughes Goodman, LLP - Raleigh, NC, and (4) Dan Thompson, Partner in Boyer & Ritter - Camp Hill, PA.

Following brief introductory comments by Paul Metrey, about one-half of workshop time was allocated to a discussion of tax issues other than manufacturer image upgrade payments.

These issues are reported in more detail below. The remaining workshop time was allocated to a more complete discussion of manufacturer image upgrade payments. My report on this portion of the workshop discussion is included in the article which begins on page 16 ... *"Part II ... An Update ... Taxability of Manufacturer Assistance Payments to Automobile Dealerships for Facility Improvements & Image Upgrades."*

NADA'S REQUEST FOR LIFO RELIEF UNDER SECTION 473

Mr. Metrey summarized some of NADA's involvement with tax issues during 2011. He discussed a letter that NADA sent to the Treasury and the IRS requesting expedited relief under Section 473 for franchised car and truck dealers using LIFO who experienced significant reductions in their new vehicle and parts year-end inventory levels.

Manufacturers for many dealers, particularly Honda, Subaru and Toyota/Scion, were affected by the tsunamis and earthquakes earlier last year. These events resulted in many dealers not being able to have enough inventory because of production and supply difficulties and disruptions experienced by the manufacturers. As a result, if those dealers were on LIFO, their inventories were considerably lower, and that, in some instances, resulted in the dealers having to recapture some of their LIFO reserve dollars.

At the time of the Convention, NADA had not received a reply from the Treasury/IRS. However, subsequently, NADA was notified that no relief would be forthcoming under Section 473 for dealers using LIFO.

IRS MOTOR VEHICLE TECHNICAL ADVISOR

Section 263A inventory cost capitalization rules. Ms. Harris did not go into any discussion about Section 263A and the specifics of the safe harbors (provided by Rev. Proc. 2010-44) ... i.e., how they work, how Forms 3115 should be filed, etc.

Ms. Harris emphasized that once 2011 tax returns have been filed, if a dealership did not elect to come under these safe harbors, then the scope limitations which may limit the ability to obtain automatic consent (provided in Rev. Proc. 2011-14) would apply.

In other words, in some cases, now it may be necessary for a dealership to obtain advance consent from the IRS in order to elect to come under the protection of the Section 263A safe harbors.

Employee tool and equipment plans. The second area that Ms. Harris covered related to another situation where the IRS found a tool plan that did not meet the business connection requirements in Section 62(c).

She was referring to ILM 201120021 in which the IRS held that an employee tool reimbursement plan failed to meet the business connection requirement (i.e., the first requirement of the three-prong test that plans must satisfy in order to qualify as accountable plans). The holding by the IRS in this ILM should come as no surprise.

Deductibility of goodwill. Ms. Harris also mentioned another internal IRS guidance relating to the (non-)deductibility of goodwill.

In Field Attorney Advice 20111101F, the IRS held that an auto dealer was not permitted to deduct goodwill that was associated with two franchises that the dealer had purchased as part of a larger acquisition involving three other franchises.

In this case, a dealer had acquired five franchises in one bulk transaction. He had allocated a certain

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amount of the overall purchase price to each of the franchises. Subsequently, the dealer lost two of those franchises, and he wanted to write off the amounts of goodwill that he had originally allocated to the two franchises that were terminated.

The IRS correctly applied Section 197(f)(1) to this case. This Section provides that if a taxpayer acquires several franchises (or other assets that involve goodwill) at the same time in the same transaction, the taxpayer cannot write off any of the goodwill allocated to those assets which are disposed of, so long as the taxpayer retains any of the other assets that had been acquired in the same transaction. The taxpayer simply carries over the amounts of unamortized goodwill (associated with the assets disposed of) to the remaining assets.

Section 263(a) "tangibles" Regulations. The fourth, and most important, area Ms. Harris discussed concerned the Regulations that were issued in late 2011. These Regulations, which became effective January 1, 2012 and also serve as proposed Regulations, provide guidance on the application of Sections 162(a) and 263(a) to amounts paid to acquire, produce, or improve tangible property.

In previous presentations by Ms. Harris at the AICPA Auto Dealership Conferences, she had talked about the increasing attention the IRS was devoting to "capitalization versus repair" issues involving a broad range of taxpayer groups. Now, apparently, these issues are consolidated into the so-called new "tangibles" Regulations. In other words, for tangible assets as contrasted with intangible assets.

Ms. Harris specifically called attention to three examples in the Regulations that she thought would be of greater significance for dealers and accountants in determining how various expenditures relating to dealership facility improvements should be treated for income tax purposes.

These are the so-called "-6, -7 and -8" ... the "refurbishment and refreshment examples" ... that appear to basically dovetail with the Factory image program tax issues.

Ms. Harris also emphasized that if dealers are going to make changes to comply with these new Regulations, then these would technically involve changes in accounting methods and the filing of Forms 3115 with corresponding Section 481(a) adjustments.

As discussed in the article and materials beginning on page 36, these Regulations have a significant bearing on the extent to which dealerships might be able to reduce the tax impact otherwise associated with having to report manufacturer assistance payments for facility improvements as ordinary income when received.

INDUSTRY PANELISTS COMMENTS

Each of the CPA practitioner industry Panelists discussed a few other issues and recent developments.

LIFO inventory. In discussing LIFO inventory matters, Mr. Magyar mentioned that for 2011, there had been considerable inflation in used vehicle prices. He suggested that now might be a good time to take a look at possibly electing LIFO for used vehicles for 2011.

In this regard, Mr. Magyar did not mention any of the technicalities relating to possible financial statement conformity violations, nor the 4-year spread of the Section 481(a) adjustment that would be necessary. One complication might be that, if a dealer were going to make that election to use LIFO for used vehicles, there would have to be a provision for the LIFO inventory valuation reduction in the year-end financial statement. The dealer would have had to know that before the end of the year (or before the year-end financial statement was released) and have some projection related to the LIFO reserve in order to satisfy the year-end financial statement conformity requirement.

The second LIFO-related comment made was in reference to dealers who had lost considerable amounts of inventory at year-end 2011 and how this corresponded with the Section 473 relief that NADA had requested. Some dealers experiencing significantly lower inventories at the end of the year, some for general reasons and others more specifically for reasons related to their manufacturers being affected by natural disasters in early 2011.

Mr. Magyar emphasized that in some instances, a dealer might have an ending inventory that might be down by one-third or more compared to the prior year. However, that did not necessarily mean that the dealer was going to have to recapture one-third of the LIFO reserve on the books. The reason for this is because there is no "proportionality" relationship between (1) the percentage of decline in ending inventory level (compared to the prior year) and (2) the percentage of LIFO Reserve that might be recaptured as the result of that significant decrease/decrement in inventory level.

Finally, there also was a brief discussion of the possibility of the repeal of LIFO - if not for this year, in future years.

see **NADA CONVENTION TAX ISSUES WORKSHOP**, page 10

 (Continued from page 8)

Off-Shore reinsurance. In discussing this area, Mr. Magyar referenced the proposed Regulations that were issued in 2010 regarding "cell" arrangements. These Regulations involve certain cell arrangements set up by dealers who are involved with controlled foreign corporation (CFC) issues and who might have organized their activities through the providers who are handling their CFC or other off-shore reinsurance compliance work.

Often what they have done is to set up separate "cells" in order to isolate income, expense and liability from the other "cells" associated with other dealers because there might be nine dealers, and none of them want to be treated as part of one larger collective group. Therefore, the reinsurance activities of each dealer is set up in a separate "cell" ... And, this has created some technical issues. Mr. Magyar said that advisors really ought to be monitoring dealers' activities if they are involved with these off-shore arrangements.

Form 8938. The second area that Mr. Magyar covered related to the new Form 8938 that a dealer might be required to file if he had certain levels of investment in specified foreign financial assets. Form 8938 is quite long and the instructions for Form 8938 are formidable, to say the least.

His comments were a reminder that it is now necessary to determine whether Form 8938 needs to be filed with a dealer's 2011 individual return (Form 1040) as a result of the new disclosure requirements for U.S. shareholders in foreign corporations (i.e., the *FACTA* legislation).

If a dealer is involved with assets in foreign countries, investments in foreign countries, bank accounts, interests in partnerships, and other activities involving investments of that nature, then it will be necessary to review Form 8938 and determine whether it might have to be included in the dealer's 2011 individual income tax return.

Federal estate and gift tax. In this area, Mr. Robbins talked about various Federal estate and gift tax changes. He provided a quick run-through of all of the key changes in exemptions and limitations ... 2011 vs. 2012.

His presentation was a straight-forward litany of exemptions, tax rates being changed and issues related to the so-called "portability" of the unused portions of the exemptions (i.e., the ability of a surviving spouse to accede to the portion of an exemption that was not used by his/her deceased spouse).

He also emphasized that there is still a limited "window of opportunity" for dealers to maximize estate planning opportunities by taking advantage of greater exemption amounts. Mr. Robbins' presentation was a good review for dealers and their advisors.

Related-party transactions. Finally, Mr. Thompson talked about related-party transactions. This topic was discussed more as a general reminder than as a new item or a new development. Apparently, Ms. Harris and the IRS are seeing more instances where taxpayers are not being properly accounting for transactions between related parties.

Mr. Thompson made the point that it is necessary to be careful because with C corporations, the related-party situations do not come into play unless there is a more-than-50%-stock-ownership-interest in the corporation. Therefore, the related-party transaction limitations and rules do not apply to C corporations where there are exactly 50-50% ownership interests held by unrelated individuals.

Alternatively, the related-party transaction rules apply to S corporations and/or partnerships regardless of the percentages of interest involved. In other words, the difference between C corporations (where a "related-party" relationship requires ***more than 50%*** actual or constructive ownership) and S corporations and partnerships is that every S corporation shareholder and every partner in a partnership is considered to be a "related party," regardless of his or her percentage of ownership.

Note also that the rules of attribution (of ownership) under 267(c) must also be considered.

Self-charged rentals. With regard to self-charged rentals, apparently the IRS often finds dealers misapplying rules. In some cases, a dealer may own the dealership facility and rent the facility to the dealership; and the dealer - for whatever reason - grants a rent holiday or otherwise reduces the rent. Often, in this scenario, the dealership pays less rent, and as a result, the entity (or individual dealer) owning the rental property will show a net loss from rental operations. This is a classic "self-charged rental" situation. And, in most cases, that net loss from rental operations is considered to be a passive loss that cannot be used against other active (i.e., non-rental) income. In other words, the net loss from rental operations can only be offset against net income from other passive/rental income sources.

MANUFACTURER IMAGE PROGRAMS

The Panelists' discussions related to manufacturer image upgrade payments are incorporated in the accompanying article, *"Part II ... An Update ... Taxability of Manufacturer Assistance Payments to Automobile Dealerships for Facility Improvements & Image Upgrades,"* which begins on page 16.

Instructions Revision
March 2012

FORM 3115 APPLICATION FOR CHANGE IN ACCOUNTING METHOD REVISIONS TO FORM 3115 INSTRUCTIONS

- Form 3115 is the form that taxpayers must file when they are changing most accounting methods.
- The IRS has updated the Instructions to Form 3115 in a revision dated March 2012. This supersedes the previous Instructions which were last revised in December 2009.
- This revision updates all references relating to automatic changes to refer to Revenue Procedure 2011-14 (which superseded Rev. Proc. 2008-52) as the controlling document.
    - It reflects new automatic changes (#162 through #180) which may be made in connection with the new Tangibles Regulations under Sections 162, 167, 168 and 263(a) which concern the proper treatment of expenditures for repairs and improvements to tangible property.
    - It also clarifies that certain automatic changes in method ... relating to materials and supplies and repair and maintenance costs (#143 and #144) ... are only available for amounts paid or incurred in taxable years beginning before January 1, 2012.
    - The total of the Automatic Changes that do not require advance permission from the IRS is now 180. (But that includes several "automatics" that are now obsolete.)
- If taxpayers file Schedule M-3 with their income tax returns, they must indicate whether the proposed change in method is related to the adoption of International Financial Reporting Standards (IFRS).
- With respect to Section 481(a) adjustment computations, page 8 of the revised Instructions now contains ...
    - Revised wording which describes information to be attached in connection with the computation.
    - A second example (below) that shows an acceptable reporting format describing the Sec. 481(a) adjustment.

Example #1 - Retained in the Revision - Acceptable Format for Disclosure Change in Method of Accounting for Capitalized Inventory Costs Under Section 263A

Beginning inventory for year of change under proposed method	$ 120,000
Beginning inventory for year of change under present method	100,000
Section 481(a) adjustment (positive)	$ 20,000

Example #2 - Description of Section 481(a) Adjustment which Has 2 Components

- WXY Corporation, a calendar year taxpayer, is a producer and capitalizes costs that are required to be capitalized into inventory under Section 263A.
- Each February, WXY Corporation pays a salary bonus to each employee who remains in its employment as of January 31 for the employee's services provided in the prior calendar year.
- Under its present method, WXY Corporation treats these salary bonuses as incurred in the tax year the employee provides the related services.
- For 2011, WXY Corporation proposes to change its method of accounting to treat salary bonuses as incurred in the tax year in which all events have occurred that establish the fact of the liability to pay the salary bonuses and the amount of the liability can be determined with reasonable accuracy....
- The computation of WXY Corporation's net Section 481(a) adjustment for the change in method of accounting for salary bonuses is demonstrated as follows:

Salary bonuses treated as incurred under the present method, but not incurred under the proposed method		$ 40,000
Beginning inventory as of Jan. 1, 2011, with capitalized salary bonuses computed under the present method	$ 100,000	
Beginning inventory as of Jan. 1, 2011, with capitalized salary bonuses, computed under the proposed method	92,000	
Decrease in beginning inventory as of Jan. 1, 2011	(8,000)	(8,000)
Net Section 481(a) adjustment (positive)		$ 32,000

MERCER REPORT ON FACTORY FACILITIES PROGRAMS

With a variety of manufacturer facilities Programs going on over the last few years, it was not surprising that the National Automobile Dealers Association (NADA) began receiving comments from many dealers that were critical of the pressures, terms and conditions they felt were being imposed by these Programs. As a result, NADA requested that Glenn A. Mercer, a respected industry analyst, prepare a research paper summarizing the current state of affairs.

Mr. Mercer conducted in-depth, confidential interviews with approximately 70 individuals. These interviews involved many dealers, representing all dealership sizes, representatives from the manufacturers and experts in various automotive retailing areas (CPAs, facility appraisers, lenders, economists, equipment vendors and brokers). He also sought insights from other retailing industries such as franchised restaurants and hotels which have their own facility upgrade programs.

The "Mercer Report" - formally titled *"Factory Facilities Programs: An NADA Research Project"* - was first released at the 2012 NADA Convention, followed by a workshop during which Mr. Mercer discussed the Report in detail. Mr. Mercer's workshop at the Convention and his Report are summarized in this article.

Mr. Mercer concluded that most Factory upgrade programs include elements of three different types or "layers" of emphasis ... Expansion, Modernization and Standardization. He also identified several issues that cut across all of the manufacturers' programs. These cross-cutting program issues involve timing, size bias - including the impact of the incentives, and design for the future (referred to as the Internet and the "dealer of the future").

Below is a matrix or representation of these framework parameters that may assist in grasping the overall "big picture." This is not taken from nor included in the Mercer Report.

The different "layers" of activity or types of programs. One type of program relates to Expansion of the facility. A second type relates to Modernization of the facility. And, the third type involves the concept of Standardization of dealerships or making them all look alike as opposed to modernizing or expanding them.

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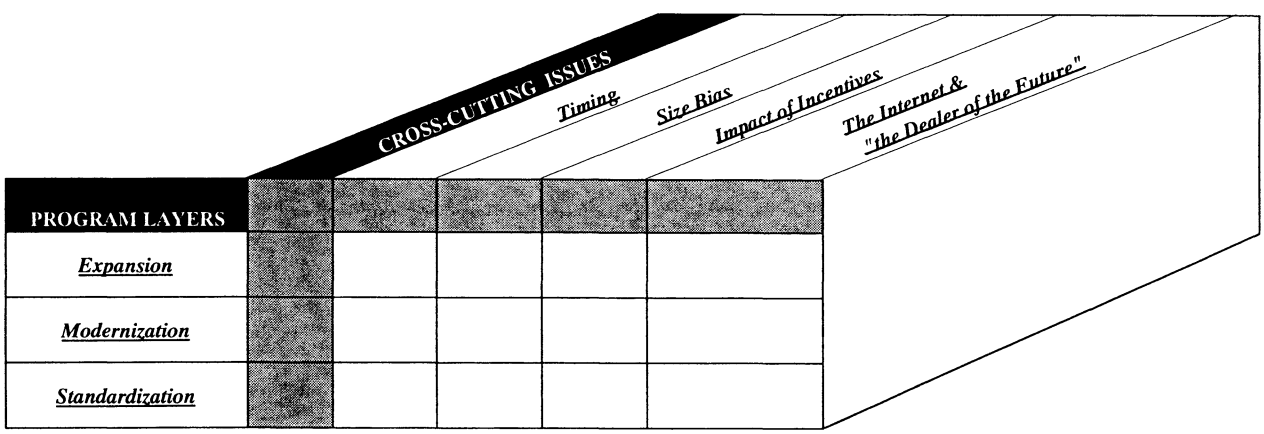
THE MERCER REPORT ON FACTORY FACILITIES PROGRAMS ... FEB. 2012

FRAMEWORK PARAMETERS: MIXTURE OF PROGRAM LAYERS & CROSS-CUTTING ISSUES



EXCLUSIONS ... AREAS & ISSUES THAT ARE NOT ADDRESSED BY THE *REPORT*

1. The whole body of legal, regulatory and legislative activity which affects, and in some cases, governs exactly how and what a Factory/OEM program can or cannot ask from a dealer.
2. Exclusivity requirements (i.e., the issues of exclusivity of stores).
3. Comparative advantages, disadvantages, contrasts, or other evaluations of specific Factory/OEM programs.

Source: **De Filipps University, *"2012 NADA Convention Tax Report Emphasizing Factory Facilities Programs & Payments"* Audio Seminar (3/7/2012)**

It was generalized that, in terms of dollar spending, 40% of dollars were or would be involved in spending on Expansion, 40% on Modernization and 20% on Standardization issues. It was also generalized that, overall, upgrade programs usually cost 20-30% more than they should really cost.

EXPANSION

Basically, Expansion involves attempting to correctly size dealership sales, storage and service areas to meet current and projected demand.

Expansion relates to adding asphalt, showroom space and service stalls to support expected growth in either units in operation (UIO) or expanded product lines.

With respect to Expansion, the Report comments ...

"When an OEM and a dealer discuss adding parking space (for customers or for vehicle inventory), service stalls, and interior space (such as showroom or service waiting area square footage), they are discussing Expansion.

"Typically the Expansion discussion starts because a brand's UIO (units in operation) has grown rapidly (necessitating adding service bays to repair the larger fleet), or because an OEM is adding new models (necessitating a larger showroom), or forecasting higher future sales or market share (requiring Expansion of the entire store).

"Tension here tends to arise when the factory asks for more Expansion than the dealer thinks is necessary, e.g. due to inflated volume forecasts."

Mr. Mercer reported that Expansion issues / programs generated the least argument and tension between dealers and manufacturers. One reason given for this was it was the only layer where "hard numbers" might be available. However, aspects of improvement related to Expansion issues include: (1) proving more realistic forecasts of space requirements, (2) stabilizing such forecasts so that they do not shift over time, and (3) updating capacity formulas to fit some current dealer practices such as extended service hours that increase service bay capacity.

MODERNIZATION

The second type of manufacturer program places emphasis on Modernization in an attempt to bring the dealership facilities - exterior and interior - up to what the manufacturer perceives to be contemporary standards.

Accordingly, Modernization would involve such activities as upgrading the exterior and/or interior of the dealership to contemporary standards relating to such items as furniture, fixtures, tile, carpet, paint and décor.

In his workshop presentation, Mr. Mercer drew quite an appreciative response when he remarked that he could have called his Report ... "The Tile Report," because if there was any aspect or any small piece of the Report that really aggravated dealers, it was the insistence of some Programs that a specific kind of tile be used in showrooms, coffee rooms and restrooms.

With respect to Modernization, the Report comments ...

"Assuming the dealership facility is sized correctly, the next layer at issue is Modernization: bringing the store up to contemporary standards both inside and out, for example with new building fascia or windows outside, or with upgraded furniture, fixtures, and equipment (e.g. free Wi-Fi) inside.

"The goal of Modernization is ... to attract more customers and to better satisfy them, by surrounding them with a pleasant and up-to-date environment.

"Tensions can arise both on the cost and benefit side of the equation: one dealer might see the value in the upgrade, but believe that the factory's approved materials vendors are too costly; another might not have a problem with the cost of the specified fixtures, but not see any value in the project, in terms of either increased sales (in cars or service work) or customer satisfaction."

Compared to Expansion issues, Modernization issues in manufacturer programs seem to generate more controversy because while the costs were easy to identify (and often stood out like a sore thumb), the benefits from undertaking such costly improvements are perceived to be "at worst minimal and at best unquantified."

Accordingly, the Report states that manufacturers should try to do a better job of demonstrating to dealers the "business case for Modernization" and reassure dealers that the necessary spending will be as cost effective as possible.

STANDARDIZATION

Manufacturer programs that emphasize Standardization basically have as their objective the creation a more-or-less uniform look for all dealerships that carry the same franchise or brand.

Standardization aspects of manufacturer upgrade programs create the most contention with dealers because the benefits are extremely difficult to measure and are often very unclear and subject.

Standardization relates to designing the exterior and interior elements of the dealership to ensure that every dealership representing that manufacturer's

see **MERCER REPORT...**, page 14

 (Continued from page 13)

brand looks similar to all of the other dealerships that represent that manufacturer's brand.

With respect to Standardization, the Report comments ...

"If the store is now the right size and is sufficiently up-to-date, the next layer facility programs often tackle is Standardization: ensuring that the updated facility looks as much as possible like those of other dealers carrying the same brand, via the use of similar or identical materials, floorplan templates, and commonized furniture and fixtures.

"The goal of Standardization seems to be to somehow reinforce the power of the brand by providing a similar look, feel, and experience for a customer of a given brand - whichever store she or he happens to visit.

"Tensions arise here in part over the cost of Standardization, but especially over its worth: ... many interviewees had trouble seeing why Standardization - as defined by some but not by all OEMs - might be valued by a customer."

ISSUES THAT CUT ACROSS PROGRAM TYPES

The interviews that Mr. Mercer conducted often echoed questions relating to issues that cut across all types of programs.

Timing. One set of questions related to issues of timing. Why do we have to do this now? Can we do it later? Why does it have to be done so quickly? All of those influence each of these points of emphasis.

Size bias. The second cross-cutting issue is called "size bias." In other words, the perception, if not the reality, held by some interviewees that some programs were certainly going to be biased against the smaller dealers in the sense that it would put smaller dealers at competitive disadvantage of one sort or another to larger dealers.

Impact of incentives. One element within the size bias concern, is the issue of the potential impact of the incentives that manufacturers are offering to dealers to induce them to "voluntarily" participate in the programs.

If it's just cash, what are the strings attached, or is it simply a windfall? ... i.e., "Here it is, here's a check for $300,000 against your $1,500,000 expenditure." Are there going to be better allocations in the future? Is the incentive (or one of the incentives) going to be a reduction of cost so much per vehicle purchased? Or, per vehicle sold? Just what are the incentives?

Are some of these incentives nothing more than two-tier pricing systems in disguise? [For more on this aspect, see the discussion on page 21 of this Edition of the DTW.]

Other incentives might loosely be called "future promises." For example, might a participating dealer get priority to be the first in line for the next point that's going to open up nearby? ... Or, to buy another dealer's franchise?

These are just some of the incentive considerations that seem to cut across all of the manufacturers' programs.

"Dealer of the future." Finally, the last cross-cutting issue relates to design for the future (i.e., the Internet and the "dealer of the future"). Can you blame a dealer for being reluctant or skeptical about investing "$X million dollars" right now based on the Factory's anticipation that the "new facility" that will be created will be viable a few - or several - years down the road?

What's the dealership of the future going to be like? Are we going to have Taj Mahals? Mr. Mercer commented wryly that some dealers said that they didn't want to be building "Garage Mahals." Some dealers said they didn't want to have some edifice that looks beautiful today, but 15 years from now, is a white elephant because the dealer cannot sell the property to anyone except another a dealer that wants something "as ornate as this sucker is."

It's not like in the days of old when there was a dealership on almost every corner ... It was a Ford dealership on Friday; and then over the weekend, the dealership changed hands and a new dealer with a Chevrolet franchise came in. On Monday, the new dealer could sell Chevys out of the former facility that was used by the Ford dealership a few days before.

By the way, have you recently driven by what used to be Hummer dealership?

Interestingly, the Mercer Report does not directly mention the issue of functional obsolescence.

GENERAL REACTIONS FROM THE INTERVIEWEES

Mr. Mercer provided these generalizations concerning the different groups of individuals he interviewed.

Dealers (i.e., dealerships) that were interviewed were mostly supportive of the concept of image upgrade. However, they were critical, or highly critical, of the economics of the image upgrades.

The Factories - the OEMs - were (obviously) highly supportive of the concept ... although they were highly diverse in how they executed their programs. Different manufacturers offered different incentive arrangements ... What the timing was, how much the dealer was required to do in terms of Expanding, Modernizing and Standardizing.

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The industry experts (CPAs, consultants, brokers, etc.) were supportive of the concept of image upgrades, but they tended to be skeptical.

The big question. The big question that dealers, as well as the experts, raised was ... Where will the additional sales that are supposed to materialize from doing all these upgrades be coming from?

Are these anticipated future sales going to be coming from cannibalizing competitors who are also "brand X dealers" or are these sales going to be "conquest" sales in which the dealers are actually taking sales away from a different brand or a different franchise?

No one really knows the answer to that question. But, there certainly ought to be a more thorough effort to try to quantify those results over a period of time, and then address the implications in the structuring of future programs.

Customers ... the last group of interviewees ... were, in general, indifferent and unimpressed. Collectively, their attitude seemed to be ... "You know, I'm going to buy a car or a truck, whatever it's going to be ... we're going to buy a vehicle. We might price shop on the Internet, or we might go to *ABC's* dealership, or we might go to *XYZ*'s dealership, or we might even go to another dealership ... They're all reasonably close to home. We're maybe not so particular about where we buy the vehicle from ... The dealership could be a beautiful Taj Mahal or just simply a place that can deliver the vehicle I want to buy."

REPORT FINDINGS & RECOMMENDATIONS

The Mercer Report reached three basic findings.

First ... The economic value of manufacturer programs has only been weakly demonstrated. The Report recommended that there should be (i.e., the manufacturers should take the initiative to provide) a better demonstration of the value of investment in facilities.

To this end ... "The manufacturers need to show better demonstration and quantification of the value of investment in facilities. This is needed not so much in Expansions, but certainly in Modernizations, and especially in Standardizations, where the value is completely unclear."

Second ... Program costs are excessively high. The Report recommended that there should be (i.e., the manufacturers should take the initiative to provide) more aggressive control of the cost of facilities investments.

It suggested, "The manufacturers and dealers need to work together to demonstrate how programs can be executed at lower cost ... by (1) more flexibility as regards designed-in cost (e.g. material specifications, vendor approval lists) and (2) better implementation of program execution cost (e.g. fewer shifting deadlines, fewer squabbles over exceptions sought or granted, less confusion caused by 'outsourcing' decisions to third-parties such as design firms)."

Furthermore, concerning the matter of size bias and the potential impact of incentives, the Report suggested, "As regards the 'small store cost penalty' specifically: 'tiering' a program to offset these disproportionate costs might make sense (beyond just scaling square footage)."

Third ... These programs may not be best preparing automotive retailers for the future evolution of the industry. Regarding this cross-cutting issue, the Report recommended, "All parties involved should move quickly to research and share their views of the dealership of the future, so as to avoid facility programs incentivizing the building of stores that are quickly made obsolete, by evolution in consumer shopping and buying behavior and needs."

FOLLOW-UP TO THE MERCER REPORT

In a NADA communique *"Facility Upgrades: 'Your Voice Is Being Heard,'"* dated May 2012, NADA reported that since the Mercer Report was issued, representatives of NADA had personally met with and presented the findings of the Mercer Report to the senior level management of 12 manufacturers. Also, in order "to take this issue to the next level," NADA will be retaining industry experts to assist in several ways.

In a "Phase Two" initiative, NADA now wants to look more closely at the Mercer Report recommendation that OEMs need to better demonstrate and quantify the value of dealer investment in facilities. NADA has said it will do this by "running the numbers" - by looking at actual dealership data in a sample of dealers who have already participated in Factory image programs as well as dealers who did not.

Finally, NADA said that on the one-year anniversary of the Mercer Report, it will conduct a review that will focus on whether the OEMs have modified their programs in response to concerns raised in the Report.

A GREAT PRACTICE DEVELOPMENT TOOL

Any CPA or advisor to dealerships should read the Mercer Report if they have not already done so. It will provide wonderful opportunities for discussion with your dealer clients. The discussions in the Mercer Report and the follow-up developments that NADA has initiated will provide the best practice development tool you are ever going to find.

The Mercer Report (dated Feb. 4, 2012) can be downloaded from www.nada.org.

PART II ... AN UPDATE ...
TAXABILITY OF MANUFACTURER ASSISTANCE PAYMENTS TO AUTOMOBILE DEALERSHIPS FOR FACILITY IMPROVEMENTS & IMAGE UPGRADES

INTRODUCTION

On pages 32-51 of the last Edition of the *Dealer Tax Watch* (Year-End 2011), I included a lengthy article and supplementary materials which addressed the subject of taxability of manufacturer assistance payments to automobile dealerships for facility improvements and image upgrades. Let's consider that as *Part I* of an exposition on this highly significant subject.

Virtually all dealers and franchises have been affected previously by, or are currently enmeshed in, manufacturer programs. CPAs who have dealerships as clients not only need to be aware of the nature of these programs and the tax consequences, but they are facing significant pressures from dealers when they tell the dealers that, generally, assistance payments received should be treated as taxable income when received and not as reductions of basis.

This article and the attachments comprise *Part II ... An Update* on these issues. For your reference, the only material I'm repeating here that was in Part I is the "Executive Summary" on the facing page.

Just to refresh your memories, Part I discussed the following... (1) the Code, Regulations, case law and guidance with respect to manufacturer assistance payments, (2) the common characteristics of facility improvement programs, (3) the comments from the *Dealer Franchise Legal Update* at the 2011 AICPA Dealership Conference, (4) the General Motors *Essential Brand Elements* (EBE) Program, and (5) other considerations and observations.

Also, included as supplementary materials to the Part I article were... (1) IRS IDD Directives #1 & #3 relating to the IRS concerns over non-compliance with Section 118, (2) IRS audit Information Document Requests where payments received were not treated as taxable income, (3) extracts of the relevant portions of the *John B. White, Inc.* case (where payment by Ford Motor Co. to induce a dealership to relocate was taxable upon receipt) and the *James Brown* case (where payment received by an individual to induce him to purchase a minority stock interest was held to be a reduction of his cost basis).

This Part II update addresses some new developments and information, and it also provides further thoughts and analysis on a few key areas discussed in Part I. Briefly, these new developments include the following.

First... There was substantial discussion on this subject during the *"Exploring 2012 Tax Issues with Industry Experts"* workshop at the 2012 NADA Convention in Las Vegas in February. (All of the other tax issues that were covered in the workshop are discussed in a separate article beginning on page 8.) My report on this workshop discussion includes the "consensus opinion" of the Panelists ... with one notable dissent ...as to the proper tax treatment of payments received.

see **MANUFACTURER ASSISTANCE PAYMENTS**, page 18

Part II ... Facilities & Image Upgrades

MANUFACTURER ASSISTANCE PAYMENTS TO DEALERSHIPS FOR FACILITY IMPROVEMENTS & IMAGE UPGRADES

Executive Summary

MANUFACTURER ASSISTANCE PAYMENTS TO AUTOMOBILE DEALERSHIPS FOR FACILITY IMPROVEMENTS & IMAGE UPGRADES

- The many different programs that manufacturers have introduced to encourage their dealers to expand or completely rebuild their facilities have raised many legal, tax, accounting and practical issues for dealers and their advisors.
- In interacting with their dealership constituencies, the manufacturers have never done anything without expecting an equal, if not greater, benefit in return. Accordingly, it is reasonable to conclude that dealers are providing services to the manufacturers in return for their receipt of assistance payments under these programs.
- There is an extensive body of case law dealing with taxpayers' attempts to treat various payments as non-taxable contributions to capital. There is also extensive IRS guidance - some precedential and some not precedential - on this issue. This case law ... and related IRS guidance ... extend far back to many years before Section 118 came into the law in 1954.
- The *John B. White, Inc.* case (decided in 1971 by the Tax Court and upheld on appeal) and the *Detroit Edison* case present the most formidable barriers against dealerships successfully sustaining the position that payments they receive from manufacturers for facility improvements and upgrades can be excluded from taxable income.

  It is difficult to imagine circumstances - or manufacturer plan specifics - that could possibly support any treatment to the contrary. Has any manufacturer ... Chrysler, General Motors, or any other ... ever done anything that was not in its own best business interests ... or without exacting (at a minimum) a *quid pro quo*?
- The General Motors' *EBE (Essential Brand Elements)* Program requires special attention because of its unique features and because there are so many GM dealers in the country.

  The *EBE* Program consists of four components or elements. In order to be eligible to receive ***any*** payment under the *EBE* Program, the dealership must be fully compliant on a cumulative basis with all of the requirements of all four of these Program components or elements. This 100% compliance requirement inextricably links all four of the components; and it should cause any payments received by the dealership under the Program to be treated as ordinary income taxable upon receipt (rather than as basis reductions charged against fixed asset, goodwill or other accounts).

  This conclusion is consistent with case law in other areas, notwithstanding the fact that GM's summary of the Program suggests that there may be severability by the statement ... "*On average, 90% of the costs associated with the Brand Elements is dedicated toward the Facility Image Program.*"
- Some Programs, to a lesser or a greater degree, contain forfeiture provisions that would require the dealership to repay funds provided by the manufacturer either in full or according to a sliding scale over time if the dealership fails to satisfy some or all of the conditions of the Program. Some CPAs contend that amounts received under these Programs may be characterized or treated as non-taxable loans (rather than as taxable income immediately upon receipt). This contention, more likely than not, would not be successful.
- The position of the IRS is that Section 118 applies ***only to corporations***. This would exclude from Section 118 many dealerships that conduct operations in non-corporate form (i.e., as disregarded entities electing to be taxed as partnerships or LLCs). The IRS is actively monitoring and challenging partnerships that are trying to secure the non-taxable treatment benefits of Section 118, and it describes these non-corporate entities as being ***abusive***.
- In filing income tax returns for years in which manufacturer assistance payments have been offset against basis (in reliance on the position that these payments are Section 118 contributions to capital or on some other theory), consideration should be given to adequate disclosure and potential accuracy-related penalties, taxpayer penalties and tax return preparer penalties. This involves Schedule M-1, M-3 and/or Schedule UTP disclosure matters and/or whether Form 8275 should be filed with the tax return. There are also statute of limitation considerations because different depreciation deductions will result from Section 118 treatment.
- At this time, there is no specific "guidance" from the IRS on the proper tax treatment by dealerships for payments received from the manufacturers under their various and sundry facility improvement and image upgrade programs. These programs and the difficult tax issues they raise should become a new priority item requiring published guidance if the IRS hopes to enforce any degree of consistent treatment by dealerships.

Source: **Reprinted from the Year-End 2011 Edition of the *Dealer Tax Watch*, page 33.**

Second ... The IRS has not published any "precedential" guidance on this subject. However, as discussed below, in February 2012, the IRS Motor Vehicle Technical Advisor issued a 2-page *Automotive Alert* - "Factory Image Upgrade Payments."

Third ... Since the last Edition went to press with Part I, I have presented several audio seminars and had discussions on this subject with many practitioners. In the course of refining my own thinking and benefiting from these other discussions, I've reached some additional conclusions that are part of this update. Also, I've added some of the anecdotal information for your consideration.

Fourth ... In late December 2011, the Treasury issued temporary Regulations which provide guidance on the application of Sections 162(a) and 263(a) to amounts paid to improve tangible property. In February 2012, the IRS MVTA issued an *Automotive Alert* summarizing these Regulations with particular emphasis on a few examples.

These Regulations will have a significant bearing on the extent to which dealerships might be able to reduce the tax impact otherwise associated with having to report manufacturer assistance payments for facility improvements as ordinary income when received. For a discussion of these Section 263(a) Regulations and the examples referred to in the *Automotive Alert*, see the article and materials beginning on page 36.

NADA CONVENTION TAX ISSUES WORKSHOP

There was substantial discussion of Factory image upgrade payments during the *"Exploring 2012 Tax Issues with Industry Experts"* workshop at the 2012 NADA Convention in Las Vegas in February.

Actually, there were two presentations of this workshop, and I attended the first of the two live presentations. I also have reviewed the DVD of the second presentation of this workshop (which was given two days after the first) which is available directly from www.nadauniversity.com.

The workshop was moderated by Paul Metrey, Chief Regulatory Counsel for NADA, and was presented by a Panel consisting of (1) Terri Harris, the IRS Motor Vehicle Technical Advisor/Specialist - Grand Rapids, MI, (2) Joe Magyar, Partner in Crowe Horwath, LLP - Tampa, Florida, (3) Wayne Robbins, Partner in Dixon Hughes Goodman, LLP - Raleigh, NC, and (4) Dan Thompson, Partner in Boyer & Ritter - Camp Hill, PA.

The Factory image upgrade portion of the workshop was divided into the following three sections, with each of the CPA Panelists presenting one section. The sections - based on their PowerPoint handout were: (1) a discussion of the general types of Factory image upgrade payments, (2) arguments in favor of including incentive payments in the income of the dealer, and (3) arguments in favor of excluding incentive payments from the income of the dealer.

The actual workshop handout was only three pages, each with only a few bullet points followed by blank lines at the bottom for notes. If you purchase the workshop DVD (which include the handout), you will see that a sentence or two has been added to amplify the bullet points in the handout.

In connection with the discussion of general types of Factory image payments, I would add that the Mercer Report includes a footnote which lists the many types of Factory incentive payment situations. Also, my own list of common characteristics or elements of programs was included in the Part I article on page 37 of the Year-End 2011 Edition of the *DTW.*

Also, Mr. Magyar commented that his firm was seeing that, in a number of instances, manufacturers are allowing dealer-specific adjustments in implementing their programs. In other words, some (many?) dealers are pushing back against the manufacturers. They are asking ... "Do I really have to do all of this? Do I really have to do it in such and such time frame? And, is it really necessary to spend so much money in order to do X, Y or Z?" Essentially, dealers are negotiating with the manufacturer over many particulars. This seems to be a common practice, and it seems to be becoming prevalent. This was attested to in the remarks made by Richard N. Sox, Esq., to the AICPA National Auto Dealership Conference in October 2011. (See page 38 of the Year-End 2011 *Dealer Tax Watch.*)

For the "Arguments in Favor of Including the Incentive Payments," only the following appeared ... (1) IRC Section 61(a), (2) TAM 9452003, (3) *John B. White, Inc. v. Commissioner* and (4) Market Segment Specialization Program. The rest of the page was blank for notes.

The most significant argument in favor of including payments in income is that Section 61 provides that gross income includes income from all sources derived ... That is the key controlling Section.

The 1994 TAM referenced involved a dealer - not an auto dealer - who was required to include assistance payments as income in the year they were received. The reference to Market Segment Specialization Program related to several holdings by the IRS that payments under image reimbursement programs for gas station owners were to be included in taxable income.

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Finally, there was a reference to the *John B. White* case. (This case is discussed in considerable detail in Part I.)

The most important observation here is that the Panel made no attempt to weight the significance or importance of these items. In other words, the Code Section is the law. A TAM is just the IRS' interpretation of the law and it cannot be cited or used as precedent so it's not even an authoritative interpretation.

The *John B. White* case was a Tax Court case. In the first workshop, mention was not made that this case had been affirmed at the Appeals level. In the second workshop, this affirmation was noted.

Similarly, For the "Arguments in Favor of Excluding the Incentive Payments," only the following bullet points appeared ... (1) *Federated Department Stores, Inc. v. Comm.*, (2) *James Brown, et al., v. Comm.*, (3) *Freedom Newspapers, Inc. v. Comm.*, (4) IRC Section 118, (5) IRC Section 362(c)(2), and (6) Revenue Ruling 76-96. The rest of the page was blank for notes.

SUMMARY OF PANELISTS' VIEWS

After the brief presentations above, the Moderator asked each of the Panelists to present the views of their respective organizations relating to these payments. Then, each Panelist was asked if he or she had any further comments to make after hearing the previous summaries.

Ms. Harris, IRS Motor Vehicle Technical Advisor, said that the IRS basically starts with Internal Revenue Code Section 61. This would suggest that the position of the IRS is that payments received by the dealer/dealership are includable in income ***and*** that the *John B. White* case is the primary obstacle that stands in the way of a dealer arguing that manufacturer payments should not be immediately taxed.

Ms. Harris was essentially reiterating and summarizing the information that is in the *Automotive Alert* on "Factory Image Upgrade Payments" that her office released in February of 2012.

The first paragraph of the *Alert* refers to Section 61 which defines gross income as income from whatever source described. The next two paragraphs refer to Section 118, emphasizing that the Regulations state that a contribution to capital is not excluded when money or property is transferred to the corporation in consideration for goods or services rendered. Almost all of the remainder of the *Alert* refers to the *John B. White* case.

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

This *Alert* is reproduced on pages 26-27.

Mr. Thompson said that his firm realizes that basis reduction is a logical concept. However, his firm believes that concept (i.e., the concept of reducing the basis of assets by payments received from the manufacturer) just doesn't apply in this situation. Overall, his firm's position is that these manufacturer payments are taxable income because the manufacturers are not making payments to dealerships out of the goodness of their hearts, nor are they motivated by disinterested generosity. They (i.e., the manufacturers) are expecting benefits in return for these payments, and they have a lot of clout to help to achieve that return.

Mr. Thompson pointed out that since basis reduction (under Section 1016 or any other case law precedent) is just a timing difference, his firm views the treatment by a dealership of payments received as a risk management issue. In considering this more broadly as a risk management issue, his firm strives to maximize the after-tax cash flow in the year when the image upgrade is being made without subjecting the dealership to undue risk.

Mr. Thompson indicated that some of the adverse tax impact (of reporting manufacturer payments as income when received) could be significantly minimized by the consideration and appropriate use of several techniques. These include (in no particular order of significance)...

- Treatment of appropriate expenditures as repair expenses (rather than as capitalizable expenditures) under the new tangibles Regulations and examples.
- Writing off undepreciated portions of an old facility that is being replaced (i.e., such as roof replacements) through the upgrade process ... but under the provisions of the new tangibles Regulations.
- Assignment of appropriately short class lives to the pools of dollars that are required to be capitalized ... 5-year ... 7-year ... 15-year class lives.
- Beneficial use of (i.e., maximizing) Section 179 expense deductions and 100% special depreciation deductions (applicable to the years 2010 - 2011) and

see **MANUFACTURER ASSISTANCE PAYMENTS**, page 20

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50% special depreciation deductions (applicable to the year 2012).

- Use of other favorable tax provisions including (1) energy efficient commercial building deduction provisions, and (2) special retail facility shortened useful life periods ... qualified leasehold and qualified retail improvements provisions.

Mr. Robbins summarized his firm's position by saying that it comes down more on the side of the issue that the payments received by the dealerships are taxable on receipt (than on the side that would support excluding those payments from income). He added that "it may be difficult not to come down on that side of the fence" - referring to excluding those payments from income - because of the authority of the *John B. White* case.

Mr. Magyar presented the position of his firm by initially agreeing that Section 118 does not apply. However, he added that, basically, his firm takes a "holistic" approach to the matter, striving to make the after-tax cash flow to be as favorable as possible for the dealership. This, of course, would involve the use of Section 179 bonus depreciation and all of the other opportunities indicated by Mr. Thompson.

However, Mr. Magyar's initial remarks agreeing with the other Panelists were really the preface for his statement of his firm's position that basis reduction may be appropriate for these payments.

He indicated that "We (i.e., his firm) believe in the offsetting approach as it may be applicable where there are significant terms up front that might support it." He did not elaborate whether by referring to "significant up-front terms," he was referring to provisions that might require repayment by the dealer at a later date if certain defaults occurred or give any other examples of what might constitute "significant up-front terms."

He indicated that his firm's reliance on an offsetting approach (i.e., a reduction of asset basis under Section 1060 or otherwise) is based on the *Brown* case and on the last footnote included in a 1999 Tax Court decision involving General Motors (specifically citing footnote 30). He provided no further explanation of the support these are believed to provide.

Mr. Magyar said ... "Where we are in areas where there are cases on both sides of the issue, we think we need to look at these factors and come to a reasonable conclusion that is going to be in the best interest of the taxpayer paying the right amount of tax and potentially having some uncertainties within the risk level they (i.e., the taxpayers) are willing to take on."

Summary. All of the Panelists basically agreed that Section 118 does not apply to facility upgrade payments from manufacturers. All of the Panelists also agreed that, in some cases depending on the specific provisions of the contracts between the manufacturer making the payments and the dealership receiving the payments, in certain circumstances, it might be appropriate to treat the receipt of these payments as loans from the manufacturer.

The important distinction to be noted, however, is that one Panelist set forth strong support for considering payments from the manufacturers to be basis reductions, rather than taxable upon receipt.

My opinion that basis reduction treatment for these payments is not appropriate is explained in the separate article that begins on page 28.

OTHER NEW MATTERS & OBSERVATIONS

An updated survey of different manufacturer programs. For a current summary of manufacturer facility upgrade projects, see *"Facilities Projects: Who's Asking for What?"* by James. B. Treece (jtreece@crain.com) on pages 54-55 in the January 30, 2012 *Automotive News*. This article discusses programs for the following manufacturers ... General Motors, Chrysler, Toyota, Hyundai, Nissan, Honda, Audi, Kia, Lincoln and Mercedes-Benz.

Also, the front page article in this same issue of the *Automotive News* (Jan. 30, 2012) expands on the degree of detail and diversity to be found in these programs. See *"Fed-Up Dealers: Stop Nitpicking on Store Rules,"* by Amy Wilson (awilson@crain.com).

The Mercer Report. Certainly an interesting development has been the publication of the Mercer Report, formally titled, *"Factory Facilities Programs: An NADA Research Project."* This research paper summarizes the comments and attitudes about the current manufacturer facilities programs that Mr. Mercer obtained from more than 70 interviews with dealers, customers, manufacturers' representatives and other professionals involved with the industry.

Although the Mercer Report does not directly address the tax issues, as discussed on page 12 of this Edition of the *DTW*, it is essential background reading for all dealer advisors.

Legality of some manufacturer programs. At a recent AICPA Auto Dealership Conference, during the Legal Update presentation, one of the items that came up related to whether some of the Factory programs might be intruding on the boundaries of dealer rights.

Concerns over the legality issue are indirectly raised in the Mercer Report discussion of the potential →

dealer "size bias" issue as a major concern that cuts across all of the manufacturers programs.

The Mercer Report discussion of this "cross-cutting issue" is framed by the question ... *"Do OEM facility programs disproportionately burden smaller dealerships?"* and the following discussion.

"A consistent theme in our research was that facility programs were 'biased' against smaller dealerships, for the most part because they do not scale in a linear fashion, especially when it comes to Modernization and Standardization investments. (The Expansion component of course tends to scale fairly well, since every OEM lays out facility guidelines that are in proportion to planning volumes or Units In Operation.)

"As one interviewee put it, if a large dealership selling 100 units a month needs a new entry portal that costs $150,000, a small dealership selling 10 units a month won't be able to get away with a $15,000 portal: the costs are relatively higher for smaller stores.

"Factories try to adjust for this with tiered levels of requirements, but generally dealers and experts thought that these did not fully remedy the imbalance.

"This leads to real problems for the industry ... with all parties involved accusing each other of bad faith, or hidden motives, or inflexibility.

"In our view, taking everything we heard into account, we do think OEMs could go further in flexing programs for smaller stores. This goes beyond just scaling square footage to sales and service volumes, but further into loosening or even removing some requirements for the smallest stores. Some OEMs do this now.

"(Note: Part of the anguish surrounding the facility program small-dealer problem is the related ***"two-tier pricing problem."*** That is, to the extent an OEM uses a per-car payment incentive to induce program compliance by dealers, and to the extent that some dealers sign up and some do not, then some industry participants would assert that dealers would now be paying two different prices for the same car, which opens up a whole range of important legal issues. While we are aware of this issue and discussed it with various interviewees, to the extent this is a legal matter it falls outside the scope of this Report... . But see more on the contention incentives cause generally, in the next section.)"

The Mercer Report also includes an Exhibit (#11) with direct quotes from many interviewees on the smaller store bias problem.

Lawsuits. The *Automotive News* reported (July 16, 2012) that one mega-dealer (Norman Braman) has brought a lawsuit against General Motors charging that its facilities program constitutes an illegal two-tier pricing program. This suit in Federal court questions the legality of the *EBE Program* that rewards participating dealerships with incentives based on (sales or purchase) volume. It is scheduled to go to trial in October 2013.

At issue in this case are questions over alleged violations of (1) the Federal *Robinson-Patman Act* and (2) the dealer's home state (Florida) dealer protection laws.

Here's the backstory on this suit by Normal Braman. Apparently, he began receiving payments under the GM *EBE Program* in 2010. After receiving substantial amounts, GM discontinued making significant per-vehicle incentive payments in 2011 because, according to GM, one of his dealerships was out of compliance with the Program.

Apparently, at issue was the dealer's refusal to make major renovations that would have been impossible without razing and rebuilding the dealership showroom. GM wanted the exterior walls of the showroom to be covered with limestone; but limestone was too heavy to be supported by the existing building's structure. The dealer proposed using a light-weight synthetic limestone that would be virtually identical, but GM rejected that proposal.

Another dealer (in Maryland) is also challenging the legality of General Motors' Program under Maryland's dealer protection law which provides that manufacturers cannot charge different prices for a vehicle.

EBE Program ... "All over the place." A detailed discussion of the General Motors *EBE (Essential Brand Elements) Program* was included in the Part I article on pages 39-40 of the Year-End 2011 *DTW*. This discussed the various components of the *EBE Program*; all based upon the brochure that GM sent to dealers describing the program.

Since writing Part I, many practitioners have told me that General Motors has been administering its *EBE Program* in a most inconsistent manner. It has been reported anecdotally that some dealers have received monies without benefit of any formal agreements with the manufacturer and that different amounts and incentives have been spread among dealers who would appear to be operating under virtually identical circumstances.

Note: All you have to do is Google several (relevant) keywords (i.e., "GM," "lawsuit," "EBE,"

see **MANUFACTURER ASSISTANCE PAYMENTS**, page 22

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"dealer protection laws," etc.) together to find numerous examples (in chats, blogs, discussion forums) of what dealers and others are alleging to be inconsistencies and irrationalities in the administration of the program.

There seems to be no doubt about the lack of consistency in the operation of plans and programs (either among manufacturers or within the confines of a single program for a specific group of franchise dealers). Therefore, before any reasoned conclusions may be drawn with respect to the proper tax treatment of manufacturer facility payments, at least two things must be done. First, one must read all of the relevant written information and agreements between the dealer and the manufacturer. Second, it is equally important to follow through to determine whether the payments made and incentives received are consistent with the terms of all of the agreements.

Quantifying the taxable amount in the year of receipt. Up to this point, except for more limited situations where manufacturer program payments could be substantiated as loans, all discussions relating to the taxability of these payments have focused on whether the amounts received are immediately taxable or could be treated as reductions in basis. This, of course, recognizes that if the payments are treated as reductions in the basis of depreciable assets, all taxable years in which depreciation is claimed or should be claimed on that asset will be affected by the basis reduction.

There is one very important aspect of the taxability of payments under some manufacturer programs that seems to have been entirely overlooked so far. That is whether the present value (i.e., the fair market value) of all payments to be received should be treated as the measure of the amount of income that is to be reported in the year in which the right to receive the payments becomes fixed.

In some programs where levels or plateaus of performance are part of the agreements, this consideration may be less relevant. However, in other programs where a manufacturer simply agrees to pay an amount or provide certain incentives for performance, it may be appropriate to quantify the amount that is taxable as the discounted value of the future payments ... especially if the payments/incentives are spread over more than one year.

Where the manufacturer promises the dealer volume incentive payments based on levels of future purchases or sales (in return for the construction or improvement of facilities), the performance by the dealer should establish the right to a receivable for the amount that can be quantified as the incentives to be received in the future. And, the amount of the receivable may be quantified with reference to prior or anticipated performance levels in terms of purchases or sales of vehicles (depending on the basis for the volume incentive).

All of this comes down to the exact terms of the agreements ... For how long the incentives will be paid, if they are open-ended, etc.

Consider this hypothetical ... A manufacturer agrees that if a dealer undertakes a $1 million renovation, the manufacturer will "reimburse" the dealer $500,000, and that amount is not going to be paid in cash up front, but it is going to be paid out over the next several years in the form of $xxx (say, $600 per vehicle sold or purchased).

If the value of that payment is $500,000 (or perhaps, some slightly lesser discounted amount) - even though it is going to be paid in the form of a reduced incentive per car - is it not reasonable to set up the entire amount as a receivable ... with a corresponding credit to income?

In other words, shouldn't there be a present value accounting for financial purposes and for income tax purposes? The dealer is going to receive a half a million dollars. It doesn't matter whether the dealer gets the full amount by check today or whether the dealer receives that amount in the form of reductions of inventory cost over or sales incentive monies over a subsequent stream of years. The dealer has received value - the dealer has received it right away. Shouldn't that full amount be taxed currently, rather than as it is being received over the next few years?

In some dealer situations, the immediate taxability of an amount greater than the amount of cash received up front might be preferred. Some dealers have very large net operating losses that they would like to use up. This would help use up the dealership's NOLs and the financial statements might end up looking better.

In other situations, this treatment might be less desirable because of the additional tax outlay.

To summarize... In some cases, a dealer may be receiving an incentive payment in the form of a reduction of cost or as supplemental income in the future. We have Generally Accepted Accounting Principles for quantifying the value of future payments and case law precedent in the tax area for accrual basis taxpayers.

Shouldn't these principles be applied to these manufacturer payments?

Practice Guide	CHECKLIST FOR EVALUATING RAMIFICATIONS OF DEALERSHIP - MANUFACTURER FACILITY PROGRAMS	Page 1 of 3
		Yes / No / Comments
Involvement with Manufacturer Upgrade Programs	• ***In prior years,*** has the dealership participated in other incentive payment programs from the same manufacturer or other manufacturers? If so ... ◆ Provide details regarding program specifics and payments received. ▪ Years involved in program payments. ▪ List amounts received, by year, for all prior years. ◆ How were these payments treated for financial statement purposes? ◆ How were these payments treated for income tax purposes? ▪ If the program provides for incentive payments to be paid to the dealership in future years, has the fair market value or discounted value of future payments been included in the amount set up as a receivable (and taken into income)? • ***In the current year,*** is the dealership currently participating in any Factory incentive programs? Which ones? ◆ Are any of these programs new this year? If so, describe them. ◆ Provide details regarding program specifics and payments received. ▪ Have any payments been received in the current year? ▪ As a result of participating in the manufacturer's program, does the dealer have the right to receive ... in subsequent years ... • Any additional payments, cost reductions, or other incentives? • Any other considerations or preferential treatment? ◆ How will these payments treated for financial statement purposes? ◆ How will these payments treated for income tax purposes? ◆ If the dealership has received payments under programs from the same or other manufacturers in prior years, has consideration been given to whether treatment of payments this year may constitute a change in accounting method? • Do you have copies of all written Agreements relating to the participation of the dealership in the program(s)? ◆ Is the dealer expecting any additional considerations? ... Unwritten, undocumented, inferred, side-agreements, other "understandings," etc. ◆ Are there any forfeiture or refund provisions included in the program? *[See separate checklist section below.]* • ***New dealership clients.*** If this is a dealership client that is new to the firm, do you agree with the previous financial statement treatment and the income tax return treatment for amounts received under previous programs in prior years? ◆ If not, have you discussed your concerns with the dealer?	
Dealer Pushback... ***Coordination with Counsel***	• Has the dealer expressed any disagreement or other pushback against the manufacturer in connection with the program requirements? • Has the dealer received any letters or notices from the manufacturer within the past year regarding CSI, sales, facility upgrades or image enhancements, new points, etc.? ◆ If yes, what areas of concern were addressed by the manufacturer in these letters or notices? • How has the dealer responded to these notices? ◆ Has experienced dealership counsel been involved with the process? If so, provide the details. ◆ Does the dealer have any protection available under state franchise law? ▪ If so, what are they and what remedies might be available to the dealer? ◆ Has any other action (not involving attorneys) been taken? ... Written ... Oral • What is current the status?	

CHECKLIST FOR EVALUATING RAMIFICATIONS OF DEALERSHIP - MANUFACTURER FACILITY PROGRAMS

		Yes / No / Comments
Treatment of Program Payments as Loans	• Are payments to the dealership under the manufacturer's program subject to any of the following repayment contingencies (or other forfeiture events that would require the dealership to repay the manufacturer in the event of default)? ◆ Dealer fails, for any reason, to maintain at all times exclusive manufacturer signage, sales, parts and service operations at the dealership site as required by this Letter of Agreement or the Dealer Agreement. ◆ Dealer relocates any part of the dealership's operations or dealer's business without the manufacturer's prior written consent. ◆ Dealer fails to maintain part of the dealership facilities open for business as required under the Dealer Agreement. ◆ Dealer voluntarily terminates its Dealer Agreement with the manufacturer for any reason (except a sale of all or substantially all of the assets of the dealership, which sale has approved in advance and in writing by the manufacturer). ◆ The Dealer Agreement is terminated by the manufacturer under the terms of the Dealer Agreement and applicable law. ◆ Dealer should cease operations, declare bankruptcy, become insolvent, become subject to a receiver or trustee, abandon the dealership site or otherwise perform any act reasonably and materially in breach of, or inconsistent with, an intent to perform its obligations under the Agreements with the manufacturer or under the Dealer Agreement. ◆ Dealer should default on any loan secured by the sites occupied by the dealership or any secured lender should initiate foreclosure proceedings against the dealership site. • Describe any repayment contingencies in detail. ◆ Are these repayment contingencies substantial enough to support a position (that would be taken in the income tax return filed by the dealership) that payments received from the manufacturer are loans? ◆ If so, have these payments been reflected as liabilities/loans in the dealership's Balance Sheet?	
Treatment of Payments Received for Income Tax Purposes	• What is the status of the dealership for income tax purposes? ◆ Is the dealership a corporate entity? ◆ Is the dealership an LLC? ▪ If so, has it elected to be taxed as a partnership or as a corporation? ◆ Is the dealership a disregarded entity? • Have you read the dealership's selling Agreement and all correspondence to and from the manufacturer related to the manufacturer's upgrade program? • Is the dealership considering payments received from the manufacturer as taxable income in the year received (in accordance with Section 61 and the *John B. White* case? • Is the dealership considering payments received from the manufacturer to be non-taxable as contributions to the capital of a corporation under Section 118? ◆ If so, has the cost basis of the facility asset accounts been reduced by the payments received? ◆ Are these reductions computed in accordance with Section 362(c)? • Is the dealership considering the payments from the manufacturer to be non-taxable reductions in basis under the case law in *Brown*, *GM/GMAC*, and/or *Freedom Newspapers* and/or any other precedents? ◆ In what way or ways are the dealership's fact pattern and the manufacturer's program distinguishable from those in these basis reduction cases? ◆ How is the dealership's ***fact pattern*** distinguishable from the facts in the *John B. White* case? ◆ How is the ***manufacturer's program*** different from the *John B. White* case?	

CHECKLIST FOR EVALUATING RAMIFICATIONS OF DEALERSHIP - MANUFACTURER FACILITY PROGRAMS

		Yes / No / Comments
Status of Construction, Upgrades, etc. ***Fixed Assets & Depreciation*** ***Basis Reduction Implications***	• Was there any construction, expansion and/or facility upgrade activity during the current year? ◆ If so, how were these activities financed? ◆ Are any similar activities anticipated in the next year or over the next few years? If so, what is anticipated and how will the expansion be financed? • Within recent years, has there been any major construction or improvement activities? If so, describe. • What consideration been given to use of the following techniques to minimize current-year income taxes? ◆ Treatment of appropriate expenditures as repair expenses (rather than as capitalizable expenditures) under the new Tangibles Regulations. ◆ Writing off undepreciated portions of an old facility that is being replaced (i.e., such as roof replacements) through the upgrade process (under the new Tangibles Regulations). ◆ Assignment of appropriately short class lives to the pools of dollars that are required to be capitalized ... 5-year ... 7-year ... 15-year class lives. ◆ Beneficial use of (i.e., maximizing) Section 179 expense deductions ▪ 100% special depreciation deductions (applicable to the years 2010-2011). ▪ 50% special depreciation deductions (applicable to the year 2012). ◆ Use of other favorable tax provisions including... ▪ Energy efficient commercial building deduction provisions (Section 179D). ▪ Special retail facility shortened useful life periods. ▪ Qualified leasehold and qualified retail improvements provisions. • Have depreciation strategies been coordinated with planning for ... ◆ Current-year net operating losses and carrybacks? ◆ Net operating loss carryforwards from previous years? • Cost segregation studies ◆ Have there been any cost segregation studies on the facilities in prior years? ◆ Is depreciation being maximized? If not, why not? • Anticipated future expansion ◆ Does the dealer anticipate acquiring any new dealerships or franchises? ◆ Does the dealer anticipate any new construction or facility upgrades? ◆ How will these acquisitions and/or expansion activities be funded?	
Tax Return Disclosures ***Aggressive Tax Positions*** ***Risk Management***	• Has the possibility of an adverse IRS interpretation been discussed with the dealer? If so, when? • Several "risk" or "risk-level" considerations should be appropriately discussed and their resolution and the final responsibilities for making the tax return disclosure decisions should be documented. These considerations include... ◆ Accuracy-related penalties on taxpayers ◆ Accuracy-related penalties on return preparers ◆ Schedule UTP considerations ▪ Will the dealership be subject to Schedule UTP (Uncertain Tax Positions) reporting? If so, in what year will disclosure be required? ◆ Schedule M-1 or M-3 disclosures ◆ Filing Forms 8275 or 8275-R in an attempt to minimize certain penalties ◆ Extended statute of limitations considerations because the IRS will adjust depreciation deductions claimed with respect to fixed assets whose basis has been reduced by Factory payments. . ... Section 481(a) adjustments, change in accounting method considerations, etc. • If payments have been treated as non-shareholder contributions to capital under Section 118, what disclosures, if any, are included in the income tax return to reflect this?	

IRS

Factory Image Upgrade Payments

Automotive Alert

Motor Vehicle Technical Specialist

February, 2012

Introduction

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

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

Programs and Types of Payments

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

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

What Are The Tax Questions Related to Imaging Payments?

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

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

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

How Does Current Tax Law Apply to Imaging Payments?

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

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It should be noted that this document is not an official Service pronouncement and may not be cited as authority

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

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

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

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

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

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

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

Conclusion

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

Automotive Alert 2

It should be noted that this document is not an official Service pronouncement and may not be cited as authority

WHY BASIS REDUCTION TREATMENT IS INAPPROPRIATE FOR MANUFACTURER PAYMENTS

Some advisors (including one Panelist at the 2012 NADA Tax Issues Workshop) are of the opinion that dealerships may treat Factory image upgrade payments received from the manufacturers as basis reductions.

Essentially, these advisors place reliance on three cases for this position: (1) *James Brown, et al., v. Comm.*, (2) *General Motors Corp. and Subsidiaries v. Comm.* and (3) *Freedom Newspapers, Inc. v. Comm.*

This article discusses each case and analyzes the common denominator in each which (in the opinion of many practitioners) would render them - individually and/or collectively - inapplicable or insufficient to successfully defend against the contrary position of the IRS that Factory image upgrade payments should be taxable upon receipt.

In addition, this article discusses some aspects associated with managing the risk of unsuccessful defense of the position if/when the IRS challenges the treatment and proposes to assess penalties for various reasons.

JAMES BROWN, ET AL., V. COMM.

The *James Brown* case was decided in 1928 by the Board of Tax Appeals (BTA). Of the six issues in this old case, the relevant issue relates to the proper treatment of the amount paid by the majority stockholder in a company to Mr. Brown in order to induce Mr. Brown to purchase the stock which comprised the minority interest in that company.

Mr. Brown was paid $100,000 (by the then-current majority interest stockholder) to purchase the minority interest (at an inflated price) from the then-current holder of the minority interest. This holder of the minority interest could not agree with the then-current majority interest holder on how the Company should be managed. The minority interest was held by an estate.

The BTA held that the $100,000 that Mr. Brown received as an inducement to purchase the stock was a reduction of the cost of the stock to Mr. Brown. Therefore, the $100,000 payment to Mr. Brown (by the majority interest stockholder) was not taxable income to Mr. Brown.

Additional discussion of the *James Brown* case has been included on pages 34-35. This has been reprinted from the Year-End 2011 *Dealer Tax Watch.*

GENERAL MOTORS CORP. & SUBSIDIARIES V. COMM.

This case (referred to in this summary as the "*GM/GMAC* case") was decided by the Tax Court in 1999. It involved General Motors (GM), and one of its subsidiaries (General Motors Acceptance Corporation - GMAC) and the interpretation of the provisions in the consolidated return Regulations involving the timing of reporting income and taking deductions, and the matching these items between different members of the consolidated return group.

This case is long and complex, and it involves the interpretation of the 1966 consolidated return Regulations as they should be applied to 1984 and 1985 transactions. The holdings of the Tax Court were that, based on the consolidated return Regulations in effect during the year in issue, (1) those Regulations constitute a method of reporting and not a method of accounting, and (2) deductions claimed by General Motors for rate support payments it made to GMAC were not subject to deferral under the consolidated return Regulations in effect at that time.

It should be noted that in 1996, the consolidated return Regulations were amended, and the amendments made by those Regulations would have provided a contrary result had they been applied to the year in issue.

The *GM/GMAC* case involved programs initiated by GM and carried on through GMAC which made below-market interest rate financing available to retail customers who purchased GM vehicles from independent GM dealers and - in the course of financing the purchase of the vehicles - executed retail installment sales contracts (RISCs).

Many aspects of this case can be ignored in the context of analyzing the applicability of this case to the current question of the treatment of Factory image upgrade payments to dealerships. For example, GM and GMAC changed the method of providing for anticipated retail customer prepayments in 1985, so this introduced a change in method of accounting issue. Additionally, many other GM and non-GM programs were involved. Also, the consolidated return Regulations were changed in 1996, and the IRS attempted (unsuccessfully, of course) to apply the 1996 Regulations retroactively to transactions in 1984-1985 which were subject to the then-current Regulations which had been issued in 1966.

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GM wanted to stimulate the sales of GM vehicles to GM dealers and ultimately to the buying public. Therefore, GM initiated retail rate support programs under which the purchase price financed by the customer was at an interest rate below the prevailing market interest rate. The independent GM dealers were allowed to assign these purchase contracts (i.e., the RISCs) if the contracts met GMAC's credit standards. When GMAC acquired a RISC from an independent GM dealer, GMAC paid or credited the independent GM dealer the fair market value of the assigned RISC at the time of purchase.

The fair market value was computed using the GMAC buy rate (i.e., the RISC was discounted to present value based on the GMAC buy rate). The installment notes (customers' RISCs) would have a fair market value which was less than the face amount of the note. Technically, the retail rate support payment that GM made to GMAC represented the difference between the amount GMAC paid the independent GM dealer for the RISC under a retail rate support program and the amount that GMAC would have paid the independent dealer for the RISC in the absence of such a program ... ***GM essentially reimbursed GMAC for the difference in fair market value***.

This case includes numerous examples of accounting entries for payments made by GM and received by GMAC under various rate supported RISC programs and other programs. The following example illustrates the treatment of the transaction relevant to our discussion of manufacturer payments.

The treatment by GMAC when it received a ($500) retail rate support payment from GM was an increase in its cash by $500 and an elimination of the receivable that it had previously set up when it became entitled to receive the rate support payment from GM. If the retail customer had financed $12,000 on the purchase of a vehicle for which there was a $500 retail rate support payment from GM, and the customer issued a note for $10,000 on which an additional $2,000 of interest would be collected over the life of that note, it was agreed by the taxpayer, the IRS/Commissioner and the Tax Court that ... ***GMAC's book and tax basis and the rate supported RISC was $9,500 ... $10,000 minus $500.***

Based on its interpretation of the (1966) consolidated return Regulations, the Tax Court held that the GM group was not required to defer the rate support deductions that had been claimed for RISC payments that GM made to GMAC in the consolidated income tax return that included both GM and GMAC.

Footnote 30. The preceding summary of the *GM/GMAC* case provides the context for an understanding of the significance of ... or lack thereof ... the reference to "footnote 30" upon which some advocates rely for treating current manufacturer payments as reductions of basis.

Footnote 30, in its entirety, appears in the box below.

What is applicable from this *GM/GMAC* case arises out of the very last footnote that appears ("footnote 30") in this case. And, the importance of the

see **BASIS REDUCTION**, page 30

Footnote 30

Taxability of Payments Received by GMAC from GM for Retail Installment Sales Contracts (RISCs) Subject to GM's Rate Support Payment Program

The corresponding text in the decision reads ... "Respondent [IRS] agrees that the rate support payments were not income to GMAC. /30/."

"/30/ The rate support payments were not income to GMAC; they reduced GMAC's basis in the rate-supported RISC's/fleet loans. This was because the rate support payments induced GMAC to purchase RISC's/fleet loans from independent GM dealers at face value (i.e., GMAC paid independent GM dealers more than fair market value for a below-market RISC/fleet loan only because GM made rate support payments to GMAC for the excess amount paid).

"See *Brown v. Commissioner*, 10 B.T.A. 1036, 1054-1055 (1928) (amount received by buyer to induce him to purchase property is a reduction in his cost of the property rather than income to the buyer); Rev. Rul. 73-559, 1973-2 C.B. 299 (basis in acquired mortgage is reduced by the amount of the inducement payment); see also *Freedom Newspapers, Inc. v. Commissioner*, T.C. Memo. 1977-429; Rev. Rul. 76-96, 1976-1 C.B. 23 (new car purchaser must reduce his basis by amount of manufacturer rebate)."

(Continued from page 29)

reference to the *Brown* case in this footnote is simply explanatory.

The IRS had argued that the rate support payments that GM made to GMAC were part of the intercompany transactions that should be subject to a matching rule contained in the Regulations and that GM should have deferred its deductions. The Tax Court was compelled to discuss (1) the matching rule in the consolidated return Regulations, and (2) the relationship of the receipt (by GMAC) of the amount paid by GM as a "corresponding item of income" and whether it had to "be from the very same payment that creates the deduction."

In its analysis of the relationship of the receipt by GMAC of the payment from GM, the Tax Court said ... "Respondent (i.e., the IRS) agrees that the rate support payments were not income to GMAC" and refers to footnote 30 (the very last footnote in the decision).

The reference in footnote 30 to "rate-supported RISCs/fleet loans" relates to payments made by GM to GMAC with respect to both (1) retail installment sales contracts (RISCs) which were executed by individual purchasers with independent GM dealers, and (2) fleet loans which were executed by fleet customers who purchased multiple GM vehicles (usually in a single transaction) from independent GM dealers.

Another footnote in this case (i.e., footnote 12) states, "The retail rate support payment GM made to GMAC represented the difference between the amount GMAC paid to the independent GM dealer for the RISC (retail installment sales contract) under a retail rate support program and the amount GMAC would have paid the independent GM dealer for the RISC in the absence of such a program."

In essence, this footnote says that ... The rate support payments (by GM) induced GMAC to purchase installment loan contracts from independent GM dealers at face value which was more than the fair market value of the below-market installment loan contract. GMAC purchased these loans at their face value only because GM made rate support payments to GMAC for the excess amount paid.

FREEDOM NEWSPAPERS, INC. V. COMM.

This is the third case - another Tax Court decision - which some advisors cite in the belief that it supports the position that payments for facility upgrades from manufacturers may be treated as reductions of cost basis by dealerships.

The owner of a large number of newspapers decided to dispose of 26 newspaper properties through a broker. The broker divided the total package of properties into several smaller groups of newspapers. However, the broker's commission was contingent on the sale of all 26 newspapers.

In this case, decided in 1977, Freedom Newspapers, Inc. was the entity which ultimately was paid $100,000 by the business broker as an inducement for it to purchase a business (i.e., one newspaper), which Freedom Newspapers believed was overpriced by at least that amount. The broker arranging the sale agreed to make this payment because the broker expected to earn an overall commission in excess of $1 million, and this commission would not be paid unless several businesses - including the overpriced business - were all sold as a single package.

One of the several groups of newspapers included four newspapers, three of which were attractive to the taxpayer (i.e., Freedom Newspapers, Inc.) and one of which was not. Out of a total purchase price of $10 million for these four newspapers, a sales price of $700,000 was to be allocated to the one newspaper (*The Jackson County Floridian*) which, for several reasons, the taxpayer was not interested in acquiring. One of those reasons was that the *Floridian* was not considered to be worth $700,000.

Throughout the strenuous buy-sell negotiations, the seller insisted that the "ugly duckling" *Floridian* had to be sold as part of the overall package. The broker for the sale was an independent party to the transaction whose $1 million anticipated commission depended on the sale of the four newspapers, including the *Floridian*, as a package.

The broker entered into an agreement with Freedom Newspapers - the buyer - which provided that if the buyer bought the *Floridian*, the broker would attempt to resell the *Floridian* within one year on the buyer's behalf for a sales price of at least the $700,000 paid by the buyer. If the sale could not be made at that price, then the broker agreed to pay the buyer/Freedom Newspapers $100,000. This amount was placed in an escrow account for the one-year period.

Omitting all of the underlying technicalities, Freedom Newspapers purchased the package of four newspapers, including the *Floridian*. The *Floridian* was not resold until many years later, well after the escrow expiration. Accordingly, as agreed, Freedom Newspapers was paid $100,000 out of the escrow account which had been set up by the broker to induce the buyer/Freedom to make the purchase.

In its tax return, Freedom Newspapers took the position that the $100,000 it received as an inducement to purchase the *Floridian* constituted a reduction of its tax basis for that newspaper.

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Citing *Brown v. Comm.*, the Board of Tax Appeals case in 1928, the taxpayer (i.e., Freedom Newspapers) relied upon the rule that the basis of an asset in the hands of a purchaser must be reduced by the value of any payments received by the purchaser under a third-party agreement intended to induce the purchase.

In addition, the taxpayer cited the doctrine established in 1952 by the Supreme Court in *Arrowsmith v. Comm.* In essence, Freedom contended that because the $100,000 payment was received as a direct consequence of its purchase of the *Floridian*, the character of that payment must be determined by the reference to that transaction, and accordingly, that payment would represent a reduction in the price it paid for that newspaper.

The IRS' position was that the $100,000 payment that Freedom Newspapers received from the broker was nothing more than liquidated damages for the broker's inability to resell the *Floridian* at an agreed-upon price within the agreed-upon time.

In other words, the position of the IRS was that the agreement between the broker and the purchaser should be viewed as "separate and apart" from its purchase of the newspaper.

The Tax Court, citing *Brown*, said "When the two contracts are considered together upon the basis of the intent of the parties when made, and in the light of the results reached in their final consummation, we fail to see how the amount in question can be considered as taxable income." In addition, the Court said, "We must consider the end effect of both contracts. In other words, even though petitioner [i.e., Freedom Newspapers] contracted with two different parties, the two agreements were, nevertheless, each a part of the same transaction and must be so viewed. ... Accordingly, ... the $100,000 was merely a reduction of the cost of the newspaper."

In discussing the application of the Supreme Court's decision in *Arrowsmith*, the Tax Court noted that ... "Indeed, the Board's decision in *Brown v. Commissioner* may very well have been subsumed by the Supreme Court's decision in *Arrowsmith*."

COMMON DENOMINATOR IN THESE CASES WHICH MAKES THEM INAPPLICABLE TO FACTORY FACILITY UPGRADE PAYMENTS

I do not believe that basis reduction is appropriate as it relates to most of the current Factory payments that dealerships are receiving for upgrading their facilities.

Careful analysis of the entire *Brown* case, the entire *General Motors/GMAC* case (and not only footnote 30) and *Freedom Newspapers* reveals a significant common denominator that provides a world of distinction ... notwithstanding the fact that each was a victory for the taxpayer.

The fact patterns in all three cases boils down to simply a payment made by a third party to induce another party to purchase an asset for an amount greater than its current fair market value.

The *GM/GMAC* case involves payments made between related parties (in a consolidated group context); whereas in both the *Brown* case and in *Freedom Newspapers*, the inducement payments were made by parties unrelated to the purchasers who were motivated to see the purchase transaction occur because that purchase - by a third party - would be in their own best interests.

Furthermore, the result of the inducement payments that were made - in all cases - was simply just to get the purchaser back to a point of paying market value or a fair price for the asset that the purchaser (Brown, GMAC or Freedom Newspapers) was acquiring.

Simply put, after receiving the (inducement) payment, the taxpayer simply netted back to not being out-of-pocket for an amount in excess of the fair market value or market value of the asset it was purchasing (i.e., the minority interest in the *Brown* case, the RISCs that GMAC was acquiring or the *Floridian* that Freedom Newspapers acquired).

In my opinion, this difference clearly distinguishes the fact patterns in these three cases from the receipt by dealerships of Factory facility program payments.

STRONG CASE LAW PRECEDENT REQUIRING TAXABILITY

A discussion of why basis reduction treatment is inappropriate for manufacturer payments would be incomplete without referring to the strong case law that suggests payments by the manufacturer should be taxable. Although many cases might be cited for the general proposition that manufacturer payments are immediately taxable, the Tax Court's decision in *John B. White* seems to be the most persuasive.

John B. White, Inc. involved the question of whether Section 118 of the Code would permit the dealership to exclude from income the assistance payments that were received from a manufacturer for facility improvements and/or image upgrades. Section 118 provides that a corporation may exclude contributions to its capital by a non-shareholder.

The facts are as follows. The dealership Corporation operated an authorized Ford dealership in Philadelphia, Pa. In 1965, the manufacturer (Ford),

see **BASIS REDUCTION**, page 32

(Continued from page 31)

which held none of the Corporation's stock, paid the Corporation $59,290 to induce it to move to another location within Philadelphia. This payment was offered by Ford in order to increase the sales of its products and enhance its image by having the Corporation's dealership located in a more desirable neighborhood and in a more attractive and better equipped building than its current location.

The IRS and the Tax Court (in 1971) held that the payment received by the dealership was taxable as ordinary income upon receipt and that Section 118 was inapplicable to the transaction. The decision of the Tax Court (55 T.C. 729) was upheld by the United States Court of Appeals for the Third Circuit ... April 24, 1972 (71-1 USTC ¶9368; 458 F2d 989 - affirming Tax Court *per curiam*). Supreme Court *Cert* denied, 409 US 876; 93 SCt 127.

It is instructive to note that in reaching its decision, the Tax Court reviewed the dealership's franchise Agreement and all of the correspondence the dealer had received from the manufacturer (and the dealer's responses) as part of its determination of the factual basis supporting its conclusion.

In February 2012, an *Automotive Alert* (*"Factory Image Upgrade Payments"*) stated, "The Court first cited Code Section 61 and noted that the payment from Ford enhanced White's wealth and allowed the dealership to acquire improved facilities at a more advantageous location. ... The *White* case in particular appears to be on point with the general facts surrounding the payments and should be considered carefully when evaluating the proper treatment of image upgrade payments."

It should be noted that an *Automotive Alert* by the IRS Motor Vehicle Technical Advisor is not considered to be an official Service pronouncement, nor should it be cited as authority. Accordingly, proponents for basis reduction treatment might consider the *White* case to be less significant.

WHAT ARE THE RISKS?
HOW ARE THEY MANAGED?

Some who would advocate for basis reduction treatment say that what they want to do is arrive at a position for the dealer where the dealer is paying the right amount of tax within the risk level that the dealer/dealership/taxpayer is willing to accept.

In this regard (i.e., in discussing the risk level that a taxpayer is willing to accept), it is important to have a well thought out and carefully documented approach for how the treatment of these payments will be disclosed in the tax return. Especially if one believes there is no real disclosure necessary since the payment received is simply offset against the basis of the asset by accounting or journal entries.

Even if accounting entries offset the carrying value of the assets, it is more than likely that the Internal Revenue Service may ask questions about participation in manufacturer plans and the receipt of payments in their Information Document Requests (IDRs) in the normal course of an audit of the dealership. Part I of this article series (in the Year-End 2011 Edition of the *Dealer Tax Watch*) included copies of IDRs that were suggested in the Industry Directors Directives.

In this regard, these IDRs were focusing on whether or not taxpayers had treated payments received as excluded from gross income under Section 118. Specifically, taxpayers were asked by the IRS to identify any payments that were excluded from gross income under Section 118, and/or from ... ***"any other provision of the Internal Revenue Code and/or its accompanying Regulations and/or any common law doctrines or principles."*** The emphasized portion clearly would cover situations where a dealership might have excluded Factory image upgrade payments from income based either on Section 1060 and/or the "common law doctrines or principles" that were discussed in connection with the analysis of the *Brown*, *GM/GMAC* and *Freedom Newspapers, Inc.* cases.

The point is that one should expect the IRS to ask broadly phrased questions to pinpoint or pry out the treatment a dealership has accorded these payments in its tax returns.

Several other "risk" or "risk-level" considerations should be appropriately discussed and their resolution and the final responsibilities for making the tax return disclosure decisions should be documented. These considerations are discussed briefly below.

Accuracy-related penalties on taxpayers and return preparers. It has now become standard practice for the IRS to assert various accuracy-related penalties when it proposes deficiencies. Evolving case law in situations where taxpayers and/or preparers have asserted defenses against the penalties clearly establishes that penalties cannot be avoided in cases where all of the underlying documentation (i.e., facts and circumstances) have not been made known to the preparer and/or have not been taken into consideration by a return preparer competent to assess all of the facts and circumstances.

As evidenced from the *James White* case, a successful defense against these penalties cannot be made if all of the Agreements between the dealer →

and the manufacturer have not been taken into consideration. This includes even reviewing the dealer's selling (franchise) Agreement with the manufacturer.

Schedule M-1 or M-3 disclosures. Schedule M-3 contains a specific line (Line 36 on Page 3) with respect to exclusion of payments from income under Section 118 and requires that an explanation be attached describing these payments.

Form 8275 filing considerations. Form 8275 *(Disclosure Statement)* is used by taxpayers and tax return preparers to disclose items or positions, except those taken contrary to a Regulation, that are not otherwise adequately disclosed on a tax return to avoid certain penalties. Form 8275 is filed to avoid the portions of the accuracy-related penalty ***due to disregard of rules*** or to a substantial understatement of income tax for non-tax shelter items if the return position has a reasonable basis. It can also be used for disclosures relating to preparer penalties for understatements due to unreasonable positions or disregard of rules and the economic substance penalty.

Form 8275-R filing considerations. Form 8275-R *(Regulation Disclosure Statement)* is used by taxpayers and tax return preparers to disclose positions taken on a tax return that are contrary to Treasury Regulations. The Form is filed to avoid the portions of the accuracy-related penalty ***due to disregard of Regulations*** or to a substantial understatement of income tax for non-tax shelter items if the return position has a reasonable basis. It can also be used for disclosures relating to the preparer penalties for tax understatements due to positions taken contrary to Regulations and the economic substance penalty.

Furthermore, certain portions of the accuracy-related penalty attributable to certain types of misconduct cannot be avoided by filing either Form 8275 or Form 8275-R.

It should also be noted that both Forms 8275 and 8275-R contemplate disclosures regarding "carrybacks, carryovers and recurring items," and are accompanied by detailed pages of instructions.

Bottom line... Will the dealership be filing Forms 8275 and/or 8275-R with its income tax returns for all years in which manufacturer payments have been applied against basis instead of being treated as currently taxable income?

If not ... Why not?

Schedule UTP considerations. Also, consideration should be given to the fact that more dealerships may be required to include Schedule UTP *(Uncertain Tax Position Statement)* with their 2012 corporate income tax returns.

If a dealership, or an entity related to the dealership, issues an audited financial statement and the dealership files a corporate income tax return for the year (i.e., ***Form 1120***), the dealership will be required to file Schedule UTP with its 2012 income tax return if it has total assets in excess of $50 million. This represents a lowering of the higher previous dollar-amount threshold which exempted some dealerships from filing Schedule UTP. The treatment of payments from the manufacturer as reductions of basis would seem to constitute an uncertain tax position (if the amounts involved are material).

Other Considerations. These include (1) extended statute of limitations considerations because the IRS will adjust depreciation deductions claimed with respect to fixed assets whose basis has been reduced by Factory payments, (2) Section 481(a) adjustments, and (3) change in accounting method considerations.

New dealer client considerations. All of the considerations above must be reviewed in every situation where a CPA firm acquires a new dealership client if that dealership has previously participated in Factory image upgrade programs.

It is well accepted that the new CPA firms will, in effect, assume responsibility for validating the continuing treatment of the payments in the preparation of current income tax returns, as well as advising the dealership as to what risks it may have already assumed by excluding payments received from income in previously filed income tax returns.

In reviewing the treatment of manufacturer payments by a dealership that becomes a new client for the CPA firm, if the new CPA firms does not concur with the prior treatment, the appropriate corrective action will need to be considered and discussed with the dealer.

Regrettably, many CPAs have said that they are losing dealer clients, and/or failing to acquire new dealership clients, because dealers (obviously) prefer hearing that these payments can be offset against basis instead of being fully includable in income when received.

James Brown, et al. v. Comm.

Payment Received to Induce Purchase of Stock Was a Reduction of Cost Basis

10 B.T.A. 1036 ... Feb. 28, 1928

The Factual Essence of *James Brown*

Before

- Mr. A owns the majority interest in Corporation XYZ.
- Mr. X owns the minority interest in Corporation XYZ.
- Mr. X is an unfriendly/hostile minority interest holder who does not agree with Mr. A on how Corporation XYZ should be run.
- Along comes Mr. B (an acquaintance of Mr. A) who is not a shareholder, but who is friendly to Mr. A.
- Mr. A suggests that Mr. B should purchase the minority interest in Corporation XYZ currently owned by Mr. X.
- However, Mr. B thinks the price Mr. X wants for his stock is too high. Mr. B is unwilling to purchase the minority interest shares in Corporation XYZ at the high price that Mr. X requires.

The Inducement Transaction

- Mr. A tells Mr. B that he will give/reimburse Mr. B $20,000 if Mr. B purchases the stock from Mr. X for the price Mr. X desires.
- Mr. B purchases the minority interest in Corporation XYZ owned by Mr. X. This replaces Mr. X (the hostile owner of the minority interest) with Mr. B who is a friendly owner of the minority interest.
- Mr. A pays Mr. B $20,000, per their agreement.

After ... Part I

- Mr. B's position is that the payment of $20,000 that he received from Mr. A should be treated as a reduction of the cost of his purchase of the minority interest in Corporation XYZ.
- The Board of Tax Appeals agrees with Mr. B that the $20,000 payment is a non-taxable reduction of his cost basis in the stock of Corporation XYZ.

After ... Part II

- Mr. B (the new owner of the minority interest) is happy because he is not taxed on the receipt of the $20,000 that he received from Mr. A. The payment is not taxable as ordinary income. Instead, it is a reduction of his basis for his minority interest in Corporation XYZ.
- Mr. B is also happy because the amount he paid, when reduced by the $20,000 he received from Mr. A, leaves him feeling satisfied that the (net) price he paid was a "fair price" for the minority interest in Corporation XYZ.
- Mr. A (the owner of the majority interest) is happy because Mr. B is now the friendly minority shareholder of Corporation XYZ.
- Mr. X (the former hostile owner of the minority interest) is happy because he is out of the picture and he has received the price he was asking for his stock.

Comment: In the *James Brown* case, the unfriendly minority interest in Corp. XYZ was held by the *estate* of Mr. X.

Source: **Reprinted from the Year-End 2011 Edition of the *Dealer Tax Watch*, page 50.**

James Brown, et al. v. Comm.

Payment Received to Induce Purchase of Stock Was a Reduction of Cost Basis

10 B.T.A. 1036 ... Feb. 28, 1928

Facts

During 1920, and for some time prior thereto, one Franklin Bache was president and principal stockholder of the Kali Inla Coal Co., (hereinafter referred to as the "Coal Company"). Upon the death of J. T. Jackson, who held the remainder of the stock, the estate of Jackson offered the stock for sale. At this time there were suits pending in connection with the Coal Company and Bache was desirous that this minority interest should not be purchased by persons hostile to the Coal Company. Bache, not having funds to purchase the entire minority interest, urged petitioner, James Crosby Brown, to purchase the stock, but Brown was reluctant to make the purchase for the reason that he considered the price asked of $125 per share excessive. At this time and for some time prior thereto, Bache had been serving the Coal Company at a low salary and there was an understanding that when the condition of the Coal Company would warrant such action, Bache would be paid a substantial amount as back salary.

In order to induce James Crosby Brown to purchase some of the stock at the price offered, Bache agreed with Brown that if he (Brown) would purchase a certain amount of the stock at the price offered, he (Bache) would give him (Brown) 15% of the aforementioned back salary when received.

Accordingly, in February, 1920, Brown purchased 90 shares of the Coal Company stock at $125 per share from the Jackson estate. During 1920, Bache received certain back salary and made payments to Brown of $2,200.14 on August 30, 1920, and $1,050 on October 19, 1920. Brown made book entries on account of the foregoing amounts as payments to reduce the cost of the Coal Company stock. The Commissioner included the payment of August 30, 1920, as a part of Brown's gross income for 1920.

Opinion

The question is whether the amount paid petitioner, James Crosby Brown, by one Bache to induce Brown to purchase certain stock of the Kali Inla Coal Co. is a reduction of the cost of the stock to Brown or whether it is to be treated as taxable income.

The substance of the transaction is that when the minority stock was offered for sale, Bache, the majority stockholder, was unable to purchase the stock himself and was desirous that the stock be purchased by some one friendly to the Coal Company as it then existed.

Bache accordingly urged Brown to purchase the stock at the price offered, but Brown was reluctant to make a purchase at this price because he said he thought the price too high. Bache then agreed to pay certain amounts to Brown if he would purchase some of the stock.

Our question is whether this is to be treated as a reduction of the cost of the stock to Brown, or whether it is taxable income to him.

The Board is of the opinion that the amount paid to petitioner by Bache does not constitute taxable income to him, but was a reduction of the cost of the stock.

This amount was paid in furtherance of an understanding between petitioner and Bache under which petitioner made the purchase and, in the minds of both parties, represented a reduction of the investment by petitioner.

Petitioner acquired the stock from the Jackson estate coupled with a contract that Bache would, in effect, make the cost to petitioner less than the agreed consideration between petitioner and the Jackson estate.

When the two contracts are considered together upon the basis of the intent of the parties when made, and in the light of the results reached in their final consummation, we fail to see how the amount in question can be considered as taxable income. The action of the respondent in treating the amount paid by Bache to Brown as taxable income is accordingly reversed.

Source: **Reprinted from the Year-End 2011 Edition of the *Dealer Tax Watch*, page 51.**

NEW SECTION 263(a) "TANGIBLES" REGULATIONS ... CONFUSION CONTINUES OVER WHAT SHOULD BE CAPITALIZED

INTRODUCTION

On December 27, 2011, the Treasury published temporary Regulations that provide guidance on the application of Sections 162(a) and 263(a) to amounts paid to acquire, produce, or improve tangible property. These Regulations became effective January 1, 2012 and also serve as proposed Regulations.

In fact, amendments to the Regulations under Sections 162, 167, 168 and 263(a) are all involved in the ***nine*** sets of "new" Regulations (collectively referred to by some as the "tangibles Regulations").

This article includes several exhibits and supplementary materials which provide overviews of the Regulations and of specific definitional portions of the Regulations. These exhibits provide insight into the highly subjective and technical nature of the concepts which the Treasury and the IRS are now trying to establish.

Special emphasis is placed on the Regulations related to "improvements" to property because these Regulations have a significant bearing on the extent to which dealerships might be able to reduce the tax impact otherwise associated with having to report manufacturer assistance payments for facility improvements as ordinary income when received.

Accordingly, the focus of this article is on the new Regulations under Section 263(a) and their importance in determining the proper treatment of dealership facility expenditures under image upgrade programs.

PRECURSORS TO THE NEW REGULATIONS

Over many years, there have been hundreds of cases involving questions concerning the deductibility of expenditures for the acquisition, improvement, or repair of business assets. The Regulations issued in December 2011 have evolved over a long period of time.

More than 5 years ago, in August 2006, the Treasury issued proposed amendments to the Regulations under Section 263(a) relating to amounts paid to acquire, produce, or improve tangible property. In response to these Regulations, the Treasury re-

see **SECTION 263(a) "TANGIBLES,"** page 38

Sec. 263(a) Regulations

NEW SECTION 263(a) "TANGIBLES" REGULATIONS
IMPROVEMENTS VS. REPAIRS
CAPITALIZABLE EXPENDITURES VS. DEDUCTIBLE EXPENSES

Summaries
Exhibit I

EXECUTIVE SUMMARY ... THE NEW TANGIBLES REGULATIONS

- The term "new Tangibles Regulations" broadly refers to the nine (9) sets of temporary Regulations issued in December 2011 by the Treasury. These Regulations clarify and expand the standards for proper capitalization of specific expenditures associated with tangible property. These Regulations relate to ...
  - Materials and supplies ... Under Reg. Sec. 1.162-3T
  - Repairs ... Under Reg. Sec. 1.162-4T
  - Capital expenditures in general ... Under Reg. Sec. 1.263(a)-1T
  - Amounts paid to ***acquire or produce*** tangible property ... Under Reg. Sec. 1.263(a)-2T
  - Amounts paid to ***improve*** tangible property ... Under Reg. Sec. 1.263(a)-3T
  - Capital expenditures made by either a lessee or a lessor on leased property ... Under Reg. Sec. 1.167(a)-4T
  - General asset accounts ... Under Reg. Sec. 1.168(i)-1T
  - Accounting for MACRS (Modified Accelerated Cost Recovery System) property ... Under Reg. Sec. 1.168(i)-7T
  - Dispositions of MACRS property ... Under Reg. Sec. 1.168(i)-8T.
- The Regulations emphasize the importance of making a proper determination based upon ***all of the facts and circumstances***. The IRS acknowledges the highly factual nature of determining whether expenditures are for capital improvements or for ordinary repairs and the difficulties encountered in applying these standards in actual practice.
- Practitioners and taxpayers should approach the interpretation of the new Regulations with the expectation that it may be very difficult to avoid capitalizing substantial amounts of expenditures unless there are unusually favorable (extenuating) "facts and circumstances" that override the detailed rules.
  - *Bottom line* ... "facts and circumstances" determinations trump everything else.
- ***"Reg. -3T."*** The principles for determining whether activities and expenditures relating to buildings should be capitalized or expensed are found in the general rules for "improvements," under Reg. Sec. 1.263(a)-3T.
  - In applying these Regulations, it is critical to determine what constitutes a ***unit of property***. For a building, the "unit of property" consists of the building ***and*** its structural components ***and*** building systems. All three elements are considered together and collectively as a single "unit of property."
  - This specific Regulation includes detailed (and, in many places, subjective) rules for determining whether the expenditures are incurred for (1) a *"betterment,"* (2) a *"restoration"* to the building, building structure and/or the building systems, or (3) an *"adaptation"* of the building (including the structure and/or any of the building systems) to a new or different use.
  - This Regulation is divided into seventeen (17) Subsections which are lettered (a) through (q) and includes eighty-eight (88) fairly detailed examples.
  - An *Automotive Alert* issued by the IRS Motor Vehicle Technical Advisor (Feb. 2012) identified three examples as likely to be relating to the current dealership activity involving facility upgrades and improvements. These are *Examples #6, #7* and *#8*, which are included among the 19 examples under Reg. Sec. 1.263(a)-3T(h)(4).
    - These three examples are not dealer-specific. Upon close analysis, these examples provide little helpful insight except to create the expectation that significant amounts usually will have to be capitalized when all of the facts and circumstances are taken into consideration.
- The new Regulations (under 1.168(i)) include important correlative revisions to the fixed asset tax accounting rules for depreciation and disposition when a replacement of a major component or substantial structural part of a building occurs.
  - This includes the revision (expansion) of the definition of a "disposition" ... so that taxpayers may treat the retirements of structural components of buildings as "dispositions" of property.
  - This will allow taxpayers to recognize a loss on the disposition of a structural component of a building before the disposition of the entire building.
  - Accordingly, taxpayers will not have to continue to depreciate amounts allocable to structural components that are no longer in service. In other words, taxpayers will not be required to capitalize and depreciate simultaneously amounts paid for both the removed and the replacement properties.
- ***Changes in accounting methods.*** In conforming existing practices to comply with the new Regulations, taxpayers will be required to make changes in methods of accounting. Most of these changes will be "automatic," and they will involve the computation of Section 481(a) adjustments. Under the limitations currently included in the Regulations, it may be extremely difficult - if not impossible - to make proper computations of the required Sec. 481(a) adjustments.
  - Unless the changes in accounting methods under consideration are relatively straight-forward and do not reflect practices that involve large dollar amounts over a lengthy span of years ... taxpayers may prefer to wait until these new Regulations are finalized before they file Forms 3115 to make these changes.

(Continued from page 36)

ceived numerous written comments and held a public hearing in December 2006.

In March 2008, after consideration of the comment letters and the statements at the public hearing, the Treasury withdrew the 2006 proposed Regulations and proposed new Regulations. These Regulations were under Sections 162(a) (relating to the deduction for ordinary and necessary trade or business expenses) and Section 263(a) (relating to the capitalization requirement). In response to this second set of Regulations, taxpayers submitted written comments and testified at a public hearing in June 2008.

After considering these written and oral comments, the Treasury withdrew the 2008 proposed Regulations and, in December 2011, issued the new Regulations. Technically, these new Regulations are temporary and proposed Regulations. However, even though these "new" Regulations are not final Regulations, taxpayers and the Internal Revenue Service may rely on them for tax years beginning on or after January 1, 2012.

In the context of this timetable, there was one other development related to the controversial area of capitalization versus repairs. In November 2010, the IRS had published an *Audit Technique Guide* (*ATG*) specifically dealing with the capitalization versus repairs issues.

The *ATG* was intended to assist examiners in determining whether an expenditure should be capitalized or deducted. Although this *ATG* is still valuable as a reference, many positions of the IRS expressed in the *ATG* have been modified or entirely superseded by the new Regulations under Section 263(a). Accordingly, anyone using the *ATG* as a reference for background information on capitalization versus repair issues should be aware of the now "dated" status of the material it contains.

THE NEW REGULATIONS - IN GENERAL

The Regulations are long, complex and extremely detailed. This is to be expected in light of the years of litigation, conflicting decisions as to what should or might be capitalized or expensed and the efforts made by the IRS/Treasury to incorporate, at this time, a current set of standards to be applied on a going-forward basis.

The IRS has acknowledged that these Regulations reflect the highly factual nature of determining whether expenditures are for capital improvements or for ordinary repairs and the difficulty in applying the standards in practice. In just the portion of the Regulations under 1.263(a)-3T dealing with improvements to property, there are 88 examples ... most of which are quite detailed.

Overall, the Regulations (1) clarify and expand the standards for proper capitalization of specific expenses associated with tangible property in the current Regulations, (2) provide some bright-line tests - for example, a *de minimis* rule for specific acquisitions - for applying the standards, (3) amend the general asset account Regulations, and provide guidance under Section 168 on the accounting for, and dispositions of, MACRS depreciable property.

Summaries of selected portions of the Regulations are included as *Exhibits II*, *III* and *IV* on pages 44-49.

CHANGES IN ACCOUNTING METHOD

As practitioners explore the meaning of these Regulations, they should understand that if taxpayers are going to make changes to comply with these new Regulations, they will be dealing with other provisions involving changes in accounting methods (CAMs), Section 481(a) adjustments and filing Forms 3115.

For example, CAMs are necessary in order to recharacterize previously capitalized expenditures as currently deductible repairs, or to deduct the undepreciated tax basis of a structural component (such as a roof) when it has been replaced.

In January 2012, the IRS issued two Revenue Procedures (Rev. Proc. 2012-19 and Rev. Proc. 2012-20) which provide procedures by which taxpayers may make automatic changes in accounting methods (CAMs) under these Regulations. These CAMs are for taxable years beginning on or after January 1, 2012.

For a summary concerning automatic change in accounting methods under the new Regulations, see pages 42-44. Also, see pages 58-59 for selected automatic CAMs that are applicable to dealerships and facilities upgrades.

MORATORIUM ON AUDITS

On March 15, 2012, the Large Business & International branch of the IRS issued an important new Directive. This Directive stated that for taxpayers who had adopted a method of accounting (change) relating to the conversion of capitalized assets to repair expense under Section 263(a), IRS examining agents should (1) discontinue any current exam activity, and (2) not begin any new exam activity.

Also, if the taxpayer under examination files a Form 3115 with regard to these issues on or after December 23, 2011, the Directive stated that the examining agent "should risk assess the Form 3115 and determine (in consultation with the *Change in Accounting Method Issue Practice Group*)" whether to examine the Form 3115.

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In effect, this is a "moratorium" or a "stand-down order" for 2012 and 2013.

APPLICABILITY OF NEW REGS TO UPGRADES OF DEALERSHIP FACILITIES

Currently, many dealerships are expanding, modernizing and/or standardizing their current facilities by replacing or significantly improving/upgrading them. Some of these changes are dealer-initiated and others result from strong encouragement or other forceful persuasion from the manufacturers.

During a presentation in late 2010 to the AICPA Auto Dealership Conference, Ms. Terri Harris, the IRS Motor Vehicle Technical Advisor, stated that a new area of major audit concern related to whether dealerships should be capitalizing or expensing repairs and improvements to their buildings and facilities. At that time, the previously mentioned IRS *Audit Technique Guide* was important in this context.

NADA Tax Issues Workshop. The 2012 NADA Convention *Dealer Tax Issues* Workshop included significant discussion by Panelists of manufacturer assistance payments to dealerships for facility improvements.

It was the consensus of the Panelists that these payments received by dealerships would be includable (i.e., taxable as ordinary income) upon receipt. Also, it was their consensus that the adverse tax impact of including these payments as taxable upon receipt could be significantly minimized by the consideration and appropriate use of several techniques including the treatment of appropriate expenditures as expenses (rather than as capitalizable expenditures) under the Section 263(a) tangibles Regulations and examples.

MVTA Automotive Alert. In February 2012, the IRS Motor Vehicle Technical Advisor issued an *Automotive Alert* entitled "IRS Issues New Regulations ... Deduction and Capitalization of Expenditures Related to Tangible Property." This *Alert* includes an Addendum entitled, "Regulation Examples #6,-7 and -8 re: Store Remodels and Refreshes."

This *Automotive Alert* appears on pages 50-53.

The *Alert* states that the portion of the Regulations which addresses amounts paid to improve personal tangible property (i.e., Reg. Sec. 1.263(a)-3T) is "most likely to be of interest to dealers who periodically upgrade, remodel, refresh or otherwise improve dealership facilities."

The *Alert* suggests a 2-step process to determine if property has been improved. Step 1 is to determine "what is the unit of property?" Step 2 is to determine if "the work performed constitutes an improvement to the unit of property."

Exhibit II - IV, included as supplementary material to this article on pages 44-49, provide more detail on these considerations. The important point to keep in mind is that the expenditures must be capitalized if the activities performed have (1) resulted in a betterment to the unit of property *[Subsection (h)]*, (2) restored the unit of property *[Subsection (i)]*, ***or*** (3) adapted the unit of property to a new or different use *[Subsection (j)]*.

If any one of these three conditions is met (note the ***"or"***), then the expenditures are considered to have been improvements and the taxpayer is required to capitalize (rather than currently deduct) all of the direct costs of the improvement and all of the indirect costs that directly benefit or are incurred by reason of the improvement.

In this regard, the new Regulations introduce a critical distinction ... which will undoubtedly work to the disadvantage of most dealerships and other taxpayers ... by providing that in general, the building ***and*** its structural components are considered to be one unit of property.

Therefore, amounts are treated as paid for an improvement to the building if these amounts either improve (1) the building structure ***or*** (2) a building system.

What is more critical (and disadvantageous) is that the new Regulations define 5 different building systems that are involved in all dealerships, 2 more that may be found in larger, more elaborate dealership facilities and only 1 that is not likely to be found in a dealership. See *Exhibit II* (pages 44-45).

Accordingly, dealers and practitioners should approach the interpretation of these Regulations with the expectation that it may be very difficult to avoid capitalizing substantial amounts of expenditures unless they are blessed with most favorable extenuating "facts and circumstances."

In other words, after sorting through all of the discussion and examples, it seems that it all comes down to "facts and circumstances" determinations.

EXAMPLES RELEVANT TO DEALERSHIPS

As mentioned previously, Panelists at the 2012 NADA Dealer Tax Issues Workshop specifically cited three examples in the Regulations thought to be of greater significance for dealers and accountants in determining how various expenditures relating to dealership facility improvements should be treated for income tax purposes. These Examples appear to

see **SECTION 263(a) "TANGIBLES,"** page 40

(Continued from page 39)

basically dovetail with the Factory image program tax issues.

The texts of these three examples are included in their entirety in the Motor Vehicle Technical Advisor's *Automotive Alert*. They are referred to by three different names ... (1) the "dash 3 examples" (i.e., -3T) ... (2) the "-6, -7 and -8 examples" or ... (3) the "refurbishment and refreshment examples." Technically, they are found as the three examples (#6, 7 and 8) in the Regulations at Reg. Sec. 1.263(a)-3T(h).

These Examples are not specific to dealerships. They relate to a company that owned a nationwide chain of retail stores. IRS has considerable experience working with many taxpayers in various studies which involve chains of retail stores, gasoline stations, retail stores. Every eight or ten years (or so), they want a refresh the look of their stores - i.e., the image of their stores. It is a concept that is often applied in the hotel industry.

These Examples are "unpacked" in an easier format to follow on pages 54-57. They are summarized below.

Example 6 is not a betterment, but a refresh ... refreshing the building. *Example 6* is a situation that involves a betterment, with that term being used in its technical sense. However, in this situation, the activities did not rise to the level of constituting a betterment ... instead, they constituted a "refresh."

The first paragraph in *Example 6* states all of the facts. The work done was to replace and reconfigure a small number of display tables, make certain lighting relocations and floor repairs, and maybe moving a floor, patching some holes in the walls, damaged ceiling tiles, final floor power washing.

The last sentence in that first paragraph finally states the ***assumption*** that the work does not ameliorate any material conditions or defects that existed nor does it result in any material additions.

Based upon the facts ***and*** that assumption, the holding is that the taxpayer is not required to treat the amounts paid for the refresh of its store buildings and building systems as betterments. (See third line from the bottom of the last paragraph in Example 6 in the *Automotive Alert*.)

It is important to understand that the Regulations include specific definitions - broad, comprehensive definitions - for nine different potential building systems ... including heating and ventilation (HVAC), plumbing, electrical, fire protection and alarm, security system. Those are all separate building systems.

Example 6 reflects a situation where there were no material improvements, no correction of material defects or conditions. Example 6 reflects a refresh that keeps the building in ordinary efficient operating condition. Accordingly, the taxpayer would be permitted to expense (i.e., deduct) the expenditures.

Example 7 involves a refresh with some limited improvement. *Example 7* builds on *Example 6*. But caution: the word "improvement" should be a signal that some activities and/or expenditures will be required to be capitalized.

Example 7 involves (i.e., it assumes) the same fact pattern as found in *Example 6* ... except that the taxpayer also pays certain amounts to remove and replace certain elements or building systems. In this case, it is the plumbing which constitutes a building system. With respect to these activities, the taxpayer is required to capitalize all the costs because they involve a betterment; they resulted in a material increase in the quality of each plumbing system.

The taxpayer is also required to capitalize all of the indirect costs that directly benefit or are incurred by reason of the betterment.

However, within the context of this "limited" improvement, since these improvements were made *"in addition to"* those that were made to refresh the building, the taxpayer would still be permitted to deduct as expenses the expenditures that were related to the refreshment aspect of the overall remodeling activity.

Example 7 reflects a greater degree of involvement. It involves a refresh that also includes an improvement to a building system. Within that fact pattern, the taxpayer is still permitted to deduct the expenditures related to the refreshment activity. But note that is only the portion of the expenditure relating to the refreshment activity. All of the other expenditures (relating to the improvement activity or aspect) are required to be capitalized.

Example 8 ... Large scale refresh and remodel involving an improvement to the building. *Example 8* is the granddaddy of them all.

Example 8 cannot be read without first reading *Example 6*, because *Example 8* starts with... "Assume the same facts in *Example 6*, but assume further that ***the work performed to refresh the stores directly benefits or was incurred by reason of a substantial remodel to X's store buildings***" ... and in addition, ... ***"X performs significant additional work to alter the appearance and layout of its stores in order to increase customer traffic and sales volume."***

In other words, *Example 8* assumes the same facts as those in *Example 6*, ***but*** *Example 8* further

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assumes that the work performed to refresh directly benefits or was incurred by reason of a substantial remodel. (Note: "remodel" is another technical term.)

The taxpayer performed significant additional work to alter the appearance and the layout of the stores in order to increase the traffic. The work performed included removing walls, replacing ceilings, rebuilding interior and exterior facades, replacing conventional doors, replacing carpet, working on the electrical system, the wiring system, the lighting, removal of a whole lot of things.

The paragraph describing these activities involves the analysis of several different provisions in the Regulations - (e)(2) ... (h)(3) ... (h)(1) ... (f)(3) ... (d)(1), and then back again to ... (e)(2). One has to understand all of these provisions in order to grasp the totality and the context in which the conclusion in this Example is reached.

Example 8 involves both a betterment activity ***and*** a remodeling activity. Accordingly, it requires that any work on a building system must be capitalized. The cost of all of the work done in *Example 8* has to be capitalized ... this includes the portion of the work that relates to refreshing the building.

Because *Example 8* involved a greater degree of activity, that greater degree of activity converted the expenditures that otherwise could have been expensed or deducted (i.e., the work that constituted the refresh activities when that was all that had been done) to expenditures that are required to be capitalized.

Accordingly, the taxpayer in *Example 8* loses all deductions and must capitalize all of the expenditures.

Because there was a more comprehensive upgrade - technically referred to as a betterment or a building remodel situation - all of the expenditures (that were incurred in *Example 6*) which are now part of the overall betterment are required to be capitalized. In other words, the portion of the expenses that could have been expensed under the facts in *Example 6* cannot be expensed when they are included as part of the overall activities in *Example 8*.

PRACTITIONER CONCERNS OVER THE NEW REGULATIONS

In May 2012, the Treasury held a public hearing at which interested parties presented comments on the Temporary and Proposed Regulations regarding deduction and capitalization of expenditures related to tangible property.

In addition to the general criticism that the new Regulations are too complex and burdensome administratively, several other concerns were raised.

First, the Regulations retain, in many cases, most of the facts and circumstances determinations despite appearing to offer more specific or concrete examples of how the rules are intended to be implemented.

Second, the *de minimis* rule is unfair, too complicated, unrealistic and causes problems because the taxpayer does not know at the beginning of the year what its *de minimis* amount will be for the year. That amount is only determined after the end of the year. Also, the requirement that the taxpayer must have an AFS (Applicable Financial Statement) unfairly discriminates against smaller taxpayers who have not need for audited financial statements.

Third, the Regulations are essentially retroactive in the sense that adjustments are required under Section 481(a) in connection with any related changes in accounting method that may be made if the taxpayer attempts to obtain favorable treatment (i.e., the deduction for previously capitalized repair expenditures, etc.).

Finally, Section 481(a) adjustments will be difficult to compute in many cases because (prior year) information may not be available, and the Regulations do not allow the use of extrapolation procedures for purposes of estimating these amounts.

Informally, the IRS has acknowledged that some of these concerns may be addressed when these Regulations are finalized.

Perhaps this suggests that it might be wise to wait until the Regulations are finalized before filing Forms 3115 to make changes in accounting methods, unless the changes are relatively straight-forward and do not reflect practices that involve large dollar amounts over a lengthy span of years.

<table>
<tr><td><u>Summary</u>
Automatic
CAMs</td><td>

AUTOMATIC CHANGES IN ACCOUNTING METHOD (CAMS)
RELATED TO NEW REGULATIONS UNDER SECTION 263(a)

</td></tr>
<tr><td>Background</td><td>

In order to implement compliance with the new Regulations, as well as to secure some of the taxpayer-favorable treatments for certain transactions, a taxpayer will have to make certain changes in its accounting methods for tangible property transactions.
In order to make these changes, a taxpayer will have to comply with two new Revenue Procedures (2012-19 & -20) which set forth the terms and conditions for making specific changes by amending certain Sections of the Appendix to Revenue Procedure 2011-14.
To facilitate the making of these changes, the IRS revised the Instructions to Form 3115 (in March 2012) which assigns automatic CAM numbers 162 to 180 to these changes.

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<tr><td>Rev. Proc.
2012-19
&
Rev. Proc.
2012-20</td><td>

In January 2012, the IRS issued two Revenue Procedures which provide procedures by which taxpayers may make automatic changes in accounting methods (CAMs) under these Regulations.
These CAMs are for taxable years beginning on or after January 1, 2012.
Rev. Proc. 2012-19 is for CAMs involving ...

Materials and supplies ... Under Reg. Secs. 1.162-3T & -4T
Capital expenditures in general ... Under Reg. Sec. 1.263(a)-1T
Transaction costs ... Under Reg. Sec. 1.263(a)-2T
Improvements ... Under Reg. Sec. 1.263(a)-3T

Rev. Proc. 2012-20 is for CAMs involving ...

Leased property ... Under Reg. Sec. 1.167(a)-4T
General asset accounts ... Under Reg. Sec. 1.168(i)-1T
MACRS (Modified Accelerated Cost Recovery System) property ... Under Reg. Sec. 1.168(i)-7T
Dispositions of MACRS property ... Under Reg. Sec. 1.168(i)-8T.

In order to implement the procedures for making these automatic CAMs, both Revenue Procedures modify Revenue Procedure 2011-14 ... Specifically, they modify three sections in the Appendix to Rev. Proc. 2011-14.

Section 3 ... Trade or Business (Section 162)
Section 6 ... Depreciation or Amortization (Sections 167, 168, 197, et al.)
Section 10 ... Capital Expenditures (Section 263)

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<tr><td>Form 3115
Instructions

Automatic
CAMs
List</td><td>

The IRS revised the Instructions for Form 3115 to be used with the Dec. 2009 revision of Form 3115.

This revision of the Form 3115 Instructions includes an updated list of all of the automatic changes in accounting method that may be made under Rev. Proc. 2011-14.
This revision clarifies that certain automatic changes in method ... relating to materials and supplies and repair and maintenance costs (#143 and #144) ... are only available for amounts paid or incurred in taxable years beginning before January 1, 2012.
All of the CAMs that might be made in connection with the new Tangibles Regulations are listed by referencing the new automatic change numbers (i.e., #162 through #180) to the new Section numbers that have been added to the Appendix to Rev. Proc. 2011-14 (i.e., Sections 3, 6 or 10).

These new automatic CAMs are listed on the facing page.

</td></tr>
<tr><td>Transition
Dates</td><td>

Eleven of the automatic CAMs state the following ...

“This change applies only to the amounts paid or incurred in taxable years beginning on or after January 1, 2012.”
This applies to CAMs ... #164, 165, 166, 169, 170, 175, 176, 177, 178, 179 and 180.

Also, see the clarification above with respect to CAMs #143 and #144 which now are only available for amounts paid or incurred in taxable years beginning before January 1, 2012.

</td></tr>
<tr><td><u>Caution</u>

Form 3115
Filings</td><td>

In order to be eligible to file Form 3115 as an automatic change, the filer/applicant must be within the scope of, and comply with, all of the applicable provisions of the published guidance that authorizes each listed change.
If the taxpayer is not eligible for automatic change treatment, Form 3115 must be filed under the provisions of Revenue Procedure 97-27.
Be sure to review the filing requirements for the original and for the copies of the Form 3115.
In some instances, the taxpayer is required to file a copy of the Form 3115 with the IRS in Ogden, Utah (“Ogden copy”) instead of with the National Tax Office in Washington, D.C.

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</table>

Summary Automatic CAMs	***Automatic Changes in Accounting Method (CAMs) Related to New Regulations Under Section 263(a)***

Trade or Business (Sec. 162) Section 3 ... Appendix to Rev. Proc. 2011-14	
3.10	#162. Deducting repair and maintenance costs
3.11	#163. Change to the regulatory accounting method
3.12	#164. Deducting non-incidental materials and supplies when used or consumed*
3.13	#165. Deducting incidental materials and supplies when paid or incurred*
3.14	#166. Deducting non-incidental rotable and temporary spare parts when disposed*
3.15	#167. Change to the optional method for rotable and temporary spare parts
3.16	#168. Deducting dealer expenses that facilitate the sale of property
3.17	#169. Deducting *de minimis* amounts*
3.18	#170. Deducting certain costs for investigating or pursuing the acquisition of property*
3.19	#171. Change to the safe harbor routine maintenance on property other than buildings
Depreciation or Amortization (Sections 167, 168, 197, et al.) Section 6 ... Appendix to Rev. Proc. 2011-14	
6.27	#175. Depreciation of leasehold improvements*
6.28	#176. Depreciation of MACRS property (permissible)*
6.29	#177. Dispositions of a building or a structural component*
6.30	#178. Dispositions of tangible assets (other than a building or its structural components)*
6.31	#179. Dispositions of tangible depreciable assets in a general account*
6.32	#180. General asset account elections*
Capital Expenditures (Section 263) Section 10 ... Appendix to Rev. Proc. 2011-14	
10.08	#172. Non-dealer expense to facilitate the sale of property
10.09	#173. Capitalizing acquisition or production costs
10.10	#174. Capitalizing improvements to tangible property
Selected CAMs Applicable to Dealerships & Facilities Upgrades *(See pages 58-59 for details)*	
Dealership-Related CAMs	• The list above reflects the three groupings found in the *Appendix* to Rev. Proc. 2011-14 which are by related Code Section numbers (i.e., Section 162, 168 - et al., etc., and 263). • From the above list of Automatic CAMs, the following are more likely to be applicable to dealerships, either in general or in connection with facility improvements and upgrades ... #162. Deducting repair and maintenance costs #169. Deducting *de minimis* amounts* #171. Change to the safe harbor routine maintenance on property other than buildings #174. Capitalizing improvements to tangible property #175. Depreciation of leasehold improvements* #176. Depreciation of MACRS property (permissible)* #177. Dispositions of a building or a structural component* #178. Dispositions of tangible assets (other than a building or its structural components)* #179. Dispositions of tangible depreciable assets in a general account* #180. General asset account elections*

Notes: The asterisk (*) indicates that the change applies only to amounts paid or incurred in taxable years beginning on or after January 1, 2012. A brief description of each change is included in the revised Instructions for Form 3115. For complete information, one must refer to the Section in the *Appendix* which describes the change.

SELECTED REGS ... CAPITALIZATION CONCEPTS
DETERMINATION OF UNIT OF PROPERTY, ET AL. ... -3T(d), (e) & (f)

Comments ... Introduction

- Some of the general principles relating to expenditures that should be capitalized are discussed in -3T(d), (e) and (f).
- These related principles are grouped in this Exhibit and serve as the foundation for understanding the discussions in the Regulations of expenditures that are required to be capitalized in connection with building activities. Three key points to keep in mind are ...
  - The unit of property for a building consists of the building and its structural components.
  - In determining whether an amount paid is for an improvement to the building, the taxpayer must consider the effect of the expenditure on certain significant and specifically defined components of the building (rather than the building and its structural components as a whole).
  - There are no percentage thresholds or recovery period limitations for determining whether a replacement activity rises to the level of affecting a major component or substantial structural part of a unit of property. (The previous Regulations had included certain percentage thresholds which have been eliminated from the new Regulations.)
- The full text in the Regulations of all of the excerpts below include numerous references and cross-references to other subsections of the Regulations, as well as to other Code Sections (i.e., Sections 48, 168, 263A and 1016). The full text of the Regulations should always be consulted for exceptions and limitations.

Selected Subsection Divisions of the -3T(d), (e) & (f) Regulations

(d) Requirement to capitalize amounts paid for improvements

- A taxpayer generally must capitalize the aggregate of related amounts paid to improve a unit of property owned by the taxpayer. (Note: Special rules and treatments are provided for amounts paid to improve leased property.)
- A unit of property is improved if the amounts paid for activities performed after the property is placed in service by the taxpayer...
  (1) Result in a betterment to the unit of property,
  (2) Restore the unit of property, ***or***
  (3) Adapt the unit of property to a new or different use.

(e) Determining the unit of property

(1) In general

(2) Building

(i) In the case of a building, each building and its structural components is a single unit of property (building).

(ii) An amount is paid for an improvement to a building if the amount paid results in an improvement to ***any of the following***...

(A) Building structure ... A building structure consists of the building and its structural components other than the structural components designated as buildings systems.

(B) Building system ... Each of the following structural components, including the components thereof, constitutes a building system that is separate from the building structure, and to which the improvement rules must be applied ...

(1) ***Heating, ventilation, and air conditioning ("HVAC") systems*** (including motors, compressors, boilers, furnace, chillers, pipes, ducts, radiators),

(2) ***Plumbing systems*** (including pipes, drains, valves, sinks, bathtubs, toilets, water and sanitary sewer collection equipment, and site utility equipment used to distribute water and waste to and from the property line and between buildings and other permanent structures),

(continued...)

SELECTED REGS ... CAPITALIZATION CONCEPTS
DETERMINATION OF UNIT OF PROPERTY, ET AL. ... -3T(d), (e) & (f)

(e) (2) (ii) (B) (3) ***Electrical systems*** (including wiring, outlets, junction boxes, lighting fixtures and associated connectors, and site utility equipment used to distribute electricity from property line to and between buildings and other permanent structures),

(4) All ***escalators***,

(5) All ***elevators***,

(6) ***Fire-protection and alarm systems*** (including sensing devices, computer controls, sprinkler heads, sprinkler mains, associated piping or plumbing, pumps, visual and audible alarms, alarm control panels, heat and smoke detection devices, fire escapes, fire doors, emergency exit lighting and signage, and firefighting equipment, such as extinguishers, hoses),

(7) ***Security systems for the protection of the building and its occupants*** (including window and door locks, security cameras, recorders, monitors, motion detectors, security lighting, alarm systems, entry and access systems, related junction boxes, associated wiring and conduit),

(8) ***Gas distribution system*** (including associated pipes and equipment used to distribute gas to and from property line and between buildings or permanent structures), ***and***

(9) ***Other structural components*** identified in published guidance.

(iii) Condominium

(iv) Cooperative

(v) Leased building

(A) In general

(B) Application of improvement rules to a leased building

(1) Entire building

(2) Portion of a building

(3) Property other than building

(i) In general

(ii) Plant property

(iii) Network assets

(iv) Leased property other than buildings

(4) ***Improvements to property*** ... An improvement to a unit of property (other than a lessee improvement) is not a unit of property separate from the unit of property improved. The unit of property for lessee improvements is discussed elsewhere.

(5) Additional rules

(i) Year placed in service

(ii) Change in subsequent taxable year

(6) Examples ... Text of 19 Examples

(f) ***Special rules for determining improvement costs*** ... (1) and (2) omitted

(3) Certain costs incurred during an improvement

(i) ***In general*** ... A taxpayer must capitalize all the direct costs of an improvement and all the indirect costs (including, for example, otherwise deductible repair or component removal costs) that directly benefit or are incurred by reason of an improvement in accordance with the rules under Section 263A. Therefore, indirect costs that do not directly benefit and are not incurred by reason of an improvement are not required to be capitalized under Section 263(a), regardless of whether they are made at the same time as an improvement.

(4) ***Aggregate of related amounts*** ... The aggregate of related amounts paid to improve a unit of property may be incurred over a period of more than one taxable year. Whether amounts are related to the same improvement depends on the facts and circumstances of the activities being performed and whether the costs are incurred by reason of a single improvement or directly benefit a single improvement.

SELECTED REGS ... CAPITALIZATION CONCEPTS
BETTERMENTS ... -3T(h)

Comments ... Introduction

- The Regulations include safe harbor rules that allow for the expensing of routine maintenance costs. These rules, however, apply only to property ***other than buildings***. In other words, these safe harbor rules are not applicable to work performed on buildings.
- Therefore, routine maintenance activities and costs ***for buildings*** require their own special analyses.
- The proper analysis for determining whether routine maintenance costs ***for buildings*** should be capitalized or expensed ***requires the application of the general rules for improvements***. This includes analyzing the rules for determining whether the costs are incurred for a betterment or restoration to the building or the building systems, or to adapt the building or any of its systems to a new or different use.
- The Regulations include rules to clarify the application of the improvement standards to a building and provide examples illustrating the application of these rules.
- In general, if the word "improvements" is used in the Regulations, that signifies that the expenditures involved are required to be capitalized.
- In other words, *betterments* and *restorations* are ***improvements*** to buildings and are required to be capitalized.
- Reg. Sec. -3T(h) discusses betterments; Reg. Sec. -3T(i) discusses restorations.

Subsection Divisions of the -3T(h) Regulations

(h) Capitalization of betterments

(1) *In general* ... A taxpayer must capitalize amounts paid that result in the betterment of a unit of property.

An amount paid results in the betterment of a unit of property only if it ...

(i) ***Ameliorates a material condition or defect that either existed prior to the taxpayer's acquisition*** of the unit of property or arose during the production of the unit of property, whether or not the taxpayer was aware of the condition or defect at the time of acquisition or production,

(ii) ***Results in a material addition*** (including a physical enlargement, expansion, or extension) to the unit of property, ***or***

(iii) ***Results in a material increase in capacity*** (including additional cubic or square space), productivity, efficiency, strength, or quality of the unit of property or the output of the unit of property.

(2) *Betterments to buildings* ... In the case of a building, an amount results in a betterment to the unit of property if it results in a betterment to ...

- The building,
- The building structure, ***or***
- Any of the building systems, etc.

(3) *Application of general rule*

(i) ***Facts and circumstances*** ... To determine whether an amount paid results in a betterment, it is appropriate to consider all the facts and circumstances including, but not limited to ...

- The purpose of the expenditure,
- The physical nature of the work performed,
- The effect of the expenditure on the unit of property, and
- The taxpayer's treatment of the expenditure on its applicable financial statement.

(ii) ***Unavailability of replacement parts*** ... If a taxpayer needs to replace part of a unit of property that cannot practicably be replaced with the same type of part (for example, because of technological advancements or product enhancements), the replacement of the part with an improved, but comparable, part does not, by itself, result in a betterment to the unit of property.

(continued...)

SELECTED REGS ... CAPITALIZATION CONCEPTS
BETTERMENTS ... -3T(h)

(h) (3) (iii) ***Appropriate comparison***

(A) ***In general*** ... In cases in which a particular event necessitates an expenditure, the determination of whether an expenditure results in a betterment of the unit of property is made by comparing the condition of the property ***immediately after*** the expenditure with the condition of the property ***immediately prior*** to the circumstances necessitating the expenditure.

(B) ***Normal wear and tear*** ... If the expenditure is made to correct the effects of normal wear and tear to the unit of property (including the amelioration of a condition or defect that existed prior to the taxpayer's acquisition of the unit of property resulting from normal wear and tear), the condition of the property immediately prior to the circumstances necessitating the expenditure is the condition of the property after the last time the taxpayer corrected the effects of normal wear and tear (whether the amounts paid were for maintenance or improvements) or, if the taxpayer has not previously corrected the effects of normal wear and tear, the condition of the property when placed in service by the taxpayer.

(C) ***Particular event*** ... If the expenditure is made as a result of a particular event, the condition of the property immediately prior to the circumstances necessitating the expenditure is the condition of the property immediately prior to the particular event.

(4) *Examples - [...]* indicates text deleted

- 19 examples are included under (h)(4).

Example 1. *Amelioration of pre-existing material condition or defect* [...]
Example 2. *Not amelioration of pre-existing condition or defect* [...]
Example 3. *Not amelioration of pre-existing material condition or defect* [...] [...]
Example 4. *Not amelioration of pre-existing material condition or defect* [...]
Example 5. *Amelioration of material condition or defect* [...] [...]
Example 6. ***Not a betterment; building refresh*** [...] [...] *
Example 7. ***Building refresh; limited improvement*** [...] *
Example 8. ***Betterment; building remodel*** [...] [...] *
Example 9. *Not betterment; relocation and reinstallation of personal property* [...]
Example 10. *Betterment; relocation and reinstallation of manufacturing equipment* [...]
Example 11. *Betterment; regulatory requirement* [...]
Example 12. *Not a betterment; regulatory requirement* [...]
Example 13. *Not a betterment; replacement with same part* [...]
Example 14. *Not a betterment; replacement with comparable part* [...]
Example 15. *Betterment; replacement with improved parts* [...]
Example 16. *Material increase in capacity* [...]
Example 17. *Material increase in capacity* [...]
Example 18. *Not a material increase in capacity* [...]
Example 19. *Not a material increase in capacity* [...]

*** *Examples #6, #7* and *#8* above are the examples included in the IRS MVTA *Automotive Alert* and are referred to as likely to be relating to the current dealership activity involving facility upgrades and improvements.** ***[The full text of these three examples is included in the* Automotive Alert*, and each is analyzed in the accompanying article and materials.]***

- ***Example #6*** **... Not a betterment, building refresh.**
- ***Example #7*** **... Building refresh, limited improvement.**
- ***Example #8*** **... Betterment, building remodel.**

SELECTED REGS … CAPITALIZATION CONCEPTS
RESTORATIONS & REPLACEMENTS OF MAJOR COMPONENTS … -3T(i)

Comments … Introduction

- *Betterments* and *restorations* are ***improvements*** to buildings and are required to be capitalized.
- Reg. Sec. -3T(h) discusses betterments; Reg. Sec. -3T(i) discusses restorations.
- In the list below of 6 types of restorations, -3T(i)(1)(vi) … i.e., *"the replacement of … a major component or a substantial structural part of the unit of property"* … seems to best fit into the current activity involving dealership facility upgrades.
- ***Adaptation to a new or different use.*** Reg. Sec. -3T(j) must also be considered. This provides that taxpayers must capitalize amounts paid to adapt a unit of property to a new or different use.
    - In general, an amount is paid to adapt a unit of property to a new or different use if the adaptation is not consistent with the taxpayer's intended ordinary use of the unit of property at the time originally placed in service by the taxpayer.
    - In the case of a building, an amount is paid to adapt the unit of property to a new or different use if it adapts to a new or different use the building, the building structure, ***or*** any of the building systems.

Subsection Divisions of the -3T(i) Regulations

(i) Capitalization of restorations

(1) *In general* … A taxpayer must capitalize amounts paid to restore a unit of property, including amounts paid in making good the exhaustion for which an allowance is or has been made.

An amount is paid to restore a unit of property only if it …

(i) Is for the replacement of a component of a unit of property and the taxpayer has properly deducted a loss for that component (other than a casualty loss under Reg. Sec. 1.165-7),

(ii) Is for the replacement of a component of a unit of property and the taxpayer has properly taken into account the adjusted basis of the component in realizing gain or loss resulting from the sale or exchange of the component,

(iii) Is for the repair of damage to a unit of property for which the taxpayer has properly taken a basis adjustment as a result of a casualty loss under Section 165, or relating to a casualty event described in Section 165,

(iv) Returns the unit of property to its ordinarily efficient operating condition if the property has deteriorated to a state of disrepair and is no longer functional for its intended use,

(v) Results in the rebuilding of the unit of property to a like-new condition after the end of its class life, ***or***

(vi) ***Is for the replacement of a part or a combination of parts that comprise a major component or a substantial structural part of a unit of property (see paragraph (i)(4) of this section).***

(2) *Restorations of buildings* … In the case of a building, an amount is paid to restore the unit of property if it restores any of the properties, including …

- The building,
- The building structure, ***or***
- Any of the building systems, etc.

(3) *Rebuild to like-new condition* … A unit of property is rebuilt to a like-new condition if it is brought to the status of new, rebuilt, remanufactured, or similar status under the terms of any Federal regulatory guideline or the manufacturer's original specifications.

(continued…)

(i) (4) ***Replacement of a major component or a substantial structural part*** ... To determine whether an amount is for the replacement of a part or a combination of parts that comprise a major component or a substantial structural part of the unit of property, ***it is appropriate to consider all the facts and circumstances.***

- These facts and circumstances include the quantitative or qualitative significance of the part or combination of parts in relation to the unit of property.
- A major component or substantial structural part includes a part or combination of parts that comprise a large portion of the physical structure of the unit of property or that perform a discrete and critical function in the operation of the unit of property.
- However, the replacement of a minor component of the unit of property, even though such component may affect the function of the unit of property, will not generally, by itself, constitute a major component or substantial structural part.

(5) *Examples - [...]* indicates text deleted

- 26 examples are included under (i)(5).

Example 1. *Replacement of loss component* [...]
Example 2. *Replacement of sold component* [...]
Example 3. *Restoration after casualty loss* [...]
Example 4. *Restoration after casualty event* [...]
Example 5. *Restoration of property in a state of disrepair* [...]
Example 6. *Rebuild of property to like-new condition before end of class life* [...]
Example 7. *Rebuild of property to like-new condition after end of class life* [...]
Example 8. *Replacement of major component or substantial structural part; personal property* [...]
Example 9. *Repair performed during a restoration* [...]
Example 10. *Related amounts to replace major component or substantial structural* [...] [...]
Example 11. *Not replacement of major component or substantial structural part; personal property* [...]
Example 12. *Replacement of major component or substantial structural part; roof* [...]
Example 13. *Replacement of major component or substantial structural part; roof* [...]
Example 14. *Not replacement of major component or substantial structural part; roof membrane* [...]
Example 15. *Replacement of major component or substantial structural part; HVAC system* [...]
Example 16. *Replacement of major component or substantial structural part; HVAC system* [...]
Example 17. *Not replacement of major component or substantial structural part; HVAC system* [...]
Example 18. *Replacement of major component or substantial structural part; fire protection system* [...]
Example 19. *Replacement of major component or substantial structural part; electrical system* [...]
Example 20. *Replacement of major component or substantial structural part; plumbing system* [...]
Example 21. *Not replacement of major component or substantial structural part; plumbing system* [...]
Example 22. *Replacement of major component or substantial structural part; remodel* [...] [...]
Example 23. *Not replacement of major component or substantial structural part; windows* [...]
Example 24. *Replacement of major component or substantial structural part; windows* [...]
Example 25. *Not replacement of major component or substantial structural part; floors* [...]
Example 26. *Replacement of major component or substantial structural part; floors* [...]

- **This list of Examples can be used as an index to assist in locating an example that may approximate the situation or fact pattern for which guidance is needed.**

IRS

Automotive Alert

Motor Vehicle Technical Specialist

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IRS ISSUES NEW REGULATIONS

DEDUCTION AND CAPITALIZATION OF EXPENDITURES RELATED TO TANGIBLE PROPERTY

Introduction

In December 2011, the IRS and Department of Treasury issued proposed and temporary regulations that provide guidance regarding deduction and capitalization of expenditures related to tangible property. The regulations were issued in both proposed and temporary status to allow for public comments on the proposed regulations while the temporary nature of the new regulations allows taxpayers and the IRS to rely on the regulations for tax years beginning on or after January 1, 2012.

The provisions of the regulations are broad and this document does not address all of the provisions. We will provide an overview of the document only and recommend that dealers consult their tax advisor for a complete analysis of how the new regulations may affect dealership activities.

The regulations include modification to several sections of the Internal Revenue Code (IRC) including, but not limited to, §§162, 263(a), and 168 and are intended to clarify and expand the standards in the current regulations and provide certain bright-line tests for applying these standards.

Changes to a taxpayer's treatment of tangible assets based on the new regulations are generally considered to be changes in methods of accounting. Prior to changing any method of accounting, taxpayers must request and receive permission from the IRS. Depending on the type of change, taxpayers may either fall under the advance consent requirements or the automatic change requirements. Each imposes different responsibilities on a taxpayer in order to properly change a method of accounting. We anticipate that there will be further published guidance addressing how a taxpayer can change its method(s) of accounting to comply with the new regulations.

The regulations are not dealership specific and may have a significant affect on many taxpayers. However, one section in particular may be of interest to auto dealerships. Regulation 1.263(a)-3T addresses amounts paid to improve tangible property. While other provisions will undoubtedly affect dealerships, this section is most likely to be of interest to dealers who periodically upgrade, remodel, refresh, or otherwise improve dealership facilities.

Brief Table of Contents of Regulations Sections (not all inclusive) The list below is just a portion of the IRC sections that were modified in the new regulations.

- §1.263(a)-1T Capital Expenditures in General
- §1.263(a)-2T Amounts Paid to Acquire or Produce Tangible Property
- §1.263(a)-3T Amounts Paid to Improve Tangible Property
- §1.162-3T Materials and Supplies
- §1.162-4T Repairs

Overview of Section 1.263(a)-3T – Amounts Paid to Improve Tangible Property

Section 1.263(a)-3T provides a two-step process to determine if property has been improved.

- Step One – What is the unit of property (UOP)?
- Step Two - Did the work performed constitute an improvement to the unit of property?

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It should be noted that this document is not an official Service pronouncement and may not be cited as authority

This two step process is outlined and defined in the new regulations but in fact is the process that taxpayers have always had to engage in when considering improvements to tangible property.

The regulations include UOP rules related to buildings, property other than buildings, and leased property. The scope of this document does not permit a complete discussion of all of the UOP rules. For purposes of this document, we will focus on the building and building systems.

Step One – Determine the Unit of Property
In general, the building *and* its structural components are one UOP, e.g. "the building." Amounts are treated as paid for an improvement to a building if they:

(1) improve the building structure **or**
(2) a building system.

Building systems include the following systems: (not all inclusive – see the regulations for a full list)

- Plumbing,
- HVAC,
- Electrical,
- Fire protection and alarms, and
- Security systems.

Step Two – Apply Improvement Rules (§1.263(a)-3T(d))
A UOP is improved if the amounts paid for activities performed after the property is placed in service by the taxpayer:

- Result in a betterment to the unit of property (subsection (h)) **or**
- Restore the unit of property (subsection (i)) **or**
- Adapt the unit of property to a new or different use (subsection (j))

(see the regulations for a full discussion of each item)

If the amounts paid to improve tangible property are determined to be improvements, the taxpayer must capitalize (rather than currently deduct) all of the direct costs of an improvement and all of the indirect costs that directly benefit or are incurred by reason of the improvement.

Conclusion
Whether or not amounts paid in a store remodel or refresh qualify as an improvement may be a question of degree. The temporary regulations include many examples intended to clarify all of the provisions. Examples relevant to store remodels and refreshes are found in Treas. Reg. 1.263(a)-3T. Examples 6, 7, and 8 discuss the refresh and remodel of a retail store (not a dealership specifically) and include facts intended to clarify when the activities rise to the level of a betterment requiring capitalization. We have included the three examples in the addendum to this Alert.

The regulations related to amounts paid to improve tangible property are complex and each transaction must be analyzed individually. In addition, the regulations contain provisions other than those discussed above that may affect the determination of whether amounts expended in a remodel or refresh result in costs that must be capitalized. If you have any questions regarding the new regulations, we urge you to consult with your tax advisor.

DEDUCTION AND CAPITALIZATION OF EXPENDITURES RELATED TO TANGIBLE PROPERTY

REGULATIONS EXAMPLES – STORE REMODELS AND REFRESHES

The preamble to the temporary regulations discusses the treatment of store remodels and refreshes. It concludes that the analysis of whether store refresh or remodel costs result in betterment that would require capitalization rather than deduction requires an examination of all the facts and circumstances.

To provide additional guidance in this area the temporary regulations provide a number of examples that address the refreshing and remodeling of retail buildings. The examples demonstrate a range of outcomes based on the amount and type of work performed on the building and its structural components.

The examples in the temporary regulations illustrate (emphasis added):

- a refresh of retail buildings that merely **keeps the buildings in ordinarily efficient operating condition**;
- a refresh of retail buildings that also **includes an improvement to a building system**; and finally,
- **a large scale refresh and remodel** of retail buildings **that involve an improvement to the buildings**.

Note: *the examples below refer to a building "system." The full definition of a building system can be found in the temporary regulations but can include the following systems (not all inclusive): HVAC, plumbing, electrical, fire protection and alarms, security, and gas.*

Although the examples are not dealership specific, a review of the following examples found in Treas. Reg. 1.263(a)-3T should assist dealers in analyzing the facts and circumstances and determining the proper tax treatment of costs related to tangible property. We recommend that dealers consult their tax advisor for a complete analysis of the regulations and how they relate to dealership activities. *(The emphasis added by bolding and underlining some sections below is for ease of reading only and is not present in the temporary regulations.)*

Example 6. Not a betterment; building refresh.

(i) X owns a nationwide chain of retail stores that sell a wide variety of items. To remain competitive in the industry and increase customer traffic and sales volume, X periodically refreshes the appearance and layout of its stores. The work that X performs to refresh a store consists of cosmetic and layout changes to the store's interiors and general repairs and maintenance to the store building to make the stores more attractive and the merchandise more accessible to customers. The work to each store building consists of replacing and reconfiguring a small number of display tables and racks to provide better exposure of the merchandise, making corresponding lighting relocations and flooring repairs, moving one wall to accommodate the reconfiguration of tables and racks, patching holes in walls, repainting the interior structure with a new color scheme to coordinate with new signage, replacing damaged ceiling tiles, cleaning and repairing vinyl flooring throughout the store building, and power washing building exteriors. The display tables and the racks all constitute section 1245 property. X pays amounts to refresh 50 stores during the taxable year. In its applicable financial statement, X capitalizes all the costs to refresh the store buildings and amortizes them over a 5-year period. Assume that each section 1245 property within each store is a separate unit of property. Finally, assume that the work does not ameliorate any material conditions or defects that existed when X acquired the store buildings or result in any material additions to the store buildings.

(ii) Under paragraph (e)(2)(ii) of this section, if an amount paid results in a betterment to the building structure or any building system, X must treat the amount as an improvement to the building. **Considering the facts and circumstances**, as required under paragraph (h)(3)(i) of this section, including the purpose of the expenditure, the physical nature of the work performed, the effect of the expenditure on buildings' structure and systems, and the treatment of the work on X's applicable financial statements, **the amounts paid for the refresh of each building do not result in material increases in capacity, productivity, efficiency, strength, or quality of the buildings' structures or any building systems** as compared to the condition of the buildings' structures and systems after the previous refresh. Rather, the **work performed keeps X's store buildings' structures and buildings' systems in the ordinary efficient operating condition** that is necessary for X to continue to attract customers to its stores. Therefore, X is not required to treat the amounts paid for the refresh of its store buildings' structures and buildings' systems as betterments under paragraph (h)(1)(iii) of this section. However, X is required to capitalize the amounts paid to acquire and install each section 1245 property in accordance with § 1.263(a)-2T(d)(1).

Example 7. **Building refresh; limited improvement.**

Assume the **same facts as Example 6 except, in the course of X's refresh of its stores, X pays amounts to remove and replace the bathroom fixtures** (that is, the toilets, sinks, and plumbing fixtures) with upgraded bathroom fixtures in all of the restrooms in X's retail buildings in order to update the restroom facilities. As part of the update of the restrooms, X also pays amounts to replace the floor and wall tiles that were removed or damaged in the installation of the new plumbing fixtures. Under paragraph (e)(2)(ii) of this section, if any of the amounts paid result in betterments to the building structure or any building system, X must treat the amounts as an improvement to the building. Under paragraph (e)(2)(ii)(B)(2) of this section, **the plumbing system in each of X's store buildings, including the plumbing fixtures, is a building system. X must treat the amounts paid to replace the bathroom fixtures with upgraded fixtures as a betterment because they result in a material increase in the quality of each plumbing system** under paragraph (h)(1)(iii) of this section. Under paragraph (f)(3) of this section, X is required to capitalize all the indirect costs that directly benefit or are incurred by reason of the betterment, or improvement, to each plumbing system. Because the costs to remove the old plumbing fixtures and to remove and replace the bathroom tiles directly benefit and are incurred by reason of the improvement to the plumbing system, these costs must also be capitalized under paragraph (f)(3) of this section. Therefore, in accordance with paragraph (e)(2)(ii) of this section, **X must treat the amounts paid for a betterment to each plumbing system as an improvement to X's retail building to which the costs relate, and must capitalize the amounts** under paragraph (d)(1) of this section. However, X is not required under paragraph (f)(3) of this section to capitalize the costs described in Example 6 to refresh the appearance and layout of its stores because those costs do not directly benefit and are not incurred by reason of the improvements to the stores' plumbing systems. Thus, X is not required to capitalize under paragraphs (f)(3) of this section any costs specified in Example 6 for the reconfiguration, cosmetic changes, repairs, and maintenance to the other parts of X's store buildings.

Example 8. **Betterment; building remodel.**

(i) Assume the **same facts as Example 6**, but **assume that the work performed to refresh the stores directly benefits or was incurred by reason of a substantial remodel** to X's store buildings. In addition to the reconfiguration, cosmetic changes, repairs, and maintenance activities performed in Example 6, X **performs significant additional work to alter the appearance and layout of its stores in order to increase customer traffic and sales** volume. First, X pays amounts to upgrade the buildings' structures as defined under (e)(2)(ii)(A). This work includes removing and rebuilding walls to move built-in changing rooms and specialty departments to different areas of the stores, replacing ceilings with acoustical tiles to reduce noise and create a more pleasant shopping environment, rebuilding the interior and exterior facades around the main doors to create a more appealing entrance, replacing conventional doors with automatic doors, and replacing carpet with ceramic flooring of different textures and styles to delineate departments and direct customer traffic. Second, X pays amounts for work on the electrical systems, which are building systems under paragraph (e)(2)(ii)(B)(3) of this section. Specifically, X upgrades the wiring in the buildings so that X can add video monitors and an expanded electronics department. X also removes and replaces the recessed lighting throughout the buildings with more efficient and brighter lighting. The work performed on the buildings' structures and the electrical systems includes the removal and replacement of both section 1250 and section 1245 property. In its applicable financial statement, X capitalizes all the costs incurred over a 10-year period. Upon completion of this period, X anticipates that it will have to remodel the store buildings again.

(ii) Under paragraph (e)(2)(ii) of this section, if any of the amounts paid result in a betterment to the building structure or any building system, X must treat those amounts as an improvement to the building. **Considering the facts and circumstances**, as required under paragraph (h)(3)(i) of this section, including the purpose of the expenditure, the physical nature of the work performed, the effect of the work on the buildings' structures and buildings' systems, and the treatment of the work on X's applicable financial statements, **the amounts that X pays for the remodeling of its stores result in betterments to the buildings' structures and electrical systems** under paragraph (h) of this section. **Specifically, amounts paid to upgrade the wiring and to remove and replace the recess lighting throughout the stores materially increase the productivity, efficiency, and quality of X's stores' electrical systems under paragraph (h)(1)(iii) of this section. Also, the amounts paid to remove and rebuild walls, to replace ceilings, to rebuild facades, to replace doors, and replace flooring materially increase the productivity, efficiency, and quality of X's store buildings' structures under paragraph (h)(1)(iii) of this section. In addition, the amounts paid for the refresh of the store buildings described in Example 6 must be capitalized** under paragraph (f)(3)(i) of this section because these expenditures directly benefited or were incurred by reason of the improvements to X's store buildings' structures and electrical systems. Therefore, in accordance with paragraph (e)(2)(ii) of this section, X must treat the costs of improving the buildings' structures and systems, including the costs to refresh, as improvements to X's retail buildings and must capitalize the amounts paid for these improvements under paragraph (d)(1) of this section. Moreover, X is required to capitalize the amounts paid to acquire and install each section 1245 property in accordance with § 1.263(a)-2T(d)(1).

Example 6 **Costs Deductible**	***BUILDING REFRESH ... NOT A BETTERMENT*** ***REG. SEC. 1.263(a)-3T(h)(4) ... EXAMPLE 6***
Facts & Assumptions (i)	• X owns a nationwide chain of retail stores that sell a wide variety of items. • To remain competitive in the industry and increase customer traffic and sales volume, X periodically ***refreshes*** the appearance and layout of its stores. • To make the stores more attractive and the merchandise more accessible to customers, the work that X performs to refresh a store consists of ... ◆ Cosmetic and layout changes to the store's interiors and ◆ General repairs and maintenance to the store building. • The work to each store building consists of replacing and reconfiguring a small number of display tables and racks to provide better exposure of the merchandise, making corresponding lighting relocations and flooring repairs, moving one wall to accommodate the reconfiguration of tables and racks, patching holes in walls, repainting the interior structure with a new color scheme to coordinate with new signage, replacing damaged ceiling tiles, cleaning and repairing vinyl flooring throughout the store building, and power washing building exteriors. • The display tables and the racks all constitute Section 1245 property. • X pays amounts to refresh 50 stores during the taxable year. • In its applicable financial statement, X capitalizes all the costs to refresh the store buildings and amortizes them over a 5-year period. • ***Assumptions ...*** ◆ Each Section 1245 property within each store is a separate unit of property. ◆ The work does not ameliorate any material conditions or defects that existed when X acquired the store buildings. ◆ The work does not result in any material additions to the store buildings.
Analysis (ii)	• If an amount paid results in a betterment to the building structure or any building system, X must treat the amount as an improvement to the building. [-3T(e)(2)(ii)] • ***Considering the facts and circumstances*** [as required under -3T(h)(3)(i)], including the purpose of the expenditure, the physical nature of the work performed, the effect of the expenditure on buildings' structure and systems, and the treatment of the work on X's applicable financial statements, ***the amounts paid for the refresh of each building do not result in material increases*** in capacity, productivity, efficiency, strength, or quality of the buildings' structures or any building systems as compared to the condition of the buildings' structures and systems after the previous refresh. • ...The work performed ***keeps*** X's store buildings' structures and buildings' systems ***in the ordinary efficient operating condition*** that is necessary for X to continue to attract customers to its stores.
Conclusions	• X is not required to treat the amounts paid for the refresh of its store buildings' structures and buildings' systems as betterments. [-3T(h)(1)(iii)]. • X is required to capitalize the amounts paid to acquire and install each Section 1245 property. [-2T(d)(1)]
Comments	• *Remember ... "Betterment" = Improvement = Expenditures required to be capitalized* • *Activities that constitute a "refresh" fall one level below activities that collectively would constitute a "betterment." The Regulations do not explicitly state this; but it appears to be a "logical" conclusion from everything else in the Regulations.* • Example 6 *reflects a situation where the activities resulted in no material improvements, nor any corrections of material defects or conditions. In other words,* Example 6 *reflects a "refresh" activity that keeps the building in ordinary efficient operating condition.* ◆ *Therefore, the taxpayer is permitted to expense (i.e., deduct) the expenditures related to the "refresh" ... but the taxpayer cannot expense the costs of the Section 1245 property that it acquired.* • *The Regulations include specific definitions - broad, comprehensive definitions - for nine different potential building systems ... including heating and ventilation (HVAC), plumbing, electrical, fire protection and alarm, security system.* ◆ *Those are all separate building systems. None of the activities/work described in* Example 6 *affected these components. (If they had, the result would have been different.)*

Example 7 Costs Partially Deductible	*BUILDING REFRESH, BUT WITH LIMITED IMPROVEMENT* *REG. SEC. 1.263(a)-3T(h)(4) ... EXAMPLE 7*
Facts & Assumptions	• This *Example* assumes the same facts as in *Example 6*, and adds additional facts. • The additional facts in *Example 7* are that, ◆ In the course of X's refresh of its stores, X pays amounts to remove and replace the bathroom fixtures (i.e., the toilets, sinks, and plumbing fixtures) with upgraded bathroom fixtures in all of the restrooms in X's retail buildings in order to update the restroom facilities. ◆ As part of the update of the restrooms, X also pays amounts to replace the floor and wall tiles that were removed or damaged in the installation of the new plumbing fixtures.
Analysis	• If ***any*** of the amounts paid result in ***betterments*** to the building structure or any building system, X must treat the amounts as an improvement to the building. [-3T(e)(2)(ii)] • The plumbing system in each of X's store buildings, including the plumbing fixtures, is a building system. [-3T(e)(2)(ii)(B)(2)] • X must treat the amounts paid to replace the bathroom fixtures with upgraded fixtures as a ***betterment*** because they result in a material increase in the quality of each plumbing system. [-3T(h)(1)(iii)] • X is required to capitalize all the indirect costs that directly benefit or are incurred by reason of the betterment, or improvement, to each plumbing system. [-3T(f)(3)] ◆ Because the costs to remove the old plumbing fixtures and to remove and replace the bathroom tiles directly benefit and are incurred by reason of the improvement to the plumbing system, these costs must also be capitalized. [-3T(f)(3)]
Conclusions	• ***Capitalize ...*** X must treat the amounts paid for a betterment to each plumbing system as an improvement to X's retail building to which the costs relate [-3T(e)(2)(ii)], and must capitalize the amounts. [-3T(d)(1)] • ***Deduct ...*** However, X ***is not required*** to capitalize the costs described in *Example 6* to refresh the appearance and layout of its stores because those costs do not directly benefit and are not incurred by reason of the improvements to the stores' plumbing systems. [-3T(f)(3)] ◆ Accordingly, X is not required to capitalize [under -3T(f)(3)] any costs specified in *Example 6* for the reconfiguration, cosmetic changes, repairs, and maintenance to the other parts of X's store buildings.
Comments	• *Remember ... "Betterment" = Improvement = Expenditures required to be capitalized* • *Whenever the Regulation uses the word "improvement," that should be a signal that some of the activities and/or expenditures will be required to be capitalized.* • Example 7 *involves (i.e., it assumes) the same fact pattern described in* Example 6 ... ***except*** *that the taxpayer also pays certain amounts to remove and replace certain elements in its plumbing ... and plumbing constitutes a "building system."* • *In* Example 7, *the taxpayer is required to capitalize all the costs associated with the betterment because they resulted in a material increase in the quality of each plumbing system ... and the plumbing system is just one of the several building systems which are integral to the overall building (unit of property).* • *The taxpayer is also required to capitalize all of the indirect costs that directly benefit or are incurred by reason of the betterment. However, within the context of this "limited" improvement, since these improvements were made "in addition to" those that were made to refresh the building, the taxpayer would be permitted to deduct the expenses related to the refreshment aspect of the overall remodeling activity.* • ***Bottom line...*** Example 7 *reflects a greater degree of involvement. It involves a refresh that also includes an improvement to a building system. Within that fact pattern, the taxpayer is still permitted to deduct the expenditures related to the refreshment activity. But note that is only the portion of the expenditure relating to the refreshment activity. All of the other expenditures (relating to the improvement activity or aspect) are required to be capitalized.*

Example 8

All Costs Capitalizable

BETTERMENT (i.e., AN IMPROVEMENT) ... BUILDING REMODEL
REG. SEC. 1.263(a)-3T(h)(4) ... EXAMPLE 8

Facts & Assumptions (i)

- This *Example* assumes the same facts as in *Example 6*, and adds even more additional facts.
- The additional facts in *Example 8* are that...
  - The work performed to refresh the stores directly benefits or was incurred by reason of a ***substantial remodel*** to X's store buildings.
  - X performs significant additional work to alter the appearance and layout of its stores in order to increase customer traffic and sales volume. This work was "in addition to the reconfiguration, cosmetic changes, repairs, and maintenance activities performed in *Example 6*."
- As part of the significant additional work to alter the appearance and layout, X pays amounts to ***upgrade the buildings' structures*** (as defined under -3T(e)(2)(ii)(A)). This work includes...
  - Removing and rebuilding walls to move built-in changing rooms and specialty departments to different areas of the stores,
  - Replacing ceilings with acoustical tiles (to reduce noise and create a more pleasant shopping environment),
  - Rebuilding the interior and exterior facades around the main doors (to create a more appealing entrance),
  - Replacing conventional doors with automatic doors, and
  - Replacing carpet with ceramic flooring of different textures and styles (to delineate departments and direct customer traffic).
- In addition, X pays amounts for ***work on the electrical systems***, which are building systems (as defined under -3T(e)(2)(ii)(B)(3)). Specifically, this work ...
  - Upgraded the wiring in the buildings so that X could add video monitors and an expanded electronics department, and
  - Removed and replaced the recessed lighting throughout the buildings with more efficient and brighter lighting.
- The work performed on the buildings' structures and on the electrical systems (as described above) also included the removal and replacement of [fixed assets that were] both Section 1250 and Section 1245 property.
- In its applicable financial statement, X capitalized all the costs incurred over a 10-year period.
  - X anticipates that it will have to remodel the store buildings again after another 10 years.

Analysis (ii)

- If any of the amounts paid result in a betterment to the building structure or any building system, X must treat those amounts as an improvement to the building. [-3T(e)(2)(ii)]
- Considering the facts and circumstances (as required by-3T(h)(3)(i)), the amounts that X pays for the remodeling of its stores result in ***betterments*** to the buildings' structures and electrical systems. [-3T(h)].
  - The "facts and circumstances" considered include...
    - The purpose of the expenditure,
    - The physical nature of the work performed,
    - The effect of the work on the buildings' structures and buildings' systems, and
    - The treatment of the work on X's applicable financial statements.
- Specifically, amounts paid to upgrade the wiring and to remove and replace the recess lighting throughout the stores ***materially increase*** the productivity, efficiency, and quality of X's stores' electrical systems. [-3T(h)(1)(iii)]
- Also, the amounts paid to remove and rebuild walls, to replace ceilings, to rebuild facades, to replace doors, and replace flooring ***materially increase*** the productivity, efficiency, and quality of X's store buildings' structures. [-3T(h)(1)(iii)]
- In addition, the amounts paid for the refresh of the store buildings described in *Example 6* also must be capitalized (under -3T(f)(3)(i)) because these expenditures directly benefitted or were incurred by reason of the improvements to X's store buildings' structures and electrical systems.

<table>
<tr><td><u>Example 8</u>
All Costs Capitalizable</td><td>BETTERMENT (i.e., AN IMPROVEMENT) ... BUILDING REMODEL
REG. SEC. 1.263(a)-3T(h)(4) ... EXAMPLE 8
Page 2 of 2</td></tr>
<tr><td>Conclusions</td><td>• X must treat the costs of improving the buildings' structures and systems, including the costs to refresh, as improvements to X's retail buildings [under -3T(e)(2)(ii)], and X must capitalize the amounts paid for these improvements [under -3T(d)(1)].
• In addition, X is required to capitalize the amounts paid to acquire and install each Section 1245 property. [Reg. Sec. 1.263(a)-2T(d)(1)]</td></tr>
<tr><td>Comments</td><td>• Remember ... "Betterment" = Improvement = Expenditures required to be capitalized
• Example 8 involves a larger scale group of activities which includes refresh activities as well as betterments/improvements to the buildings.
• Example 8 cannot be read without first reading Example 6, because Example 8 starts with ... "Assume the same facts in Example 6, but assume further ... that the work performed to refresh the stores directly benefits or was incurred by reason of a substantial remodel to X's store buildings" ... and in addition, ... "X performs significant additional work to alter the appearance and layout of its stores ...."
• Example 8 involves the analysis of several different provisions in the Regulations - (e)(2) ... (h)(3) ... (h)(1) ... (f)(3) ... (d)(1). Each of these has to be understood in its own right in order to grasp the totality and the context in which the conclusions in this Example are reached.
• In Example 6, where the situation involved only a "building refresh ... not a betterment," the taxpayer was not required to treat the amounts paid for the refresh of the buildings' structures and the buildings' systems as betterments [under (h)(1)(iii)].
• However, in Example 8, because a more comprehensive upgrade is involved ... technically referred to as a "betterment ... building remodel" situation, all of the expenditures that were incurred in the Example 6 refresh are now considered to be an integral part of the overall betterment remodeling improvement. Therefore, all of these expenditures are now required to be capitalized.
◆ In other words, the greater degree of activity in Example 8 "converts" all costs to the status of capitalizable costs.
• Bottom line ... The portion of the expenditures that could be expensed in the context of Example 6 cannot be expensed when they are included in the context of the broader activity described in Example 8.</td></tr>
</table>

Selected Automatic Changes in Accounting Methods Applicable to Dealerships & Facilities Upgrades Under the New Tangibles Regulations

Instructions for Form 3115

Department of the Treasury
Internal Revenue Service

(Rev. March 2012)

(Use with the December 2009 revision of Form 3115)

Application for Change in Accounting Method

- The descriptions for these automatic changes in accounting method are from the Instructions to Form 3115 (March 2012 revision). The Instructions include references to the applicable Sections in the *Appendix* to Rev. Proc. 2011-14 and to the corresponding Sections in Rev. Procs. 2012-19 and/or 2012-20. These references have been deleted in the summaries below.
- The filer/applicant must be within the scope of, and comply with, all of the applicable provisions of the published guidance that authorizes each listed change.
- Other automatic CAMs may be applicable to dealerships either in general, or in the context of the proper treatment of expenditures relating to facilities improvements and upgrades.
- The designated automatic CAM change number is indicated below.
- In some instances, the taxpayer is required to file a copy of the Form 3115 with the IRS in Ogden, Utah ("Ogden copy") instead of with the National Tax Office in Washington, D.C.

Automatic CAM #	Description of Change
#162 *Deducting Repair & Maintenance Costs*	• Applicable Code Section is Section 162. • For an applicant changing from capitalizing under Section 263(a) amounts paid or incurred for tangible property **to** deducting these amounts as repair and maintenance costs under Section 162 and Reg. Sec. 1.162-4T. • Also for an applicant changing its units of property under Reg. Sec. 1.263(a)-3T(e) solely for purposes of determining whether amounts paid or incurred improve a unit of property under Reg. Sec. 1.263(a)-3T.
#169 *Deducting* **de minimis** *Amounts*	• Applicable Code Section is Section 263(a). • For an applicant changing its method of accounting for amounts paid or incurred to acquire or produce (including any amounts paid or incurred to facilitate the acquisition and production of) a unit of property **to** the method of applying the *de minimis* rule under Reg. Secs. 1.263(a)-2T(g) and 1.263A-1T(b)(14) to such amounts, consistent with Reg. Sec. 1.263(a)-2T. • This change applies only to amounts paid or incurred in taxable years beginning on or after January 1, 2012.
#171 *Safe Harbor Routine Maintenance for Other than Buildings*	• Applicable Code Section is Section 162. • For an applicant changing its method of accounting for amounts paid or incurred for routine maintenance performed on a unit of property ***other than a building*** **to** the method of treating such amounts as amounts that do not improve the unit or property, consistent with Reg. Sec. 1.263(a)-3T(g).
#174 *Capitalizing Improvements to Tangible Property*	• Applicable Code Section is Section 263(a). • For an applicant changing its method of accounting **to** capitalizing amounts paid or incurred for improvements to units of property consistent with Reg. Secs. 1.263(a)-1T and 1.263(a)-3T and, if depreciable, to depreciating such improvements under Section 168.
#175 *Depreciation of Leasehold Improvements*	• Applicable Code Sections are Sections 167, 168 & 197. • For leasehold improvements in which the applicant has a depreciable interest at the beginning of the year of change, **from** improperly depreciating or amortizing these leasehold improvements over the term of the lease (including renewals, if applicable) **to** properly depreciating or amortizing these leasehold improvements under Section 167(f)(1), 168, or 197. • Schedule E of Form 3115 must be completed in connection with this change. • This change applies only to taxable years beginning on or after January 1, 2012.

Selected Automatic Changes in Accounting Methods Applicable to Dealerships & Facilities Upgrades Under the New Tangibles Regulations

#176 ***Depreciation of MACRS Property (Permissible)***	• Applicable Code Section is Section 168. • For MACRS property, from a permissible method **to** another permissible method listed in Section 6.28(3) in the *Appendix* of Rev. Proc. 2011-14. (These methods relate to items of MACRS property for which either a valid general asset account election has been made ... or has not been made ... involving single asset accounts and/or multiple asset accounts). • Schedule E of Form 3115 must be completed in connection with this change. • This change applies only to taxable years beginning on or after January 1, 2012.
#177 ***Dispositions of a Building or a Structural Component***	• Applicable Code Section is Section 168. • For an applicant changing **to** an asset that is permissible under Reg. Sec. 1.168(i)-8T(c)(4) for determining what building, [...] or structural components has been disposed of by the applicant for depreciation purposes; **or from** a method not specified in Reg. Sec. 1.168(i)-8T(f)(1), (f)(2)(i), (f)(2)(ii), or (f)(2)(iii) **to** a method specified in Reg. Sec. 1.168(i)-8T(f)(1), (f)(2)(i), (f)(2)(ii), or (f)(2)(iii) for identifying which buildings, [...] or structural components in multiple asset accounts have been disposed of by the applicant. • This change ***also will affect*** the determination of gain or loss from the disposition of the building, [...] or the structural component and may affect whether the applicant must capitalize amounts paid to restore a unit of property under Reg. Sec. 1.263(a)-3T(i). • This change applies only to taxable years beginning on or after January 1, 2012.
#178 ***Dispositions of Tangible Assets (Other than a Building or its Structural Components)***	• Applicable Code Section is Section 168. • For an applicant changing **to** an asset that is permissible under Reg. Sec. 1.168(i)-8T(c)(4) for determining what Section 1245 property or depreciable land improvement has been disposed of by the applicant for depreciation purposes; **or from** a method not specified in Reg. Sec. 1.168(i)-8T(f)(1), (f)(2)(i), (f)(2)(ii), or (f)(2)(iii) **to** a method specified in Reg. Sec. 1.168(i)-8T(f)(1), (f)(2)(i), (f)(2)(ii), or (f)(2)(iii) for identifying which Section 1245 property or depreciable land improvements in multiple asset accounts have been disposed of by the applicant. • This change ***also will affect*** the determination of gain or loss from the disposition of the Section 1245 property or the depreciable land improvement ***and may affect*** whether the taxpayer must capitalize amounts paid to restore a unit of property under the Reg. Sec. 1.263(a)-3T(i). • This change applies only to taxable years beginning on or after January 1, 2012.
#179 ***Dispositions of Tangible Depreciable Assets in a General Account***	• Applicable Code Section is Section 168. • For MACRS property for which the applicant made a valid general asset election, changing **to** an asset that is permissible under Reg. Sec. 1.168(i)-1T(e)(2)(viii) for determining what asset has been disposed of by the applicant for depreciation purposes; **or from** a method not specified in Reg. Sec. 1.168(i)-1T(j)(2)(i), (ii), (iii), or (iv) **to** a method specified in Reg. Sec. 1.168(i)-1T(j)(2)(i), (ii), (iii), or (iv) for identifying which assets have been disposed of by the applicant. • This change ***also may affect*** the determination of gain or loss from the disposition of the asset ***and may affect*** whether the applicant must capitalize amounts paid to restore a unit of property under Reg. Sec. 1.263(a)-3T(i). • This change applies only to taxable years beginning on or after January 1, 2012.
#180 ***General Asset Account Elections***	• Applicable Code Section is Section 168. • For an applicant making a late general asset account election under Section 168(i)(4) and Reg. Secs. 1.168(i)-1 and 1.168(i)-1T for MACRS property placed in service by the applicant in a taxable year beginning before January 1, 2012; **or** a late election to recognize gain or loss upon the disposition of all the assets, or the last asset, in a general asset account in accordance with Reg. Sec. 1.168(i)-1T(3)(ii); **or** for an item of MACRS property for which the applicant made a valid general asset account election, a late election to recognize gain or loss upon the disposition of that item in a qualifying disposition in accordance with Reg. Sec. 1.168(i)-1T(e)(3)(iii). • This change ***also may affect*** the determination of gain or loss from the disposition of the asset ***and may affect*** whether the applicant must capitalize amounts paid to restore a unit of property under Reg. Sec. 1.263(a)-3T(i). • This change applies only to the first or second taxable year beginning after December 31, 2011.

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A Periodic Update of Essential Tax Information

DEALER TAX WATCH

INDEX OF ARTICLES

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De Filipps' DEALER TAX WATCH **First-class**
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