

UNICAP UPDATE

Dealers are subject to the Internal Revenue Code Sec. 263A uniform capitalization (UNICAP) rules. These rules call for additional indirect costs to be capitalized into inventory that would not normally be capitalized under the traditional Sec. 471 full absorption cost accounting provisions. As a result, dealers may be required to treat certain costs that would otherwise be deducted as inventory costs. The typical inventory related costs that might be capitalized are purchasing, handling, and storage. Historically, we have advised many of our clients to adopt specific, simplified UNICAP methods. The use of these methods and meeting certain safe harbors can result in a zero UNICAP adjustment – no additional costs need to be capitalized.

The IRS has been pursuing new UNICAP theories and contending that dealers should be capitalizing even more costs under the premise that dealerships are not retail businesses and are instead producers. The UNICAP rules for producers can capture more expenses than for retailers.

These challenges have occurred during IRS audits even though there have been no legislative or regulatory changes in this area. Although, the IRS continues to suggest that a Revenue Ruling will be issued in the near future addressing these issues. Revenue Rulings apply to all taxpayers and have regulatory authority.

What's new

The IRS issued a directive to their audit branch last fall

suspending the examination of auto dealership UNICAP issues effective Sept. 15, 2009, through Dec. 31, 2010. The suspension is designed to give auto dealers a chance to voluntarily change their accounting methods to come into compliance with IRS guidance issued in 2007. During this period, examiners are instructed not to raise these issues on auto dealership examinations. Those auto dealership exams in process as of Sept. 15, 2009, may continue to develop UNICAP issues. Effective Jan. 1, 2011, the IRS says exams of auto dealership UNICAP issues will resume.

2007 guidance

In a Technical Advice Memo (TAM) issued as PLR 200736026, the IRS rejected an

(Unicap cont. on page 2)

POTENTIAL OPPORTUNITY TO INCREASE CASH FLOW

The opportunity

Staying competitive requires substantial recurring capital outlays. Maintaining equipment, replacing worn-out fixtures, reconfiguring tenant spaces, maintaining and repairing roofs, and upgrading to a new franchise image are just a few examples of the costs that business owners incur. In the past, tax law did not provide clear direction on how to treat these costs. Since the costs relate to capital assets, most

taxpayers conservatively considered them building components, typically depreciating them over 39 years. Proposed Regulation 1.263(a)-3 now provides guidance on how these costs should be treated for tax purposes. The guidance is generally favorable to taxpayers, because it may allow these items to be deducted currently as repairs and maintenance expenses, rather than depreciated over long

periods.

Benefits

There are two benefits that result from the ability to currently expense costs that would otherwise be capitalized and depreciated. The obvious benefit is that a deduction that reduces taxable income today is worth more than a deduction in the future due to the time value of money. Currently deducting amounts that otherwise would

(Cash Flow cont. on page 2)

(Unicap cont. from page 1)

auto dealer's hybrid self-developed method of capitalizing additional UNICAP costs and set forth in detail its views on how a typical auto dealer should handle costs, including repair/installation of parts on customer owned cars (treated as handling costs, not as a production activity), installation by the dealer or a subcontractor of parts to new and used vehicles owned by the dealer (these constitute production activities), and storage costs (depends on whether on-site or off-site). PLR's are only applicable to the taxpayer under audit.

The IRS has classified auto dealership UNICAP issues as a Tier III issue (risks that represent the highest compliance risk for a particular industry) because of a high level of perceived taxpayer noncompliance and developed a number of audit tools for examiners.

What's next

Each dealer will need to consider whether and when to change its tax accounting method during and beyond this moratorium. In making that decision, a dealer will need to consider the following pros and cons.

Pros

- Opportunity to spread any income increase from the change over four years.
- Avoid exposure to penalties and interest.
- Proactive change may result in a lower amount of capitalization than under an audit.
- Audit protects the issue but the calculation would still be subject to challenge.

Cons

- Costs to initiate the accounting method change.
- Increase in capitalization over current method.
- Additional complexity of future annual calculations.
- Higher tax burden.

The reasoning behind the IRS view change in this area remains unclear, as well as the technical basis for the change. As mentioned, there have been no legislative or regulatory changes, and the PLR only applies to that particular taxpayer. Additionally,

(Cash Flow cont. from page 1)

be depreciated over 15 or 39 years can easily return up to \$25 for each \$100 spent. The less obvious benefit is that reclassifying these costs as repairs and maintenance allows you to avoid depreciation recapture when you eventually dispose of the property. By avoiding depreciation recapture, you can convert ordinary gains into capital gains, which are currently taxed at lower rates. This can provide

TAX TIP

SMALL PERSONAL SERVICE S-CORPORATIONS

For many years small S corporations paid to its owners a small amount of salary and took the balance as dividends. Those dividends are exempt from self-employment tax, but are subject to income tax. IRS found massive tax avoidance in this area so Congress decided to increase the tax on small personal service S corporations where the principal income is as result of the efforts and skill of three or fewer workers. Owners of S-corporations in the fields of accounting, law, health, actuarial science, engineering, architecture, lobbying, consulting, brokerage services, investment management, sports and performing arts, will be subject to pay self employment tax on their entire profit. Currently, the tax is 15.3% of the first \$106,800 in profits and 2.9% above that.

Dividends passing through to larger S corporations or of S corporations that are not in professional service fields, such as manufacturers and automobile dealers, will continue to be exempt from self-employment tax. Thus, payments made to a shareholder-officer who performs substantial services essential to the taxpayer corporation were remuneration for employment subject to FICA and FUTA, rather than dividends

You should consult with your ATA representative to avoid being subject to this new provision.

many dealers filed automatic accounting method changes with the IRS in prior years adopting the safer harbor methods referred to above that resulted in "zero" UNICAP adjustments. Furthermore, it is not completely clear how to apply the IRS guidance suggested in the PLR and developed in their audit toolkit.

We are recommending that dealers continue to monitor this issue. We anticipate further

guidance as a result of industry/IRS discussions or via a revenue ruling. Whether, or if, the guidance comes before 2011 is anybody's guess.

Dealers should anticipate the need to file for some type of UNICAP accounting method change in the foreseeable future.

Please contact your local Auto Team America member for further information.

another \$5 to \$10 of return for each \$100 spent.

Solutions

The ability to deduct the types of costs discussed above will depend on your particular facts and circumstances, and will require proper analysis and documentation to meet the requirements of the proposed regulations. Analyzing your repairs and maintenance costs will:

- Provide you with the

opportunity to structure current and future projects for maximum tax benefits

- Allow you to review projects completed in prior years to consider if remaining depreciable basis can be deducted currently

Please contact your local Auto Team America member for the opportunity to help you analyze your situation and determine if you can benefit from this provision of the tax law.

QUICK CHECK

Do you have accounting internal control procedures set up in your dealership?

A basic, but highly beneficial, accounting internal control procedure is for the Dealer to obtain the monthly bank statements directly.

The dealer should review each cancelled check's number, date, payee, amount, signature and endorsement for accuracy, reasonableness, and appropriateness.

After completion of this review, the Dealer should subsequently review the bank reconciliation prepared for that month.

This simple procedure may or may not reveal some surprises, but will send an important message to those handling the checking account responsibilities.