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**memorandum**

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subject: Auto Dealer Facility Upgrade Programs

You have requested that the National Office issue a General Legal Advice Memorandum addressing the tax treatment for amounts that automobile dealerships receive from automobile manufacturers under Facility Image Upgrade Programs. This memorandum should not be used or cited as legal precedent.

**FACTS**

Automobiles generally are sold to the public through independently owned dealerships. To encourage automobile dealerships to expand, modernize, or renovate their facilities, some automobile manufacturers offer Facility Image Upgrade Programs (Program). Each Program is also designed to promote a standard brand image, so that all dealerships that carry a specific manufacturer's brand have a similar appearance. The extent of the renovations varies depending on the manufacturer's requirements and the dealership's condition. The most extensive renovations involve significant structural changes to the dealerships' sales and service areas to meet both current and expected demand for the manufacturers' vehicles. The least extensive renovations involve cosmetic upgrades to the facilities to meet the manufacturers' standardization requirements.

Each manufacturer creates its own Program requirements, and although each Program is voluntary, each manufacturer strongly encourages its dealerships to take advantage of Program. To provide an incentive for a dealership to participate in Program, a manufacturer may offer Upgrade Image Support Payments (Payments) to participating dealerships. The purpose of Payments under Program is to provide an incentive for each dealership to upgrade its facilities and to defray the dealership's costs for upgrades; the purpose of Payments is not to reduce the dealership's costs of vehicles. Payments are contingent on each dealership's completion of Program requirements to upgrade the dealership's facilities. The terms of Program typically are memorialized in a contract between the manufacturer and the dealership.

You indicate that dealerships treat Program Payments inconsistently. Some dealerships exclude Payments from income, asserting that Payments are nonshareholder contributions to capital under § 118 of the Internal Revenue Code (Code). Other dealerships and a trade association assert that Payments reduce the basis in the constructed assets and are not includable in gross income. You explain that in one Program the dealerships treat Payments as a purchase price adjustment to the vehicles and that, in a few cases, dealerships include Payments in income.

You asked us to consider the three factual situations described below, and we have included additional facts from the contracts you provided. In each situation, dealership participation is voluntary. Also, in each situation, Payments are to encourage the dealerships' compliance and completion of the facilities upgrades, and not to encourage dealerships' purchases or sales of vehicles. Although there are factual differences between the situations, the tax treatment of Payments is the same: Payments are includable in the dealerships' gross income.

#### Situation 1

Dealership A (A) operates an automobile dealership that sells and services Manufacturer X (X) vehicles. X has developed a brand standardization plan for dealerships that sell X's vehicles. The plan includes a standard, modernized look for dealership facilities. X offers a Program to encourage dealerships to undertake the changes needed to implement X's plan to improve dealerships' facilities. Not all dealerships are eligible to participate in Program.

A applies for Program and, after X accepts A's application, the parties enter into a Program agreement describing the terms and conditions of the approved project to improve A's facilities. A subsequently undertakes a construction project to expand the sales and service areas and to update its facilities consistent with X's standardization plan.

Under the Program agreement, A is eligible to receive Payments equal to z% of the project's construction costs, provided the work complies with X's standardization plan. A receives half of the total Payments at the beginning of the project and the other half

upon completion of the project. X has a right to inspect the completed project to ensure compliance with the Program's requirements. If A does not satisfactorily complete the project to improve its facilities, A must repay some or all of Payments.

### Situation 2

Dealership B (B) operates an automobile dealership that sells and services Manufacturer Y (Y) vehicles. Y has developed a brand standardization plan for dealerships that sell Y's vehicles. The plan includes several required elements: (1) improvements to B's facilities, (2) upgrades to B's software, internet capabilities and website enhancement, and (3) training for sales and service employees. Y offers a Program to encourage dealerships to undertake the changes needed to implement Y's plan. All dealerships are eligible to participate in Program. A participating dealership is required to complete all required elements of the plan.

B applies for Program and, after Y accepts B's application, the parties enter into a Program agreement describing the terms and conditions of the approved projects. The agreement contains a timeline for the project to improve B's facilities, not to exceed two years. B subsequently undertakes various projects to fulfill the required elements of Y's standardization plan.

Payments are made quarterly for the duration of B's participation in Program, and Payments are made only if B meets certain progress goals for each of the required elements during the preceding quarter. The amount of each Payment is determined by a formula based on the number of vehicles that B purchased from Y during the preceding quarter. B may receive Payments after the completion of the construction or improvement to its facilities because not all required elements of the plan relate to improvement of B's facilities, and those required elements may extend beyond the construction or improvements to B's facilities.

### Situation 3

Dealership C (C) operates an automobile dealership that sells and services Manufacturer Z (Z) vehicles. Z has developed a brand standardization plan for dealerships that sell Z's vehicles. The plan includes a standard, modernized look for dealership facilities that sell Z's vehicles. Z offers a Program to encourage dealerships to undertake the changes needed to implement Z's plan. All dealerships are eligible to participate in Program.

C applies for Program and, after Z accepts C's application, the parties enter into a Program agreement describing the terms and conditions of the approved project to improve C's facilities. Each approved project must be completed by the termination date of Program, and each project must meet Z's approval. C subsequently undertakes a project to fulfill the requirements of Z's standardization plan.

Program provides for two distinct types of Payments. First, one type of Payment is determined by \$x for each vehicle sold during Program, and C's right to these payments begins to accrue for the calendar year in which Z approves the plan. Z pays C accrued amounts of this type of Payment during the quarter construction is completed and makes additional Payments of this type quarterly until the termination of Program. The second type of Payment is determined by using a formula based on the expected costs of the improvements, and Z pays this type of Payment at the beginning and at the completion of the project.

## **LAW**

### **Gross Income under § 61**

Section 61 of the Code generally provides that gross income means all income from whatever source derived. The term "income" is broadly defined as "instances of undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955).

As a general principle, taxpayers in the retail industry compute gross income from sales during a year by subtracting the cost of the goods sold (CGS) from gross sales receipts. See § 1.61-3(a) of the Income Tax Regulations (regulations).

Generally, when payments are made by vendors to retailers as an inducement to purchase merchandise, the payments do not constitute separate items of gross income but instead are an adjustment to the cost or price of the merchandise purchased (purchase price adjustment). In Affiliated Foods, Inc., v. Commissioner, 128 T.C. 62, 80 (2007), the Tax Court held that a "purchase price adjustment or a price rebate that a taxpayer receives for goods that it has purchased for resale is not, itself, an item of gross income but, instead, is treated as a reduction in the cost of the goods sold." A purchase price adjustment may still indirectly affect the amount of Retailer's gross income if it results in a reduction in CGS.

As established in case law, the test for whether a payment, credit, allowance or rebate is a purchase price adjustment is what the parties intend and for what purpose the payment, credit, allowance, or rebate was paid. If the purpose was to adjust the price of the item between the parties, then the consideration given, in whatever form, is a purchase price adjustment and is not a separate item of gross income. The seminal case addressing purchase price adjustments is Pittsburgh Milk v. Commissioner, 26 T.C. 707 (1956), nonacq. 1959-2 C.B. 8-9, nonacq. withdrawn and acq. 1962-2 C.B. 5-6, acq. withdrawn and nonacq. 1976-2 C.B. 3-4, and nonacq. withdrawn in part and acq. in part 1982-2 C.B. 2. There the Tax Court concluded that allowances that a milk producer paid to buyers lowered the sales price of the milk for income tax purposes. The Tax Court held that only the net price was includable in the seller's gross income, even though the discounts were illegal. The Tax Court stated:

It does not follow, of course, that all allowances, discounts, and rebates made by a seller of property constitute adjustments to the selling prices. Terminology, alone, is not controlling; and each type of transaction must be analyzed with respect to its own facts and surrounding circumstances. Such examination may reveal that a particular allowance has been given for a separate consideration -- as in the case of rebates made in consideration of additional purchases of specified quantity over a specified subsequent period; or as in the case of allowances made in consideration of prepayment of an account receivable, so as to be in effect a payment of interest. The test to be applied, as in the interpretation of most business transactions, is: What did the parties really intend, and for what purpose or consideration was the allowance actually made? Where, as here, the intention and purpose of the allowance was to provide a formula for adjusting a specified gross price to an agreed net price, and where the making of such adjustment was not contingent upon any subsequent performance or consideration from the purchaser, then, regardless of the time or manner of the adjustment, the net selling price agreed upon must be given recognition for income tax purposes. 26 T.C. at 716-717.

### **Basis of Assets under §§ 1012 and 1016**

Section 1012 of the Code provides that the basis of acquired property is generally the cost of the property. Section 1016(a) provides that the basis of property is increased by the cost of capital improvements. See § 1.1016-2(a) of the regulations. An expenditure to produce tangible property is a capital expenditure if it meets the requirements of § 1.263(a)-2. An expenditure to improve tangible property is a capital expenditure if it meets the requirements of § 1.263(a)-3.

### **Nonshareholder Contributions under § 118**

Specific provisions of the Code exclude certain items from gross income. Exclusions from income are to be narrowly construed. Commissioner v. Schleier, 515 U.S. 323, 328 (1995).

Section 118(a) of the Code provides that the gross income of a corporation does not include any contribution to the capital of a corporation. Section 118(a) applies even when the contribution to the capital of a corporation is made by a nonshareholder. See § 1.118-1 of the regulations.

In U.S. v. Chicago, Burlington, & Quincy Railroad Co., 412 U.S. 401 (1973), the Supreme Court identified how to determine when a transfer by a nonshareholder to a corporation is a contribution of capital to the transferee corporation excludable from the gross income of the transferee corporation. It is necessary to examine the intent or motive of the transferor and the economic effect on the transferee corporation.

Factors indicative of the transferor's intent or motive are whether the benefit to the transferor is direct or indirect, specific or general, or certain or speculative. Id. at 411.

Where the transfer is not made with the purpose of receiving direct service or recompense, but only of obtaining advantage for the general community, the result is a contribution to capital. Id.

Regarding the economic effect of the transfer on the transferee corporation, the Supreme Court provided the following five factors that indicate a contribution to capital:

1. The transfer certainly must become a permanent part of the transferee's working capital structure;
2. The transfer must not be compensation, such as a direct payment for a specific, quantifiable service provided;
3. The transfer must be bargained for;
4. The transferred asset foreseeably must result in benefit to the transferee in an amount commensurate with its value; and
5. The transferred asset ordinarily, if not always, will be employed in or contribute to the production of additional income and its value assured in that respect.

Id. at 413.

### **Basis Reductions under § 362(c)(2)**

Section 362(c)(2) of the Code provides that if money is received by a corporation as a contribution to capital, and it is not contributed by a shareholder as such, then the basis of any property acquired with such money during the 12-month period beginning on the day the contribution is received shall be reduced by the amount of such contribution. Property deemed to be acquired with the contributed money shall be that property, if any, the acquisition of which was the purpose motivating the contribution. See § 1.362-2(a) of the regulations.

### **ANALYSIS**

#### **Payments are Gross Income under § 61**

Under the facts of the situations and the contracts you provided, all Payments are includable in the dealerships' gross income under § 61 of the Code. The dealerships have agreed to make specific upgrades and will receive Payments for the successful completion of those upgrades under Programs. The dealerships are responsible for contracting with the construction providers and are liable for payments to the construction providers. The dealerships, not the manufacturers, own the property that the dealerships construct or improve with Payments. Under these facts, the dealerships receive payments to defray their expense for construction of, or improvements, to their property. Therefore, the dealerships have an accession to wealth over which they have complete dominion and control. Accordingly, the dealerships must recognize gross income at the time they receive Payments or appropriately accrue the right to receive Payments under their methods of accounting.

Even though subsequent conditions may require the dealerships to return some or all of Payments, the dealerships must recognize taxable income when the dealerships receive Payments (if the dealership uses the cash method of accounting) or when the all events test is met (if the dealership uses the accrual method of accounting). See, e.g., Healy v. Commissioner, 345 U.S.278, 281-82 (1953); Schlude v. Commissioner, 372 U.S. 128,137 (1963); § 1.451-1(a) of the regulations. Further, Payments that dealership B in Situation 2 receives for modifications to its customer service practices, computer systems, website, or other systems, and Payments earned after construction is complete, are also gross income under § 61 of the Code.

The facts in this memorandum are similar to the facts in John B. White, Inc. v. Commissioner, 55 T.C. 729 (1971), aff'd per curiam, 458 F.2d 989 (3d Cir. 1972). In White, an auto manufacturer paid its authorized dealer amounts for leasehold improvements to induce the dealer to move its dealership to another location. The manufacturer offered the payment in order to increase the sales of its products and enhance its image by having the dealership located in a more desirable neighborhood and in a more attractive and better equipped building than its current location. The Tax Court held that the payment was includable in the dealer's income and was not excludable as a contribution to capital.

The Tax Court noted that the dealership was not acting on behalf of the manufacturer, and that the leasehold improvements were the property of the dealer, not the manufacturer. The Tax Court held, therefore, that the incentive payment, which financed the improvements, was an undeniable accession to the dealership's wealth and was includable in gross income under § 61(a) of the Code.

### **Payments Are Included in Basis of Dealerships' Property**

Although the manufacturers may make Payments for the intended purpose of defraying the dealerships' costs of improvements to the dealerships' facilities, the dealerships own the properties, and Payments do not reduce the basis in the dealerships' property. Accordingly, the dealerships include the full cost of construction in the basis of newly constructed property under § 1012 of the Code and include the cost of the capital improvements in the adjusted basis of existing property under § 1016.

### **Payments Are Not Purchase Price Adjustments to Vehicles**

Dealerships may cite Freedom Newspapers, Inc. v. Commissioner, T.C. Memo 1977-429, Rev. Rul. 76-96, 1976-1 C.B., and Rev. Rul. 73-559, 1973-2 C.B. 299,<sup>1</sup> in support of their position that Payments are a purchase price adjustment to the purchased vehicles. These cases and rulings generally hold that a payment that a taxpayer

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<sup>1</sup> Rev. Rul. 76-96 was suspended in part by Rev. Rul. 2008-26, 2008-1 C.B. 985.

receives as an inducement to purchase an asset is not includable in gross income and is not included in the basis of the asset. The test for whether a payment, credit, allowance or rebate is a purchase price adjustment is what the parties intend and for what purpose the payment, credit, allowance, or rebate was paid.

Based on the contracts you provided, there is no evidence that Payments under Programs were made with any intent to reach an agreed selling price of the vehicles that the manufacturers sell to dealerships. See, e.g., United Draperies, Inc. v. Commissioner, 41 T.C. 457, 465 (1964), aff'd, 340 F.2d 936, cert. denied 382 U.S. 813 (1965). In United Draperies, the Tax Court held that the taxpayer, a drapery manufacturer, could not exclude from gross income amounts that it paid to employees of a customer in order to induce the customer to buy its products. The Tax Court noted that the payments were “independent of [the taxpayer’s] agreement with its purchasers fixing the selling price of the products sold. . . . These amounts were paid for a consideration separate from the selling price of its products, . . . and the amounts received from these employers in consideration for its products sold is properly includable in petitioner’s gross income.” 41 T.C. at 465.

Under this analysis, the contracts you provided reflect that the purpose and intent of Payments is to provide an incentive to the dealerships to undertake and complete the upgrades to their facilities and to defray the dealerships’ costs for the upgrades. Nothing in the contracts suggests that Payments are an adjustment to the purchase price of the vehicles; the contracts reflect that Payments are consideration separate from the dealerships’ purchase of vehicles. Further, using the number of vehicles sold in Situation 2, or vehicles purchased in Situation 3, to calculate the amount of Payments is simply a formula to calculate the amount of Payments and is not a formula to reach the net selling price of the vehicles. See United Draperies, 41 T.C. at 465 (noting that it was immaterial that the payments in that case were a fixed percentage of sales).

### **Payments are Not Nonshareholder Contributions to Capital under § 118 and Basis of Property is not Reduced under § 362(c)(2)**

The dealerships cannot rely on § 118(a) of the Code to exclude from the dealerships’ gross income Payments that the manufacturers make under Programs. Further, because Payments are not nonshareholder contributions to capital excludable under § 118, the basis rules of § 362(c)(2) do not apply to reduce the dealerships’ basis in newly constructed property or existing property.

The transfer fails Chicago, Burlington, & Quincy for the following reasons: the manufacturers do not have the proper intent or motive because the manufacturers’ motive is not to obtain advantage for the general community. The manufacturers’ Payments to the dealerships under Programs are for the direct benefit of the manufacturers. A customer relationship exists between the manufacturers and the dealerships. The manufacturers want the dealerships to buy more vehicles from the manufacturers. The purpose of Programs is to provide an incentive for dealerships to

upgrade their facilities, which may result in increased dealership sales of vehicles for the benefit of the manufacturers.

White is dispositive for all three factual situations and the contracts you provided. In White, the Tax Court concluded that the auto manufacturer made the incentive payment in consideration for enhanced promotional activities by its authorized dealer through the use of the dealer's new facilities and the increase in sales of the auto manufacturer's products that could reasonably be expected to follow; such payment is not excludable from the dealer's income as a contribution to capital. White, 55 T.C. at 737.

Please call Brenda O'Hara at (202) 317-4730 if you have questions on § 61 of the Code and David McDonnell at (202) 317-4137 for questions on § 118.