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# Courts Rule Against Current Deduction of Lease Payments

A U.S. Court of Appeals upheld a Tax Court ruling involving a taxpayer who sought a current deduction for lease payments on property used for the storage of mobile homes being sold. Because of the process in which the mobile homes are ultimately sold to retail customers, the courts ruled that the exception for an "on-site" storage facility didn't apply to the taxpayer.

**I**n February 2009, the U.S. Court of Appeals for the Ninth Circuit ruled against a taxpayer who sought a current deduction for lease payments on property to store mobile homes. The ruling was based on a strict interpretation of Treasury Regulations that require capitalization of indirect costs associated with inventory.

## Background

The taxpayer is Associated Dealers, Inc. (ADI), which has numerous subsidiaries and related corporations that buy and sell mobile homes in the same manner. Therefore, the ruling applies to all of the related entities. ADI's salespersons are hired as independent contractors and are the only contact with the customer. ADI purchases mobile homes from various manu-

facturers and places them on lots leased to display the mobile homes. The sales staff work on these lots and interact directly with the retail customers. The sales staff can sell homes directly from the lot or take orders for custom homes. When a home is sold, the salesperson submits the purchase agreement to ADI, which then submits its own purchase order to the manufacturer. When the mobile home is delivered, ADI sells the home to the independent salesperson who initiated the order. ADI makes its money by keeping the factory incentive payment and selling the mobile home to the salesperson for the wholesale price paid to the manufacturer. The salesperson marks up the wholesale price to the retail price paid by the customer. The inde-

pendent salesperson has sole authority to set this price through negotiation with the customer.

On its corporate tax return, ADI deducted \$243,350 for lease of sales lots. Upon audit, the IRS determined that the lease payments weren't currently deductible and must be capitalized as part of the inventory cost of the mobile homes. ADI also deducted \$22,287 in miscellaneous expenses. Those expenses included shipping costs, payments to avoid a sheriff's seizure relating to back taxes owed by an independent salesperson, and various repairs on mobile homes. The IRS also asserts those costs must be capitalized rather than deducted in the year paid.

## The Taxpayer Position

ADI contends that the lease payments should be excluded from the cost of inventory by application of Treasury Regulation §1.263A-1(e)(3)(iii)(I), which exempts storage costs related to inventory in an on-site storage facility. In addition, ADI claims that Treasury Regulation §1.263A-1(e)(3)(iii)(A) also provides an exception to capitalization for the miscellaneous costs as "marketing,



selling, advertising, and distribution costs” relating to property held for resale.

## The IRS Position

The IRS maintains that the lot lease payments aren’t for an “on-site” storage facility as defined by the Treasury Regulations. Regulations §1.263A-1(e)(3)(ii)(G) and (H) specifically state that costs associated with handling and storing inventory must be capitalized and included in the cost of that inventory. IRC §263A states that all indirect costs allocable to inventory for resale must be included in the cost of that inventory. A special exception is made for costs of storing inventory at an “on-site” storage facility. The IRS maintains that the ADI lots don’t qualify as “on-site” storage. As defined by Regulation §1.263A-3(c)(5)(ii)(A), an “on-site” facility is one that is “physically attached to and is an integral part of a retail sales facility.” Regulations define a “retail sales facility” as “where a taxpayer sells merchandise exclusively to retail customers in on-site sales.” Further, a “retail customer” is defined as “the final purchaser of merchandise...and does not include a person who resells the merchandise to others such as a contractor.”

## The Tax Court

The court began with an examination of the Treasury Regulations’ meaning of “on-site” storage costs. If the lease payments aren’t for “on-site” storage, then the general rule of IRC §263A applies, which means storage costs (as indirect costs) must be capitalized and included in the cost of the inven-

tory (mobile homes).

The court looked at the actual flow of the ownership of the mobile homes. The salesperson takes a customer order and places the order with ADI. ADI buys the mobile home from the manufacturer and sells it to the independent salesperson. The salesperson marks up the wholesale price to the retail price determined by negotiation with the customer. The salesperson sells the mobile home to the customer. This means that ADI isn’t the taxpayer that “sells merchandise exclusively to retail customers in on-site sales.” The court stated that even though the ownership of the mobile home by the salesperson was brief and transitory, that ownership couldn’t be ignored. The court recognized that ADI participates in the sale of the mobile home to the customer, but the independent salesperson is the one who “sells the merchandise exclusively to retail customers in on-site sales” as required to qualify for the exception provided in the Regulations. Therefore, the lease payments for the sales lots can’t qualify for the “on-site” exception and must be capitalized and included in the cost of the inventory.

Next, the court considered the deduction of the \$22,287 in miscellaneous expenses. These expenses consisted of transportation costs, state taxes, and repair and maintenance expenses. The court stated that these types of costs are specifically identified in Regulations §1.263A-1(e)(3)(ii)(G),(K),(L) and (O) as costs that must be capitalized and included in the cost of inventory. Therefore, no current deduction is allowed.

## Ruling Upheld

In this Tax Court case the ruling against the taxpayer was upheld by the U.S. Court of Appeals for the Ninth Circuit. The taxpayer wanted a current deduction for costs of renting a lot used for the retail sale of mobile homes. The general rule of IRC §263A is that all indirect costs associated with inventory must be capitalized and included in the cost of that inventory. Treasury Regulations do provide an exception for costs of an “on-site” storage facility that is physically attached to and an integral part of a retail sales facility. Because an independent salesperson, not the taxpayer, sold the mobile homes, however, the taxpayer couldn’t qualify for the storage facility exception. The taxpayer also couldn’t deduct the transportation costs, state taxes, and repair and maintenance expenses associated with the mobile homes. These costs are specifically identified as costs that must be capitalized and included in the cost of the inventory. **SF**

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