De Filipps'

DEALER TAX WATCH

A Quarterly 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. CURRENT IRS AUDIT ACTIVITY

Reports are that the IRS is enthusiastically continuing its high energy audits... raising many major issues... and even more secondary ones.

Big issues include: Reasonableness of dealer compensation...Forms 8300 and cash transaction reporting...Accumulation of earnings...Discounts on transfers of customers' notes to related financing companies - especially in "buy-here, pay-here" situations...and Throwing out dealer LIFO elections - retroactively - because the 12th or 13th statements sent to the manufacturer or credit corporations did not reflect LIFO estimates or actual figures.

#2. ALTERNATIVE LIFO, COMPLIANCE CHECKS & CONFUSION OVER NEW ITEMS LISTS

In some regions, the IRS is also conducting spot-checks (not examinations) to assess the compliance of auto dealer's LIFO calculations with Revenue Procedure 92-79. We are now hearing from some CPAs that agents guided by the MSSP are using somewhat restrictive, unofficial lists of new items for the 1993 and 1994 model years as yardsticks for checking dealer computations.

Agents conducting these compliance checks are arbitrarily determining deficiencies in LIFO computations where differences in "new item" analysis have occurred. In some cases, they are recommending or suggesting that amended returns be filed. Apparently, the listings of new items used by these IRS agents and the MSSP were never coordinated or reviewed by the National Tax Office - the folks who actually wrote Revenue Procedure 92-79...!

Some dealers and CPAs are confused because they think "the IRS" has arrived at a uniform official determination on a certain matter. In fact, at least three different IRS agencies (i.e., the National Tax Office, the MSSP Specialists and the District Director's examining agents) are involved...and they are not always "coordinated" with each other, nor in agreement on matters of interpretation, judgment, administrative feasibility - or policy.

Dealers need a timely "coordinated" listing of new items published by an authoritative source (NADA?) - hopefully with pre-release review and approval from "the IRS."

#3. AICPA'S NATIONAL DEALER CONVENTION... IT'S SOLD OUT

The First National Annual Auto Dealership Industry Conference to be held in Las Vegas on October 31-November 1 has been sold out!

The Conference will include a broad range of subjects and many key speakers: J.D. Power will give an overview of the automotive industry, the top IRS motor vehicle specialist will present the "Latest from the IRS" ...other subjects will include dealership succession planning, valuation, internal control, fraud detection and prevention, dealership financial statement analysis, computer utilization, and a LIFO Update. We'll give you a full report on it in the next *DTW*.

If you are unable to attend or wanted to, but couldn't, the AICPA is already planning an identical

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WATCHING OUT FOR

(Continued from page 1)

conference - with all of the same speakers and topics - to be held on December 5 and 6 in New Orleans.

Audio tapes and presentation outlines will be available for a nominal price through the AICPA. Rachel Dichter (201/938-3567) is coordinating both Conferences for the AICPA.

#4. REASONABLE COMPENSATION

In the June issue of the *Dealer Tax Watch*, we began a special report on reasonable compensation for auto dealers. This issue of the *DTW* describes how dealers have met with greater or lesser degrees of success in the Tax Court. The most notable example is a 1993 case involving a dealer successfully defending $1,700,000 compensation in 1984 and slightly over $2,000,000 in 1985.

We have also summarized the factors that the Tax Court always examines in evaluating dealer compensation. This is predictable stuff...you can easily know what to expect. Our report concludes with ten suggestions for coming out on top, when the IRS raises this issue.

See page 8 for a complete listing of all articles appearing in both issues of the *DTW*.

#5. FORM 8300...FURTHER TIGHTENING

In testimony before the House Ways and Means Oversight Subcommittee, IRS Commissioner Margaret Richardson indicated that because of a decrease in Form 8300 filings, the IRS will begin another coordinated compliance effort in 1995.

The IRS takes these forms very seriously, as evidenced by the applicable penalties. The July, 1994 *Automotive Executive* reported that some salesmen in Florida dealerships were charged with conspiracy, money-laundering, structuring a financial transaction and bank fraud in $1.2 million of cash transactions. Others have been indicted for structuring cash purchases to avoid currency reporting requirements.

#6. LIFO YEAR-END FINANCIAL STATEMENT CONFORMITY REQUIREMENTS: A REMINDER

Make a note now: don't forget LIFO in those 12th and 13th statements going out to the Factory at year-end. More on this in the next issue.

#7. READER COMMENTS ON EAST FORD ARTICLE

In response to "Allocating Sale Price to Assets In Buy-Sells: Lessons from *East Ford* in the Tax Court," a reader wrote that he normally requires his client's attorney to add the following to a buy-sell contract:

"The buyer and seller will have (name of accounting firm) prepare IRS Form 8594 in accordance with the terms of this contract and attach hereto as Exhibit _. The parties also agree to file an exact copy of this exhibit along with their respective tax returns."

Our correspondent said that he has found that including this wording in the contract eliminates differences between the buyer's Form 8594 and the seller's. Had East Ford used such wording in its buy-sell contract, the IRS would not have had any differences to question because both parties would have used the same fair market valuations for the assets transferred.

We appreciate this reader's comments and want to pass them along to all our *DTW* readers. Let's continue to be interactive. ☺

#8. IRS CLARIFIES IMPACT OF C TO S ELECTIONS ON LIFO COMPUTATIONS

Revenue Procedure 94-61 issued in August provides a good example showing how C corporations electing S status should handle their LIFO computations and many other "clarifications." It also raises some new questions.

This will cause real problems for practitioners who either (1) thought switching from C to S terminated their LIFO elections or (2) started all over with indexes at 1.000 for the first S year.

Any CPA involved with financial statements (certified or not) or who prepared tax returns on the mistaken assumption that the S election terminated the LIFO election...has a host of problems and liabilities to deal with now. Those who started indexes over at 1.000 also have amended return complications.

#9. OTHER LIFO MATTERS

Because the IRS clarification in Revenue Procedure 94-61 mentioned above is so important, we plan to include highlight coverage in an upcoming issue of the *Dealer Tax Watch*. More extensive coverage, including an example of the Special Collapsed Layer required by the IRS, appears in the September, 1994 issue of the *LIFO Lookout*.

Other articles in the September, 1994 *LIFO Lookout* include:

- Replacement Cost Accounting for Parts-Type Inventories:

  In Letter Ruling 9433004, the IRS Says "No"
- Confusion Creeping Back Into the Alternative LIFO Method
- Dealer LIFO Conformity...Who's Minding the Store?
- Sampling Shortcuts: Don't Even Think About These (April, 1994 ISP Coordinated Issue Paper on Prohibited Sampling Shortcuts)
- Dual Index Approaches for Valuing Increments (July, 1994 ISP Coordinated Issue Paper on the "Earliest Acquisition Method")

SUGGESTIONS FOR REPORTING CASH TRANSACTIONS

Over recent years all types of businesses have dealt with increased enforcement of the money laundering and cash reporting rules. IRS Commissioner Margaret Richardson recently testified before the House Ways and Means Oversight Subcommittee on the reduced number of Forms 8300 filed in 1993. According to Richardson, the number of Forms 8300 filed in 1993 dropped by 3.8% from the number filed in 1992. She also stated that projected 1994 filings of Form 8300 indicate a decrease of 1.7%.

Commissioner Richardson stated that the 1991 and 1992 increases in Form 8300 filings "may be the direct result of the coordinated compliance sweeps which drew national attention in the business community." She also said that she thought that the current decrease in filings shows that "maintaining and improving compliance with the currency reporting requirements requires the combined efforts of all functions of the IRS."

The IRS will begin another coordinated compliance effort in 1995 because of the decline in filings. This compliance effort will focus on education and enforcement as it did during 1991. The Examination Office has established the new position of "Compliance Officer". By the end of the year, the Commissioner expects that 150 compliance officers will be trained to conduct compliance checks.

Regulations cover both cash reporting and money laundering. The cash reporting rules relate to the requirement that a business which receives more than $10,000 in "cash" file a Form 8300. Money laundering regulations relate to knowingly accepting money derived from illegal activities.

FORM 8300 CASH TRANSACTION REPORTING

The cash reporting rules relate to the Form 8300 filing requirement when more than $10,000 in "cash" is received. "Cash" includes: U. S. and foreign currency, cashier's checks, bank drafts, traveler's checks and money orders having a face amount of not more than $10,000 received in a designated reporting transaction (retail sale of a consumer durable) or received in any transaction in which the recipient knows the financial instrument is being used in an attempt to avoid the reporting of the transaction. Exceptions to designated reporting transactions include: a cashier's check, bank draft,traveler's check or money order which constitute the proceeds of a bank loan, payment on promissory notes, installment sales contracts or down payment plans.

Various penalties exist for not complying with the cash reporting requirements. A penalty may apply if you are required to file a return and you fail to file a correct and complete return on time and you can't demonstrate that the failure to file was due to reasonable cause. A penalty may also apply if you fail to furnish a correct and complete written statement to each person named in a required report on time. A minimum penalty of $25,000 may be imposed if the failure to file is due to the intentional disregard of the cash reporting requirements.

Additionally, some violations of the cash reporting rules may be subject to criminal prosecution, which upon conviction, may result in imprisonment of up to five years or fines of up to $250,000 for individuals and $500,000 for corporations. These violations are detailed in the last question in the article, "Form 8300 - Questions and Answers".

Because failure to comply with the cash reporting rules can have serious consequences, dealers should establish cash reporting policies and procedures.

- Track "cash" transactions to determine when a Form 8300 is required.
- Establish and document a policy which explains official company rules for handling "cash" transactions over $10,000. Obtain the signature of each employee.
- Refer all cash reporting inquiries from customers to a designated employee such as the general manager or the dealer.
- Hold frequent meetings to explain the procedures for handling a "cash" transaction over $10,000. Document these meetings and all other cash reporting "education".

see **CASH TRANSACTIONS**, page 24

FORM 8300 REVISED

The IRS has redesigned Form 8300: "Report of Cash Payments Over $10,000 Received in a Trade or Business" (Rev. August, 1994). It has also revised Publication 1544: "Reporting Cash Payments of Over $10,000".

Requests for information that is no longer needed have been deleted. For example, prior Form 8300 lines 16, 17 and 30 have been omitted from Part II. These lines related to differentiating the person on whose behalf the transaction was conducted as an individual or a corporation, indicating if the transaction was funded by another party and listing the date of birth of the person on whose behalf the transaction was conducted.

Part III contains the most changes. Certain entry areas have been changed to provide a better flow of information. Line 32 of the current form requests the breakdown of cash received by category (U.S. currency, foreign currency, cashier's check, money order, bank draft, traveler's check) which replaces prior lines 34, 35 and 36. Prior line 37 requesting information for installment sales has been eliminated. Former Line 38 "date of transaction" becomes present line 28 "date cash received".

The wording of two lines in Part IV has been slightly modified and Part I remains the same.

FORM 8300 - QUESTIONS AND ANSWERS

Every dealer and dealer's tax advisor should know the importance of adhering to the rules for reporting cash transactions in excess of $10,000. IRS compliance sweeps can result in severe penalties if the regulations are not followed correctly or are intentionally disregarded. Recent revision to Form 8300 and anticipated future IRS compliance efforts mean you should be able to answer all the questions below.

QUESTIONS	ANSWERS
Who Must File?	Any person engaged in a trade or business who receives more than $10,000 in "cash" in one transaction or two or more "related transactions" must file Form 8300.
When Would It Be Optional to File?	Form 8300 may be filed voluntarily for any "suspicious transaction" that does not exceed $10,000. Alternatively, the local IRS Criminal Investigation Division may be called. To obtain the phone number, call 1-800-800-2877.
What Is a "Suspicious Transaction"?	It is a transaction in which it appears that a person is attempting to cause Form 8300 not to be filed or a false/incomplete Form 8300 to be filed. A suspicious transaction also exists where there is an indication of possible illegal activity.
What Is "Cash"?	Cash always includes U.S. and foreign currency. Cash also includes cashier's checks, bank drafts, traveler's checks, and money orders having a **face amount of not more than $10,000** received in a **"designated reporting transaction"** or received in any transaction in which the recipient knows that the financial instrument is being **used in an attempt to avoid the reporting** of the transaction.
Is a Personal Check the Same As Cash?	No; cash does not include a personal check.
What Is a "Designated Reporting Transaction"?	It is a "retail sale" of a "consumer durable", a collectible or a travel/entertainment activity.
What Is a "Retail Sale"?	It is any sale (whether or not the sale is for resale or for any other purpose) made in the course of a trade or business if that trade or business principally consists of making sales to ultimate consumers.
What Is a "Consumer Durable"?	It is an item of tangible personal property of a type suitable under ordinary usage for personal consumption or use that can reasonably be expected to be useful for at least 1 year under ordinary usage, and that has a sales price of more than $10,000.
Are There Exceptions to Designated Reporting Transactions?	A cashier's check, bank draft, traveler's check, or money order is not considered to be received in a designated reporting transaction if it constitutes the **proceeds of a bank loan** or if it is received as a **payment on certain promissory notes, installment sales contracts, or down payment plans**.
What Are Related Transactions?	Any transactions conducted between a payor and the recipient in a 24 hour period. Furthermore, transactions that occur over a period of more than 24 hours are considered related if the recipient knows, or has reason to know, that each transaction is one of a series of associated transactions.

see **FORM 8300 - QUESTIONS AND ANSWERS**, page 6

Form **8300**

(Rev. August 1994)

Department of the Treasury
Internal Revenue Service

Report of Cash Payments Over $10,000 Received in a Trade or Business

▶ See instructions for definition of cash.

Please type or print.

OMB No. 1545-0892

1 Check appropriate boxes if: a ☐ amends prior report; b ☐ suspicious transaction.

Part I Identity of Individual From Whom the Cash Was Received

2 If more than one individual is involved, see instructions and check here ▶ ☐

3 Last name	4 First name	5 M.I.	6 Social security number

7 Address (number, street, and apt. or suite no.)	8 Date of birth (see instructions)

9 City	10 State	11 ZIP code	12 Country (if not U.S.)	13 Occupation, profession, or business

14 Method used to verify identity: a Describe identification ▶
b Issued by c Number

Part II Person (See Definitions) on Whose Behalf This Transaction Was Conducted

15 If this transaction was conducted on behalf of more than one person, see instructions and check here ▶ ☐

16 Individual's last name or Organization's name	17 First name	18 M.I.	19 Social security number

20 Doing business as (DBA) name (see instructions)

Employer identification number

21 Alien identification: a Describe identification ▶
b Issued by c Number

22 Address (number, street, and apt. or suite no.)	23 Occupation, profession, or business

24 City	25 State	26 ZIP code	27 Country (if not U.S.)

Part III Description of Transaction and Method of Payment

28 Date cash received	29 Total cash received	30 If cash was received in more than one payment, check here ▶ ☐	31 Total price if different from item 29
	$ .00		$ .00

32 Amount of cash received (in U.S. dollar equivalent) (see instructions):

a U.S. currency $ .00 (Amount in $100 bills or higher $ .00)
b Foreign currency .00 (Country ▶)
c Cashier's check(s) .00
d Money order(s) .00
e Bank draft(s) .00
f Traveler's check(s) .00

Issuer's name(s) and serial number(s) of the monetary instrument(s) ▶

33 Type of transaction

a ☐ personal property purchased
b ☐ real property purchased
c ☐ personal services provided
d ☐ business services provided
e ☐ intangible property purchased
f ☐ debt obligations paid
g ☐ exchange of cash
h ☐ escrow or trust funds
i ☐ other (specify) ▶

34 Specific description of property or service shown in 33. (Give serial or registration number, address, etc.)

▶

Part IV Business That Received Cash

35 Name of business that received cash	36 Employer identification number

37 Address (number, street, and apt. or suite no.)	Social security number

38 City	39 State	40 ZIP code	41 Nature of your business

42 Under penalties of perjury, I declare that to the best of my knowledge the information I have furnished above is true, correct, and complete.

Sign Here

(Authorized signature of business that received cash)	(Title)	(Date signed)	( ) (Telephone number of business)

Cat. No. 62133S Form **8300** (Rev. 8-94)

Form 8300 - Questions and Answers

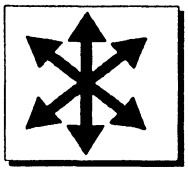
(Continued from page 4)

QUESTIONS	ANSWERS
How Are Multiple Payments Treated?	If more than one cash payment is received on a single transaction or on related transactions, then the transaction must be reported any time a total amount in "cash" payments exceeds $10,000 within any twelve month period.
When Should Form 8300 Be Filed?	It should be filed by fifteen days after the transaction occurred. If this fifteenth day falls on a weekend or legal holiday, the Form 8300 may be filed on the next business day.
When Should Form 8300 Be Filed If Multiple Payments Are Involved?	The amount received should be reported within fifteen days of the date the payment that caused the total amount to exceed $10,000 was received.
What If More Than One Report Is Required Within Fifteen Days?	A combined report may be filed no later than the date the earliest report, if filed separately, would be required to be filed.
Where Should Form 8300 Be Filed?	The form may be hand carried to a local IRS office or it may be mailed to: Internal Revenue Service • Detroit Computing Center P.O. Box 32621 • Detroit, MI 48232
How Long Should Copies of Form 8300 Be Retained?	A copy of each form filed should be kept for a minimum of five years from the date it is filed.
What Other Paperwork is Involved?	A written statement must be provided to each person who is named on a required Form 8300. An oral statement will not suffice.
What Information Must the Written Statement Contain?	It should indicate the name and address of the business, the total amount of reportable cash received, and that information on the transaction was furnished to the IRS.
When Must the Written Statement Be Provided?	It should be furnished on or before January 31 of the year following the calendar year in which the cash is received.
What Number Should Be Verified for Correctness?	The **correct** taxpayer identification number (social security number or employer identification number) of the person(s) from whom cash is received and the person(s) on whose behalf the transaction is being conducted is required to be furnished. **Penalties apply to incorrect or missing taxpayer identification numbers.**
Other Penalties Exist for Not Complying with the Cash Reporting Requirements...What Are They?	• A penalty may apply if you are required to file a return and you fail to file a correct and complete return on time and you can't show that the failure to file was due to reasonable cause. • A penalty may also apply if you fail to furnish a correct and complete written statement to each person named in a required report on time. • A minimum penalty of $25,000 may be imposed if the failure to file is due to an intentional disregard of the cash reporting requirements.

The following violations may be subject to criminal prosecution, which upon conviction, may result in imprisonment of up to five years or fines of up to $250,000 for individuals and $500,000 for corporations:

- Causing or attempting to cause a trade or business to fail to file a required report,
- Causing or attempting to cause a trade or business to file a required report containing a material omission or misstatement of fact and
- Structuring or attempting to structure transactions to avoid the reporting requirements.

AUTO DEALERS IN COURT
COMPENSATION CLAIMED AND ALLOWED AS REASONABLE
SELECTED TAX COURT (AND OTHER) DECISIONS



CASE	Year	Salary	Bonus	Total	Allowed by TAX COURT	Disallowed by TAX COURT	Allowed by IRS	Disallowed by IRS	Difference*
A.I.D., INC.	1985	$ 85,200	$1,969,531	$2,054,731	$2,054,731	$0	$ 872,000	$1,182,731	$1,182,731
A.I.D., INC. *T.C. Memo 1993-298*	1984	95,700	1,572,624	1,668,324	1,668,324	0	508,000	1,160,324	1,160,324
Schumaker	1975	36,000	68,820	104,820	104,820	0	❖	❖	❖
Schumaker *80-2 USTC*	1974	24,000	55,354	79,354	79,354	0	❖	❖	❖
Good Chevrolet *	1972	37,800	223,316	283,308	283,308	0	205,291	78,017	78,017
Good Chevrolet * *T.C. Memo 1977-291*	1971	37,800	158,327	218,793	218,793	0	160,582	58,211	58,211
Osborne Motors (H)	1969	18,000	23,500	41,500	41,500	41,500	25,050	16,450	16,450
Osborne Motors (W) *T.C. Memo 1976-153*	1969	5,980	17,752	23,732	23,732	0	11,982	11,750	11,750
Superior Motors	1969	60,000	50,000	110,000	89,000	21,000	78,094	31,906	10,906
Superior Motors *T.C. Memo 1974-187*	1969	60,000	81,775	141,775	117,000	24,775	89,729	52,046	27,271
Skyland Oldsmobile	1966	12,000	57,950	69,950	69,950	0	42,500	27,450	27,450
Skyland Oldsmobile	1965	12,000	60,100	72,100	72,100	0	42,500	29,600	29,600
Skyland Oldsmobile *T.C. Memo 1972-17*	1964	12,000	41,825	53,825	53,825	0	42,500	11,325	11,325
Van's Chevrolet	1961	17,333	31,737	49,070	49,070	0	25,000	24,070	24,070
Van's Chevrolet *T.C. Memo 1967-172*	1962	18,200	57,017	75,217	60,000	15,217	25,000	50,217	35,000

* Allowed by TAX COURT in excess of amount allowed by IRS.

❖ Not readily determinable.

* Total includes profit-sharing allocation.

A.I.D., INC. - DEALER WINS ALL

OVERVIEW

In 1993, the Tax Court approved as reasonable the payment of compensation of almost $1,700,000 in 1984 and slightly over $2,000,000 in 1985 to a very successful dealer who was running two/three dealerships through his dealership management company. Automotive Investment Development, Inc./ AIDI (66 TCM 57; T.C. Memo 1993-298) shows how thoroughly the Tax Court looks at all the facts and circumstances in reaching a decision.

Be forewarned that the dealer, Mr. Larry Van Tuyl, was extraordinary in many respects. His performance and record may be hard to match.

Initially, the Internal Revenue Service determined that the maximum reasonable compensation would only be $508,000 (about 30% of the amount paid) in 1984 and $872,000 (approximately 42% of the amount paid) in 1985. The disallowances resulted in a deficiency of more than $1,000,000 ($534,000 and $544,000) in 1984 and 1985 combined. Big dollars were at stake. And each side had presumably considered the "hazards of litigation" before stepping into the Tax Court.

The dealer has the burden of proving that the Internal Revenue Service is erroneous in its determination that compensation is unreasonable. The Court noted that (1) the amount of compensation must be reasonable, (2) the payments must, in fact, be purely for services rendered, and (3) the reasonableness of compensation is a question of fact to be determined from all of the facts and circumstances.

FACTS

AIDI was engaged in the business of investing in and managing auto dealerships and related entities since its formation in 1977. During 1984 and 1985, AIDI owned controlling interests in and performed managerial and other services for Dennis Chevrolet, Inc. (75%); R.Z. Sims Chevrolet, Inc. (75% until its sale in October of 1984); ABC Nissan/Datsun, Inc. (100%); Dennis Development, Inc. (100%); and Dennis Life Insurance, Inc. (100%).

AIDI had paid a dividend of $15,240 in 1982 and this was the only dividend paid from the time of incorporation through 1985. The board of directors held off paying dividends in other years in order to retain earnings for expansion and acquisitions.

Mr. Van Tuyl personally owned 100% of Dennis Chevrolet (a Kansas automobile dealership) from 1975 until he contributed his stock to initially capitalize AIDI. In 1981-82, AIDI sold 25% of Dennis Chevrolet's stock and thereafter, it owned 75%. Dennis Chevrolet's performance showed great (make that spectacular) improvement after being acquired by AIDI.

Mr. Van Tuyl had purchased 75% of the stock of Sims Chevrolet in 1977 and contributed it to AIDI in the initial capitalization of the corporation. In October of 1984 AIDI sold Sims Chevrolet and recognized a gain of $226,000. Dennis Development sold land to Sims Chevrolet at the same time and recognized a gain of $677,600.

Mr. Van Tuyl had negotiated the purchase of 100% of the stock of ABC Nissan/Datsun (an Arizona automobile dealership) in 1982 by AIDI and AIDI owned all of ABC Nissan/Datsun's stock through 1985. ABC Nissan/Datsun became the top Nissan dealership in the nation under Mr. Van Tuyl's management and in 1985 only three other single line dealerships in the country sold more cars than it did.

see **A.I.D., INC. - DEALER WINS ALL**, page 10

DTW ARTICLES ON REASONABLE COMPENSATION

This issue of the *Dealer Tax Watch* contains the second group of articles addressing dealer compensation...what is reasonable, what is not and factors the IRS and the Courts weigh in their consideration.

A complete listing of comp articles in the June (#1-#6) and the September (#7-#11) 1994 *Dealer Tax Watches* follows:

1. Reasonable Compensation "Valuations"
2. Corporate Minutes Checklist
3. IRS Manual Instructions to Agents for Auditing Compensation
4. Principles from Five Non-Dealer Cases
5. The IRS' Questionnaire on Dealer Comp
6. Other IRS Audit Techniques for Analyzing Compensation
7. Factors the Courts Consider in Determining Reasonable Compensation
8. A.I.D., Inc. - Dealer Wins All
9. Superior Motors, Inc. - A Contrasting Result
10. Auto Dealers in Court - A Summary
11. Ten Suggestions for Coming Out on Top:
    Determining, Documenting & Defending Dealer Compensation

The last article consolidates all others as a checklist or a discussion agenda for a Dealer-CPA conference to determine, document and defend dealer compensation from IRS attack.

FACTORS THE COURTS CONSIDER IN DETERMINING REASONABLE COMPENSATION

The question of reasonable compensation has been before many courts, many times. In evaluating the reasonableness of compensation, courts have more recently identified several factors which they have clustered together in groups for analytic purposes.

THREE-PART ANALYSIS

1. Performance of employee.
2. Salary comparisons.
3. Company character and conditions.

FIVE-PART ANALYSIS

1. The employee's qualifications and role in the company.
2. The character and condition of the company.
3. Comparison of employee's compensation with compensation paid by similar companies for comparable services.
4. Salary policy of the company for all its employees and the particular employee's salary history with the company.
5. The likelihood that a hypothetical, independent investor would be willing to compensate the employee at the levels paid by the company, taking into account dividends paid and capital growth.

DETAIL LISTING OF FACTORS

1. Performance of employee.
   - A. Employee's qualifications and training.
   - B. Role in the company, including nature, extent and scope of duties and responsibilities and positions held.
   - C. Hours worked.
   - D. Results of employee's efforts.
   - E. Employee's responsibility for company's inception and/or success.
2. Salary comparisons.
   - A. Prevailing rates of compensation for comparable services/employees in a comparable or similar business.
   - B. Amount of compensation and how it was determined.
   - C. Time of year compensation was determined and by whom.
   - D. Presence or absence of more usual fringe benefits such as pension or profit sharing plan participation, stock options, etc. (including those which may be available to executives in other companies of comparable size).
   - E. Correlation between employee-shareholder's compensation and stockholdings.
   - F. Ratio of compensation to net income (before compensation and income tax) of the business and to other factors such as total sales/revenues, gross profit, (net) asset base and growth of business.
3. Company character and conditions.
   - A. Size of the company and complexity of the business. Comparison with planning potential.
   - B. Overall economic condition and character of the company.
   - C. General/prevailing economic conditions within the industry.
   - D. Financial condition of the company after payment of the compensation.
   - E. Dividend payment record of the company, need for retention of earnings for various purposes and adequacy of retained earnings to meet current or anticipated needs.
   - F. Whether an independent, hypothetical investor would approve the compensation paid to the employee and still regard his own investment rate of return as adequate.

In its 1993 Memorandum decision (TCM 1993-298: Automotive Investment Development, Inc.), the Tax Court used the five-factor grouping above. Its analysis essentially touched on all of the factors in the more detailed listing above. The Courts are very predictable... Expect them to analyze all of these factors in any (un)reasonable compensation case they have to decide.

 (Continued from page 8)

COMPENSATION

Mr. Van Tuyl had an employment contract with AIDI which provided for compensation based on the services that he was providing to the three dealerships (ABC Nissan/Datsun, Dennis Chevrolet, and Sims Chevrolet) through the management company. AIDI's board of directors set Mr. Van Tuyl's compensation by resolution from 1979 through mid-1982. After mid-1982, his compensation was determined by the terms of his employment agreement and consisted of a base salary plus monthly and annual bonuses.

In 1984, AIDI paid him a base salary of $8,600 per month for the first seven months, and $7,100 per month for the last five months. The decrease in base salary was due to the sale of Sims Chevrolet. His employment contract also required AIDI to pay bonuses with respect to the profits or losses of Sims Chevrolet (14.5%), Dennis Chevrolet (28%), and ABC Nissan/Datsun (28%). His bonus was based upon pre-tax **profits or losses** of the dealerships. In 1985, AIDI paid Mr. Van Tuyl a base salary of $7,100 per month and a bonus of 28% of the profits or losses of Dennis Chevrolet and ABC Nissan/Datsun. His compensation totalled $1,668,324 in 1984 and $2,054,731 in 1985.

As the sole shareholder and key officer/employee, Mr. Van Tuyl was in complete control of the terms of his employment contract. One interesting aspect of his bonus arrangement was that his compensation would be increased by a percentage of the pre-tax profits earned by one of the managed dealerships, but it would be decreased by a percentage of the pre-tax losses sustained by one of the dealerships. During this period the Company did not have any retirement (pension or profit sharing plans) or other plans of deferred compensation.

TRAITS & RESULTS

- He was highly motivated and extremely productive.
- He had unique characteristics that made him irreplaceable.
- He was largely responsible for its success.
- He had an extraordinary aptitude for automotive sales.
- His dealerships succeeded far beyond comparable ventures.
- He was able to "make winners out of both losers and marginal players."
- He transformed one dealership into a "regional success."
- He turned the Nissan/Datsun dealership which had been only marginally profitable into the number one Nissan/Datsun store in the nation.
- "His spectacular success led manufacturers to seek him out... solicit his involvement in their merchandising chains."
- In the discharge of his responsibilities and in achieving these results, the dealer had regularly worked 70 to 80 hours per week with virtually no time off for vacations.
- He was responsible for the entire operations of the management company and the related dealerships, including all personnel, sales, service, dealing with manufacturers and dealing with banks.

RESPONSIBILITIES

- Recruiting, hiring, training, supervising & motivating personnel.
- Overseeing studies of customer buying trends & developing appropriate sales & business plans.
- Developing & monitoring merchandising systems.
- Coordinating customer satisfaction & public relations programs.
- Negotiating & maintaining relations with manufacturers & other suppliers.
- Investigating & negotiating property & equipment acquisitions.
- Negotiating & maintaining banking relationships.
- Developing advertising policies & generating advertising ideas.
- Establishing & monitoring comp plans, policies, procedures & benefit programs.
- Supervising the design & construction of new automobile facilities.
- Participating in the day-to-day operations of the dealerships.

FIVE FACTOR ANALYSIS

The Court analyzed five factors in evaluating the reasonableness of Mr. Van Tuyl's compensation. These factors are detailed on page 9.

THE DEALER'S ROLE IN THE COMPANY

The Court reviewed the employee's irreplaceability, responsibility for the success of the venture and the nature, extent and scope of the employee's duties and responsibilities. It found that the dealer possessed the traits - and achieved the results - listed in the box at left.

Note that there were actually two levels of services being rendered by this dealer. First, he was involved in helping his immediate employer, the management company, to perform services it was contractually bound to provide to the managed dealerships. These included providing legal, accounting, auditing and tax preparation services as well as consulting on other financial, operating and management matters. The second level of services, duties and responsibilities under the management company's contracts with the dealerships involved or required the dealer to carry out the duties above.

CHARACTER AND CONDITION OF COMPANY

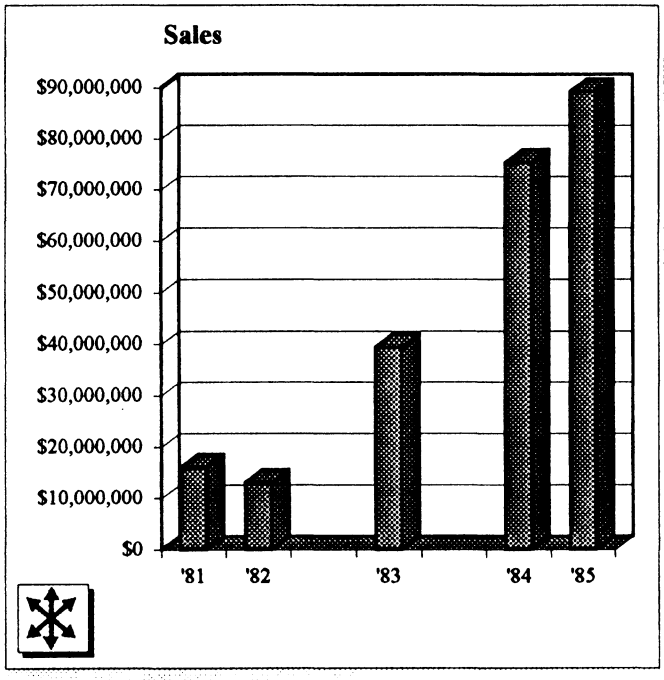
In analyzing factors related to the character and condition of the companies, the Court reviewed information summarizing the dealership's sales, net income, growth, market share and performance relative to planning potential. It also inquired into the "complexity of the business environment and the general condition of the economy."

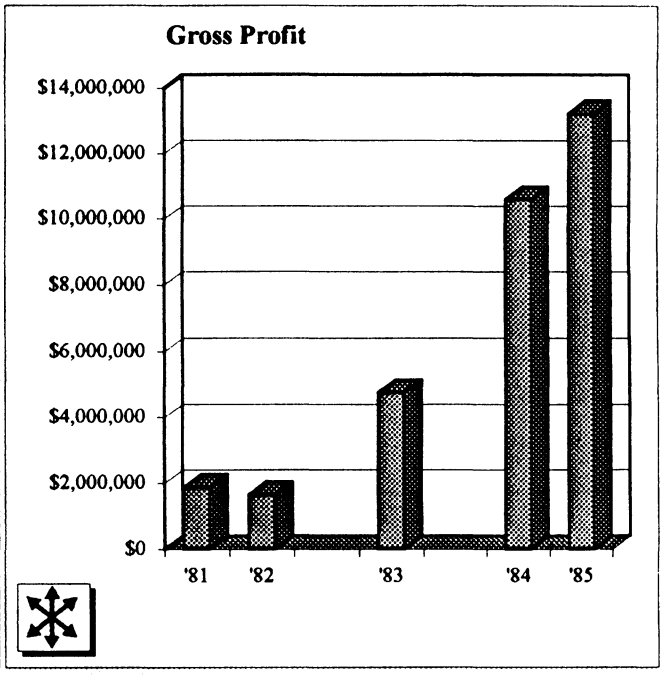
see **A.I.D., INC. - DEALER WINS ALL**, page 15

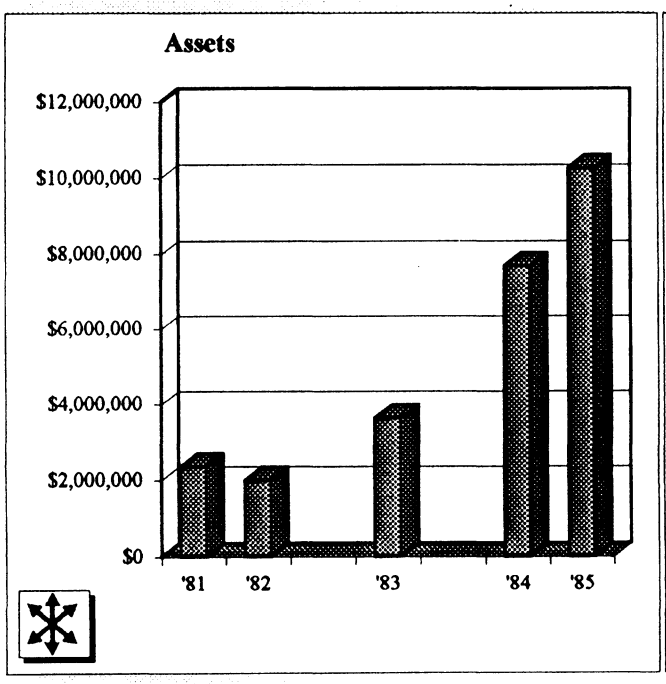
AUTOMOTIVE INVESTMENT DEVELOPMENT, INC.

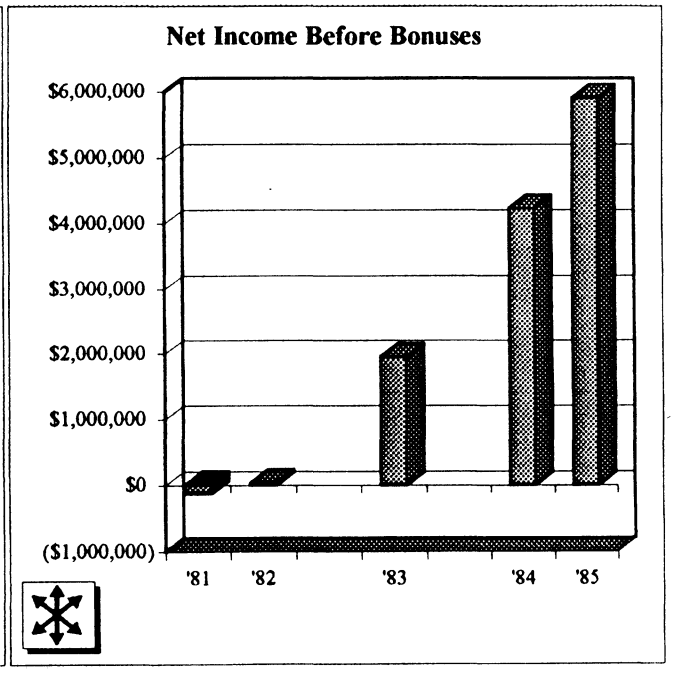
SELECTED ANALYSES FOR NISSAN/DATSUN

FOR THE YEARS 1981 - 1985









NISSAN/DATSUN

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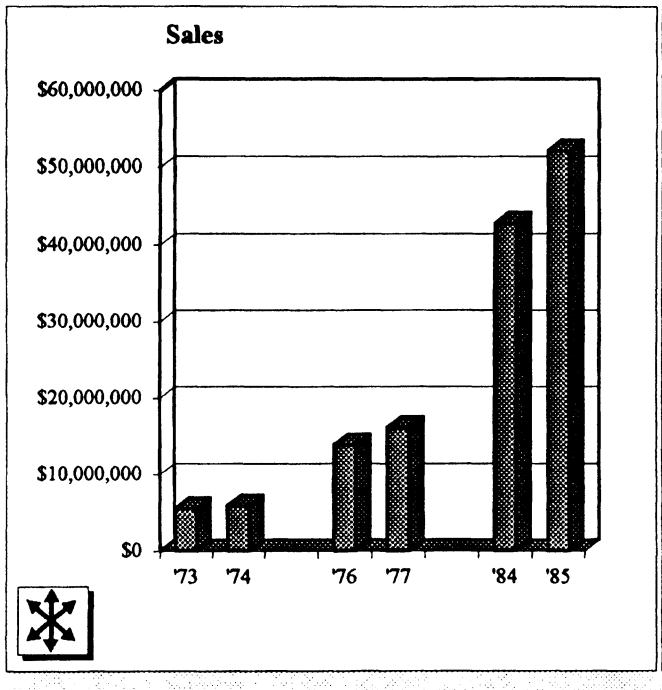
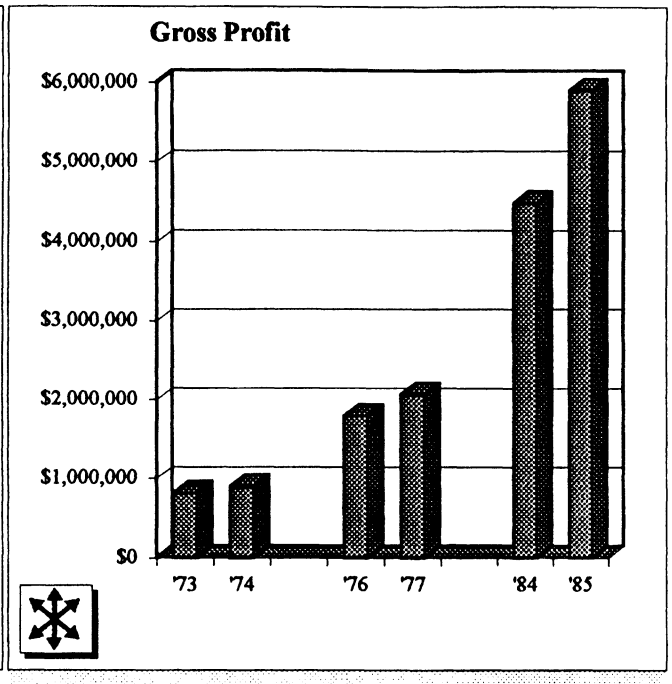
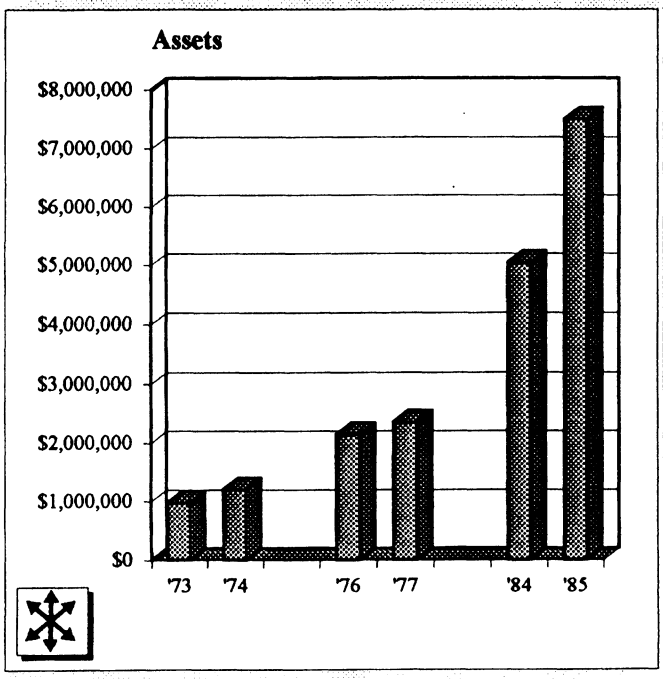
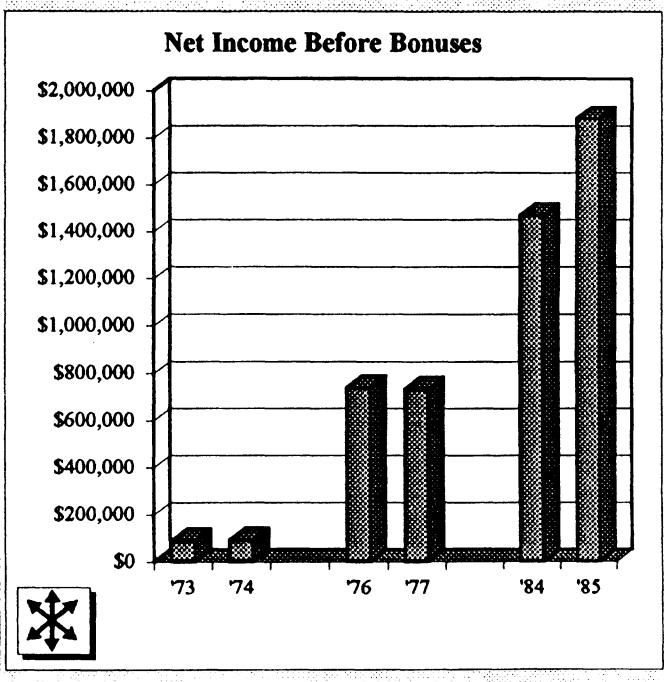
AUTOMOTIVE INVESTMENT DEVELOPMENT, INC.
SELECTED ANALYSES FOR CHEVROLET
FOR THE YEARS 1973 - 1985









CHEVROLET

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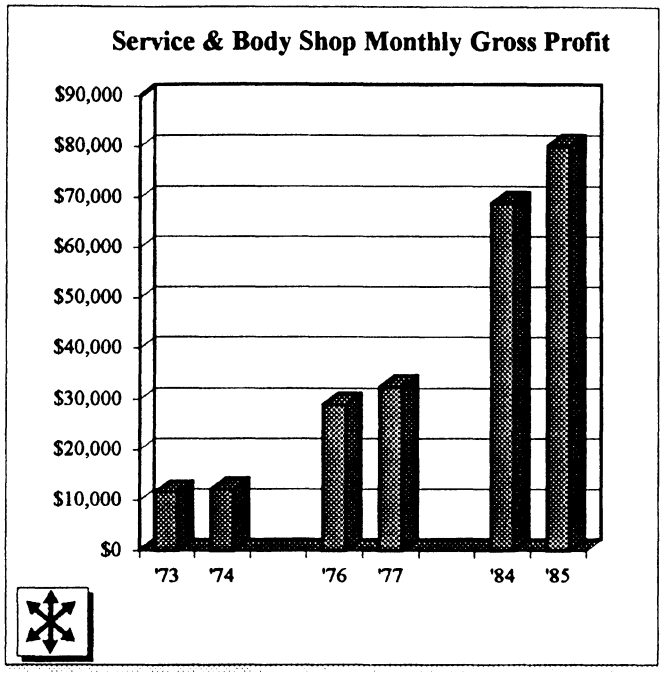
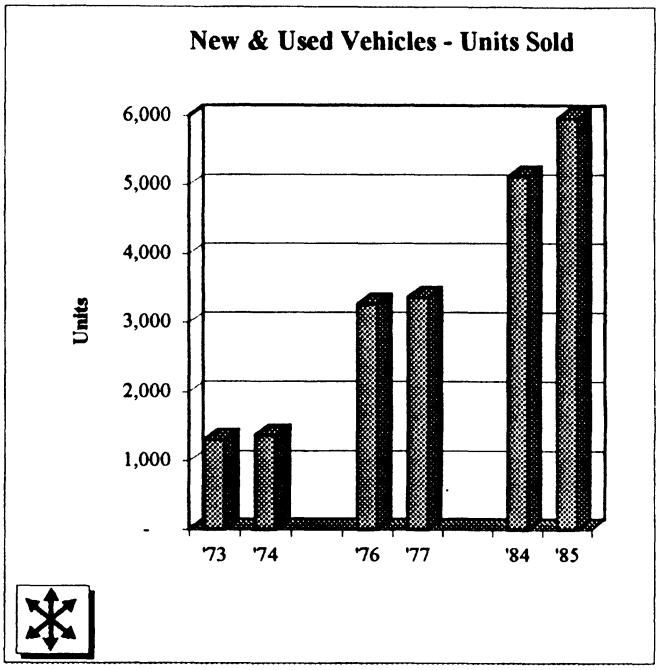
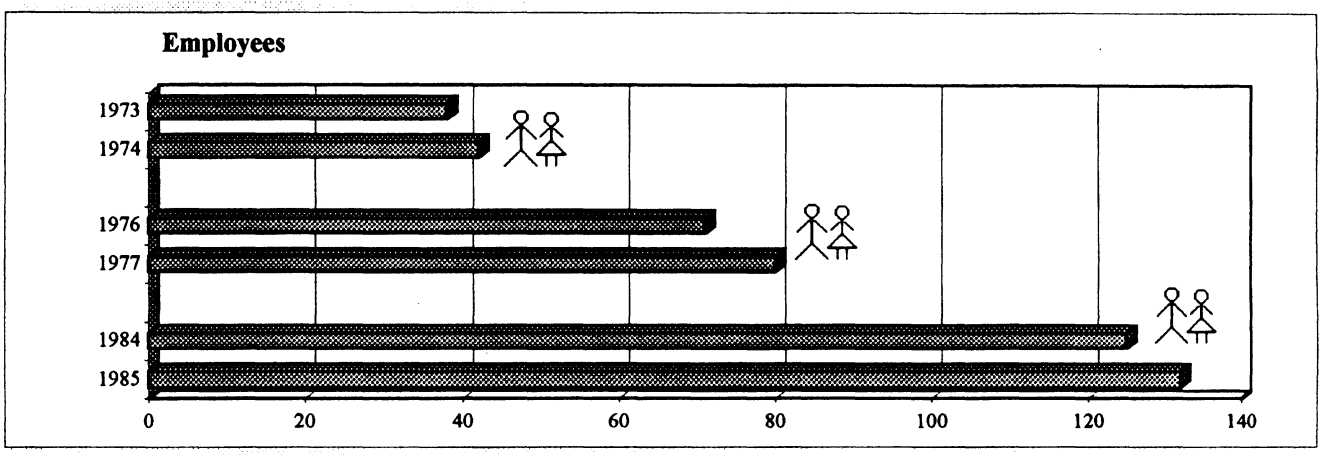
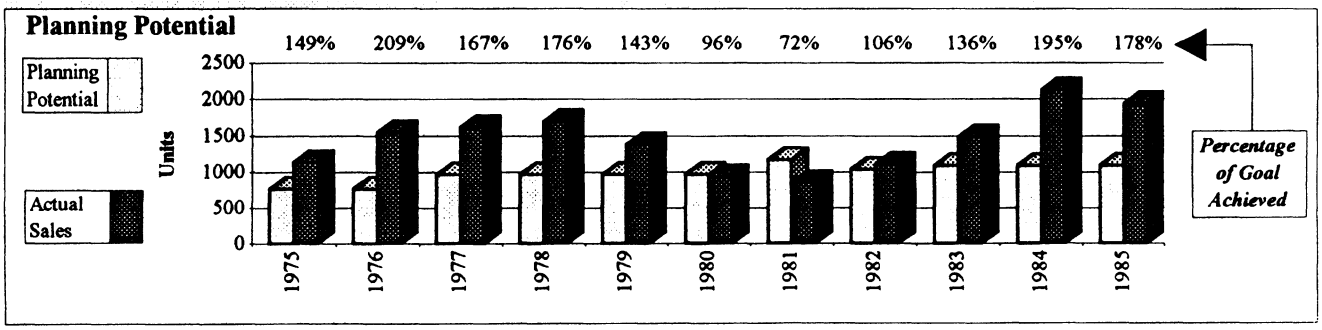
AUTOMOTIVE INVESTMENT DEVELOPMENT, INC.
SELECTED ANALYSES FOR CHEVROLET
FOR THE YEARS 1973 - 1985

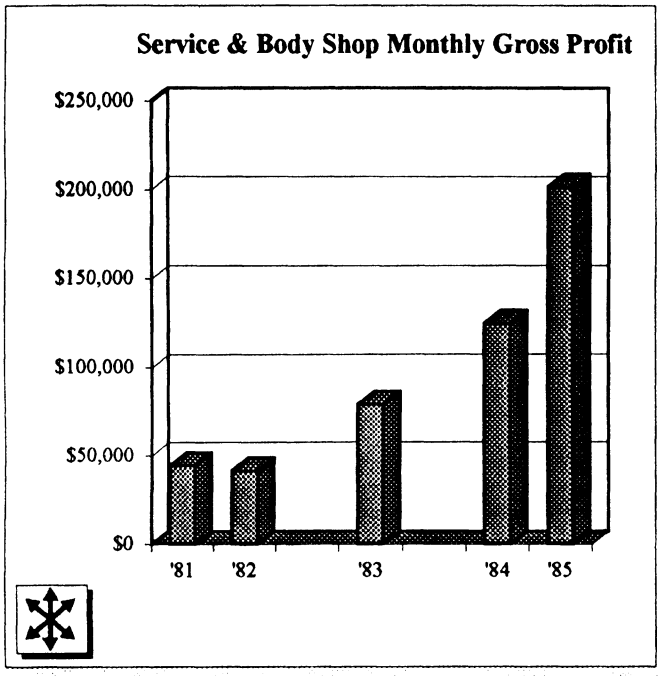


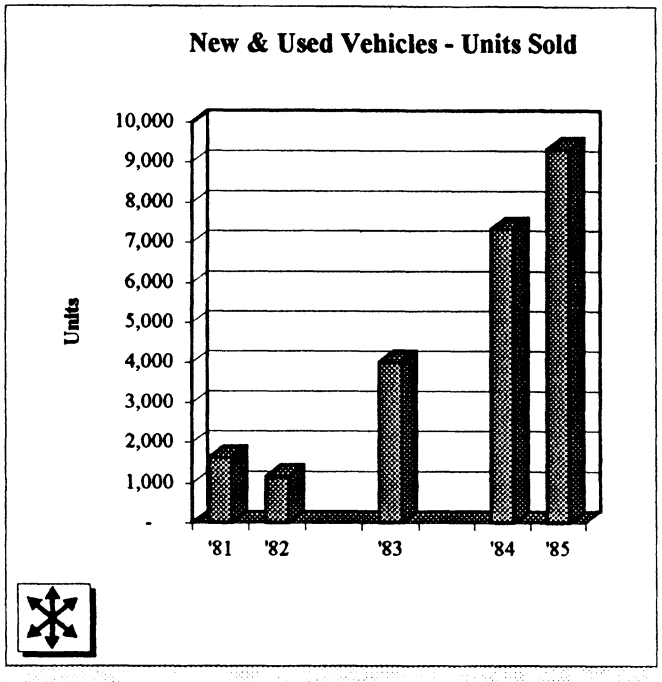


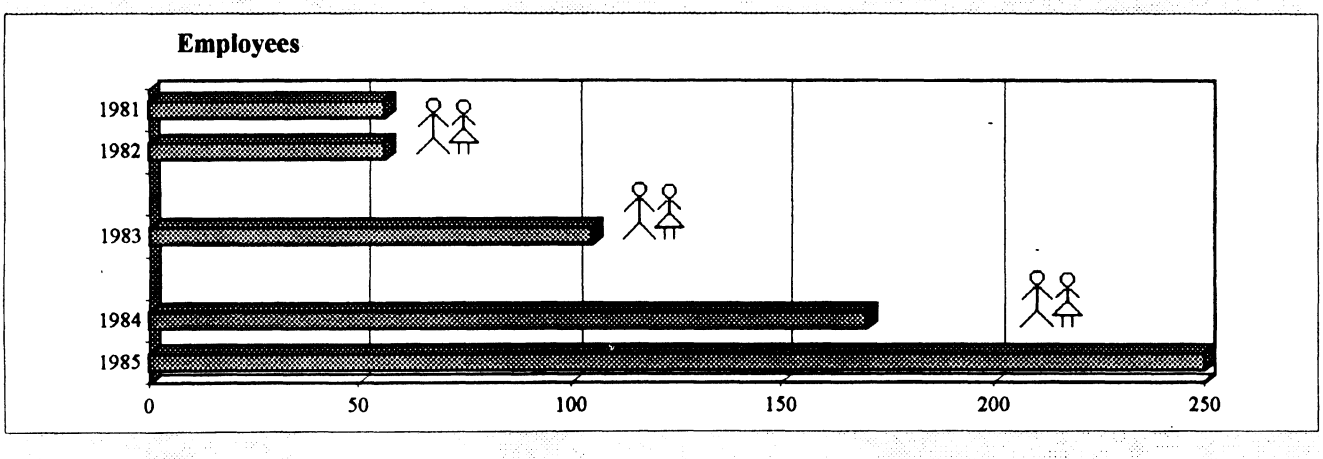


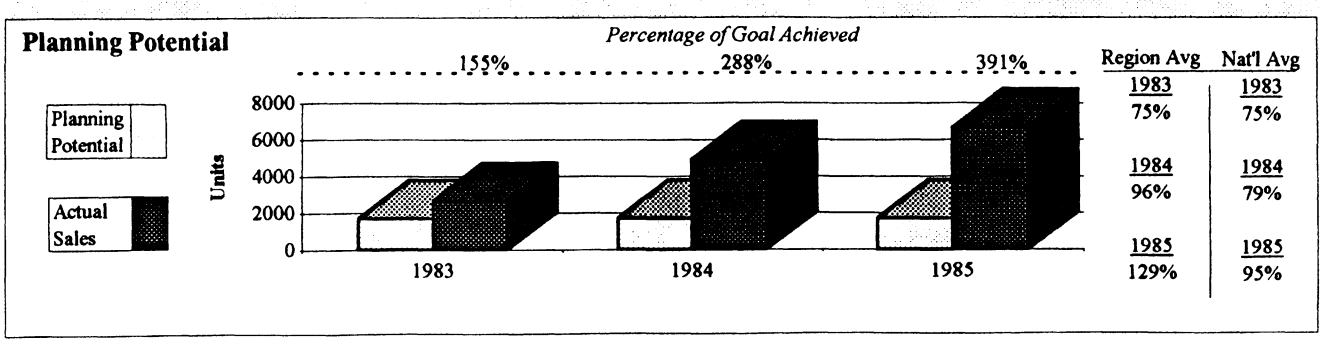


AUTOMOTIVE INVESTMENT DEVELOPMENT, INC.
SELECTED ANALYSES FOR NISSAN/DATSUN
FOR THE YEARS 1981 - 1985









(Continued from page 10)

In this regard, the Tax Court again concluded that the performance of the dealerships under the direction of the dealer was "striking." The performance of the Chevrolet dealership far surpassed the market average and the performance of the Nissan/Datsun dealership was even more impressive relative to the market. The latter achieved almost 300% of its planning potential in 1984 when the average Nissan/Datsun dealership performed according to only 80% of its planning potential **and** in the next year (1985), the Nissan/Datsun dealership achieved almost 400% of its planning potential (391%) while all other dealerships averaged only 95% success.

The Court analyzed information relative to the Chevrolet dealership which had been acquired in 1978. It contrasted performance for two years immediately before the dealership was acquired (1973 and 1974) with "turnaround results" for the two full years immediately after the dealership was acquired (1976 and 1977) ...and further compared those results with the financial results for the years under audit (1984 and 1985) which were several years after the "turnaround years." Results the Court evaluated for the selected seven years (see pages 11-14) out of this thirteen-year (1973-1985) time span are below.

RESULTS

- Sales
- Gross profits
- Assets
- Net income before bonuses
- New vehicle sales (units)
- Used vehicle sales (units)
- Average monthly service and body shop gross profit
- Number of employees

COMPENSATION PAID TO THE DEALER

In analyzing the compensation paid to the dealer and amounts that might be paid for comparable positions, the Court emphasized that Section 162 is "not designed to regulate businesses by denying them a deduction for the payment of compensation in excess of the norm" in cases where ***other*** factors call for (or might justify) higher compensation.

The position of the dealer was that his compensation was justified by the "scope of his work and his outstanding performance." His salary had been established on the basis of a formula commonly used in the automotive sales industry. His bonus and salary formula had been established at the time when the Nissan/Datsun store had been acquired in 1982 and had remained substantially unchanged.

EXPERT WITNESSES

Three expert witnesses testified at the trial regarding the dealer's compensation. The first and most credible was Mr. Carl Woodward, a CPA from Bloomington, Illinois with extensive experience specializing in automobile dealerships. His testimony addressed the customs and practice in the automobile sales industry regarding compensation during the years in issue (i.e., 1984 and 1985).

His expert witness testimony and opinion confirmed that, during the years involved, it was standard practice in the industry for automobile dealerships to pay dealer-operators a moderate base salary, supplemented by a bonus. The amount of the **base salary** might vary, usually according to the size of the dealership and the cost of living for the area in which the dealership was located (with base salaries highest for larger dealerships in urban/metropolitan areas).

The **bonus amount** typically ranged from 20% to 33% of pre-tax profits or losses. Mr. Woodward further testified that those percentages did not vary according to whether the operator also owned the dealership, nor did they vary based on the "success" of the dealership. This CPA's testimony was found to be the most relevant by the Tax Court.

The second expert witness who testified (for the dealer) was not nearly as helpful. This witness had evaluated the dealer's compensation under the so-called "Hay System." This "System" involved evaluating the dealer's services in terms of three characteristics inherent in job performance: "know how," "problem-solving" and "accountability." Various points were assigned to each category based on the perceived demands of the dealer's job. This information was then *fed into a model* to predict what an individual performing a job of the same importance with the same amount of tenure and level of performance would be paid. This second "expert's" *conclusions were not based upon data from the automotive sales industry* and the Court did not find it as relevant.

The third expert witness (for the IRS) expressed his opinion that the maximum reasonable compensation would have been slightly less than $500,000 in 1984 and $540,000 in 1985. This IRS expert's opinion was *based upon analyzing surveys of compensation paid to executives of similar size corporations* in the manufacturing industry and the wholesale and retail trade industries *...but it took no account of any data from the automotive sales industry.* Furthermore, the IRS' expert witness used statistical extrapolations from average reported salaries in these other industries in arriving at "maximum reasonable compensation figures."

The Court found the CPA's testimony regarding the customs and practices in the automotive industry in the years under audit to be of greater significance; especially his testimony that the compensation formula in the dealer's compensation agreement "was in line with the compensation formulas used by other dealerships."

SALARY POLICY TOWARD OTHER EMPLOYEES

In analyzing the compensation paid to the dealer and to all other key employees in the dealerships under the management contracts, the Court noted that the incentive formulas that were used were based on the profitability of the overall dealership or of a particular department. It noted that although the dealer's compensation was greater than that of any

see **A.I.D., INC. - DEALER WINS ALL**, page 16

 (Continued from page 15)

other employees, the Court was satisfied that his responsibilities were "far more demanding, broader in scope and more complex than those of anyone else in petitioner's employ."

The Court further noted that the dealer's salary in 1984 and 1985 was paid in accordance with a formula that had remained constant since 1982 and substantially similar since 1978. The Court also related a comparison of the dealer's salary to the gross sales of the managed dealerships and found that for the years 1982 through 1985, the salary as a percentage of sales was 1.36%, 1.61%, 1.41% and 1.45% for the years 1982 through 1985, respectively.

During this 4-year period, the sales of the managed dealerships had increased by more than 450%..growing from $31 million in 1982 to $141 million in 1985. The Court stated that as the sales of the managed dealerships increased during these years, the dealer's duties and responsibilities as chief executive became more complex and demanding. It noted that the jobs of "procuring and financing inventory presented an important executive function and an on-going challenge, as the managed dealerships vied with other dealerships for larger slices of a relatively stable supply of automobiles."

HYPOTHETICAL, INDEPENDENT INVESTOR STANDARD

The last "factor" the Court explored was from the perspective of the "hypothetical, independent investor." In this regard, the Court opined on how such an investor might evaluate the amount of compensation that the company had paid to the dealer.

The Court noted that since its incorporation in 1977, the company had paid only a $15,000 dividend in 1982. Accordingly, the Court said it had to scrutinize this case very carefully to determine whether "compensation" payments to (the dealer) were, in part, distributions of profit.

The Court stated that, "in theory, an independent investor would not approve executive compensation to the extent that the investor is deprived of a reasonable return on his or her investment in an otherwise profitable enterprise." The Court also pointed out that a history of paying small dividends or no dividends by itself does not automatically lead to a conclusion that the amount of dealer compensation is unreasonable. It noted there may be acceptable reasons for not paying dividends (e.g., the need to maintain or protect high levels of working capital and/or the shareholders' preference for capital appreciation.)

The Court considered the return on shareholder equity for the eight years 1978 through 1985 (1984-1985 being the years in issue) and these computations reflected return on shareholder equity of 69% in 1983 (the year before the alleged unreasonable compensation) and 85% in 1984 and 48% in 1985. The computation of "return on shareholder equity" was made by dividing net income after taxes by shareholder equity at the beginning of the year.

The Court concluded that "these returns (85% in 1984 and 48% in 1985) provide a good indication that management is providing compensable services and that profits are not being siphoned out of the company disguised as salary."

THE COURT'S COMMENTS ON FORMULAS

As part of its final comments, the Court listed over a dozen cases in which the courts have approved as reasonable all or substantial parts of the compensation of owner-employees computed under incentive formulas. It further noted that the IRS **in this specific case** did not contend that the use of a formula to determine the compensation of an owner-employee is unreasonable *per se*.

The Court referred to its own opinion in *Superior Motors, Inc.* (T.C. Memo 1974-187) in which it stated that, "The practice of giving bonuses at years-end is such a widely practiced method of compensating the dealer that this Court will inquire into only the reasonableness of the amount paid and whether it is in fact a payment for services actually rendered or is in reality a return on capital invested."

The Court added that the fact that the compensation of an owner-employee was determined under a contingent compensation formula, adopted in good faith and reasonable when adopted, does not necessarily mean that the compensation is reasonable. It stated that all of the circumstances must be considered in determining the reasonableness of the compensation. It remarked that in the current case, the evidence showed that the formula compensation paid to the dealer "fell within industry norms."

In addition, the record detailed "a direct link" between the dealer's extensive and innovative management and the spectacular performance of the dealerships under his control:

"Under (the dealer's) management, the fortunes of petitioner and the managed dealerships skyrocketed. We are especially impressed by the meteoric rise of the gross sales and net income. During the years in issue, petitioner enjoyed a generous annual return on shareholder equity and large amounts of taxable income remained in the (management company and the dealership) and after the payment of (the dealer's) compensation."

A SOMBER CONCLUDING REMARK

The Court concluded with this somber warning: "We hold that total dollar amounts that were deducted in 1984 and 1985 as compensation...are reasonable. In reaching this conclusion, however, we point out that there may come a time at which the application of the subject formula will result in compensation that is unreasonable under Section 162(a)."

Although the exceptional record and accomplishments of Mr. Van Tuyl enabled the Tax Court to justify all payments to him as deductible compensation, the Court wanted to emphasize that:

> "The reasonableness of compensation is a question of fact to be determined from all of the facts and circumstances."

SUPERIOR MOTORS, INC. - A CONTRASTING RESULT

While several auto dealer cases involve more "routine" fact patterns and/or analyses, the *Superior Motors* case in 1974 (TC Memo 1974-187) is particularly instructive.

The dealer was the president, chief executive officer and sole shareholder of Superior Motors, at that time one of the most successful Volkswagen dealerships in the Southeastern part of the United States. Since buying out his partner, the dealer had **set his own compensation** over the years, specifically a salary and bonus.

The dealer had worked long hours, taken no vacations, and had no substantial outside business interests which prevented him from devoting 100% of his time and attention to his dealership. In addition, he had not received any other compensation in the form of fringe benefits (i.e., he was not covered under a pension, profit-sharing, medical expense reimbursement, or other fringe benefit plan).

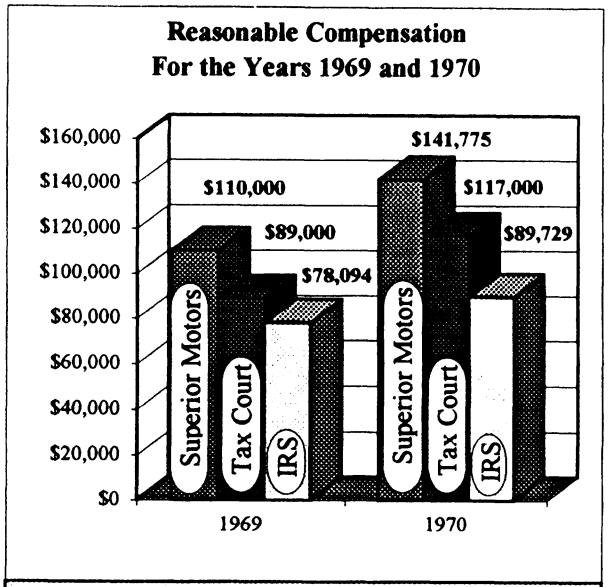
The dealership employed between 70 and 85 persons. Its business operations were organized into six departments, each headed by a manager who was responsible for his department's operations. Each manager personally supervised the employees in his department, including the hiring, firing, training and motivation of the employees. These managers reported directly to the dealer who was the president, general manager and CEO of the dealership corporation. Although the dealer was personally involved in each department, the managers had complete charge of the daily operations of their respective departments. However, policy decisions were made by the dealer who was also responsible for the dealership's advertising.

COMPENSATION

Compensation during 1969 and 1970 was at issue. In both years, a base salary of $60,000 was paid which was computed by multiplying $50 per unit by the projected new car sales of 1,200 units for the year. The Court remarked that: "With regard to salary, it is clear that the more cars a dealership sells, the lower the dollar figure per new car sale utilized in calculating the dealer's salary."

In 1969 the dealer also paid himself a bonus of $50,000. The evidence introduced into the record indicated only that this $50,000 bonus in 1969 was the same amount as his 1968 bonus (i.e., a "same as last year's" bonus) and that *the dealer believed his bonus for 1969 should not have been any less than it was in 1968.*

In 1970, the dealer changed his "method" of determining his bonus amount. The dealer's bonus for 1970 was one-third of the dealership's net profits before taxes, and this bonus amounted to $81,775.



Percentage Allowed	1969	1970
SUPERIOR MOTORS *Paid* ☺	100%	100%
TAX COURT *Allowed* ☹	81%	83%
IRS *Balked* ☹	71%	63%

His base salary for 1970 continued to be computed under the $50 per anticipated new car sale approach.

The IRS claimed that the dealer's compensation was excessive: It disallowed about 30% of the 1969 amount and about 40% of the 1970 amount.

The Tax Court agreed with the IRS that not all of the dealer's compensation was reasonable. However it disagreed with the exact amount the IRS treated as excessive, and allowed approximately $11,000 more than IRS did for 1969, and approximately $27,000 more for 1970.

The Tax Court did not explain exactly how it arrived at the amounts it allowed as reasonable: "This Court cannot and should not be expected to ascertain with mathematical precision what a reasonable allowance for compensation is. We will use our best judgment and discretion."

The dealership corporation had not paid any dividends in 1969 or 1970, nor in any of the preceding years. The dealer's compensation was 1.7% of gross sales receipts in 1969 and 2.0% of gross sales receipts in 1970. Compared to gross income, the dealer's total compensation was 9.3% and 10.4% respectively. Compared to the dealership's taxable income, it was 164% and 95% respectively.

see **SUPERIOR MOTORS - A CONTRASTING RESULT**, page 18

Superior Motors - A Contrasting Result

COMPARISON WITH DD FORMULAS

The Court reviewed tabulations indicating how much compensation the dealer would have received if the dealership corporation had paid compensation consistent with that paid under the "dealer development/DD" programs used by Chrysler, General Motors and Ford. In all cases, the dealer's compensation of $110,000 in 1969 and $141,775 in 1970 exceeded the highest amount calculated (assuming a "dealer development" bonus of 25% of net profits after salary and before taxes).

Chrysler plan: Uses an annual salary range of $30,000 to $36,000, plus a bonus of 25 percent of net profits after salary and before taxes:

Year	High	Average	Low
1969	$72,000	$70,000	$68,000
1970	101,000	99,000	97,000

General Motors plan: Uses an annual salary range of $11,400 to $30,000, plus a bonus of 25 percent of net profits after salary and before taxes:

Year	High	Average	Low
1969	$68,000	$61,000	$54,000
1970	97,000	90,000	83,000

Ford plan with two variations: One plan uses an extreme annual salary range of $12,000 to $60,000, and the other uses a normal annual salary range of $18,000 to $36,000, plus a bonus of 25 percent of net profits after salary and before taxes:

Extreme Range

Year	High	Average	Low
1969	$90,000	$72,000	$54,000
1970	119,000	101,000	83,000

Normal Range

Year	High	Average	Low
1969	$72,000	$65,000	$59,000
1970	101,000	95,000	88,000

In its overall evaluation, the Court was satisfied that industry practice was to compensate the dealer-owner by both salary and bonus and that it was acceptable to base a dealer's **salary** on a dollar figure per expected new car sales multiplied by the estimated sales in the succeeding year. The Court also was satisfied that a **bonus** of a percentage of net profits after salary and before taxes was an acceptable method of compensating this particular dealer for his services.

UNIVERSITY CHEVROLET CO.

In discussing the generally accepted practice of using bonuses as an appropriate form of reward in the auto industry, the Court made a general reference to a very important precedent in the tax law. That tax precedent comes from the *University Chevrolet Co.* case which held that just because a bonus arrangement had been set up under a General Motors dealer development arrangement, the continuation of that bonus arrangement after buy-out

(Continued from page 17)

would not necessarily justify as reasonable similarly-computed bonuses in later years. Once the dealership stock was completely acquired by the owner-employee receiving the bonus, the fact that the compensation was paid in strict accordance with the previous agreement with the manufacturer would not alone justify the amount.

In the *University Chevrolet Co.* case, the circumstances previously establishing the salary and bonus as reasonable under GM's program differed vitally once the employee became the sole owner of the corporation after buy-out. It also said that "for a sole owner to pay himself a bonus as an incentive to do his best in managing his own business is nonsense." Consequently, the rote continuation of the bonus percentage rate without adjustment for changes in circumstances or business conditions after the buy-out would appear to be susceptible to challenge by the IRS.

WHAT NOT TO DO

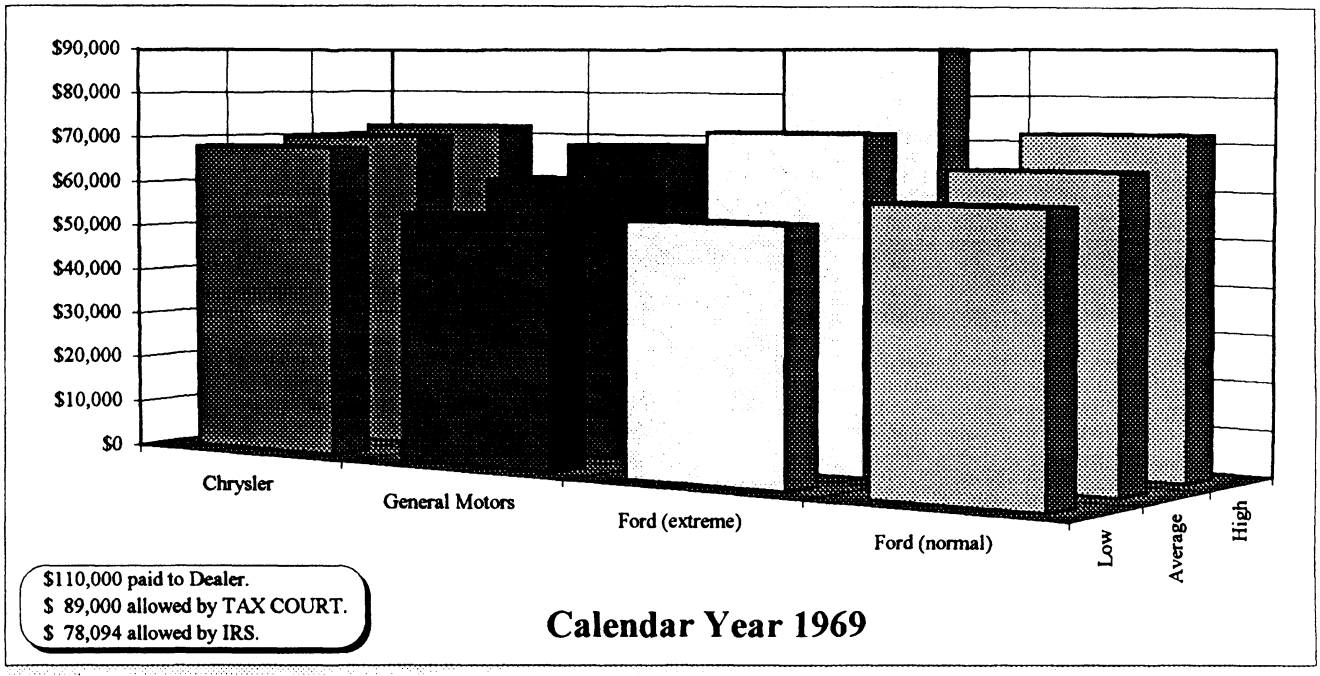
The *Superior Motors* case illustrates several things **not** to do:

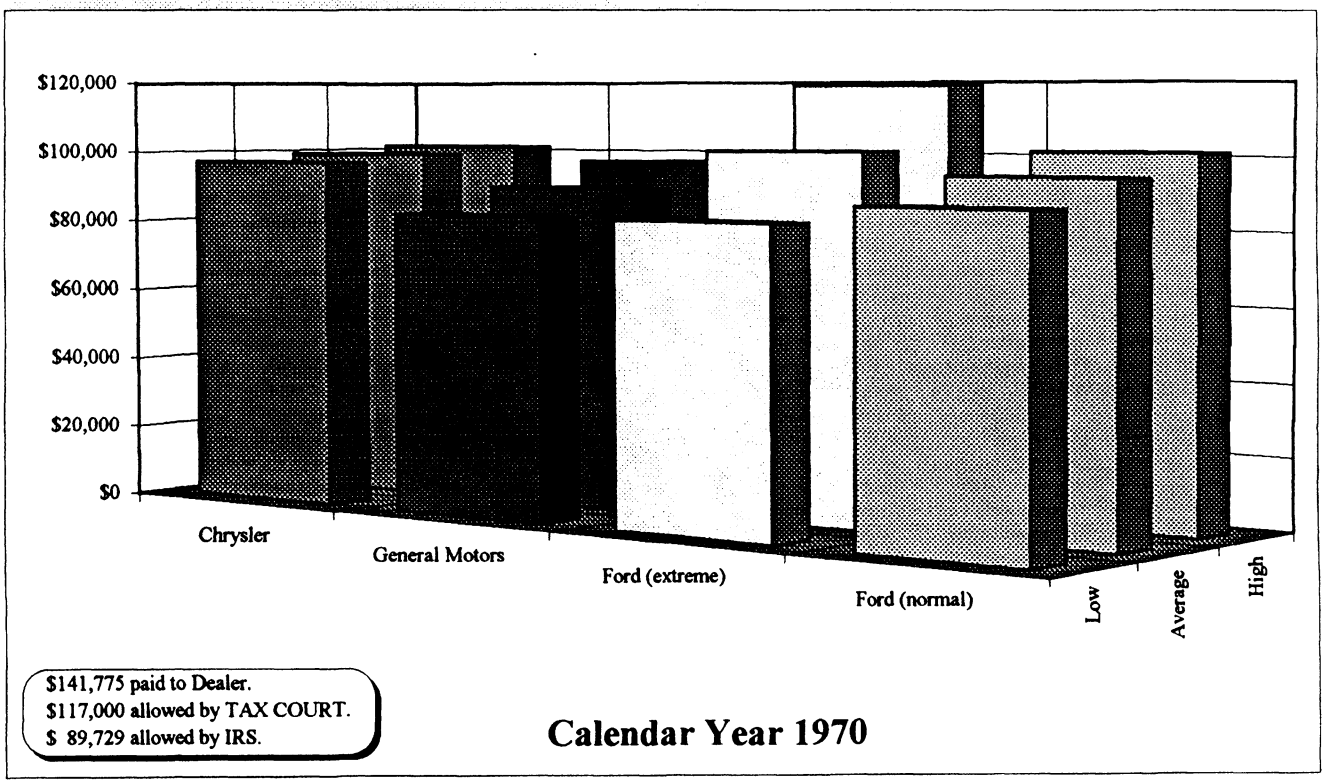
1. Don't pay the same dollar amount of bonus as was paid last year (in this case, 1969's bonus was identical to 1968's) without adequate justification for doing so. Don't expect the IRS to accept arbitrarily determined bonuses (as 1969 was simply equated with 1968's).
2. Similarly, don't change methods for computing bonuses between years without having a good reason for doing so.
3. Don't rely on expert witnesses who are not familiar with the business and the industry. The Tax Court was not impressed by the dealer's expert witnesses and emphatically said so.
4. Don't make comparisons intended to show the reasonableness of amounts paid in the years under audit with years after the years under audit. Gather and save information in support of compensation paid in the years when that compensation is being paid.
5. Don't forget to try to show that new (or expanded) duties were assumed in the years under audit. The Court remarked that the taxpayer had not introduced any evidence or discussion to show there was any increase in duties or responsibilities during the years under audit.

Although it is not lengthy, the opinion in *Superior Motors, Inc.* is quite instructive in indicating how not to go about trying to win a reasonable compensation case in the Tax Court. Don't expect "Superior" results in the Tax Court if you haven't done your homework...because you'll probably not get them.

SUPERIOR MOTORS, INC.

COMPENSATION AVAILABLE UNDER SELECTED DEALER DEVELOPMENT PROGRAMS FOR THE YEARS 1969 AND 1970





TEN SUGGESTIONS FOR COMING OUT ON TOP: DETERMINING, DOCUMENTING & DEFENDING DEALER COMPENSATION

1. REVIEW KEY CHECKLISTS

Review and discuss all three major checklists included in this series for critical factors, questions and "blind spots" or weaknesses in your own situation.

A. Factors the Courts Consider in Determining Reasonable Compensation. These factors will be analyzed by the Court. This is predictable; prepare accordingly.
B. IRS Questionnaire. Expect to be asked these questions by the IRS examining agent. The IRS Audit Manual requires them to do so. Failure to ask these questions may shift the burden of proof from the taxpayer to the IRS, so asking these questions is standard procedure.
C. Corporate Minutes Checklist. This should be very helpful.

2. DEVELOP INFORMATION OVER A PERIOD OF YEARS

Develop information on a cumulative basis reflecting a number of years (i.e., a multi-year time span) to determine the possibility of overcompensation or undercompensation in any given year or years. Start planning (maximum) compensation beginning with the first year, even if at that time the dealership cannot afford to pay it.

Because the nature of the industry is cyclical, there may be times when cash flow is such that the dealership cannot "afford" to pay the dealer a reasonable amount of compensation for his services. Accordingly, a dealer may be undercompensated or overcompensated when a single year is viewed without placing it in the perspective of a long-range span of years.

3. COLLECT INFORMATION CONTEMPORANEOUSLY - AS THINGS ARE HAPPENING

Be on the lookout for and save information that presents industry "norms," comparative data and/or testimonials. Collect this information contemporaneously. Get it while you can, and save it permanently.

A. Be alert to collect testimonials/letters from factory personnel, reps, zone managers currently (before they are transferred to another location, retire or pass away). Get this information while the getting is good.
B. Be alert to quality dealer awards as external evidence of quality performance in the dealership which can be attributed to the dealer's (special) efforts.
C. Document particularly significant events, decisions or deals that occur during the year that might otherwise get "buried" or lost in the overall year-end results. Document "deals" that fall through.

Other sources provide significant information on a regular basis, but they can best be tapped if they are read or scanned regularly. These include the *Wall Street Journal*, the *Automotive News*, various dealer oriented publications including the *Automotive Executive* and *Dealer Business*, and Dealer 20 Group composites. In addition, some manufacturers may be able to provide comparative information on a regional basis for dealerships selling their makes. This information can be extremely effective...if it can be readily collected.

4. EVALUATE YOUR SITUATION REALISTICALLY

Watch out for "boomerangs"...it may be necessary to do some damage control to minimize or dilute adverse recharacterization by the IRS of some dealer activities. Recognize and realistically evaluate weaknesses in your own case and prepare the best rebuttal possible under the circumstances.

"Boomerangs" might be other business interests or other activities or commitments that drain or take time or effort away from the operation and management of the dealership. Sometimes these activities rank high in ego-fulfillment, and the dealer may believe them to be a form of "good advertising." Quite often, the IRS sees these activities or other commitments in the opposite light, i.e., as hobbies or distractions...or even worse as potentially generating non-deductible constructive dividends.

A. Racing - all types, including stock car and vintage.
B. Horse racing or raising.
C. Cattle/livestock breeding.
D. Vacation, extensive travel...other hobby pursuits.
E. Athletic prowess or unusually keen interests in sports.
F. Time away from the dealership necessitated by illness or other family involvements or commitments.

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5. SHARPEN YOUR DEFINITION OF "NET INCOME"

In many cases, a dealer's compensation is based, in part, on a percentage of the dealership's "net income." If necessary, review and sharpen that definition of net income. Possibilities include:

A. Net income before - or after - LIFO adjustments. If "after" LIFO adjustments, the actual amount of the bonus will not be known until all LIFO computations for the year have been finalized.
B. Net income before - or after - "bonuses." Which bonuses...all bonuses or only the dealer's bonus?
C. Net income before - or after - "taxes." Which taxes...Federal and state or just Federal?

6. FIND OUT IF YOU FIT IN WITH THE INDUSTRY "NORM"... IF YOU DON'T, WHY NOT?

The industry norm for auto dealers seems to be compensation consisting of a combination of (a) a monthly or annual base salary plus (b) a bonus expressed as a percentage of "net income." Percentages most commonly mentioned are between 20 or 25% and 33-1/3%.

In some cases, a dealer's compensation/salary may be based upon a fixed amount per new vehicle sold, or a percentage of sales revenue or an arbitrarily determined amount. In these situations, it would be advisable to convert the total amount of compensation paid to express it as being equivalent to a base salary plus a percentage of "net income." In other words, if the dealer's compensation is determined by some other method, computations should be made to express the resulting total compensation as an equivalent to the "base salary plus bonus" approach. Expressed in this alternative form, the dealer has a better opportunity to see how his compensation might appear to the IRS (or to the Tax Court).

7. DON'T BE OVERCONFIDENT

Even though the business is cyclical, and for many there's been quite a dry spell, don't go reaching for the moon and expecting the IRS to allow it...unless you've got great facts and plenty of documentation. Unless you're the number one dealer in your region, or in the country, in a particular make, or exceptional in some other way, don't think the next Tax Court decision allowing a dealer to deduct $2,000,000 a year will automatically have your name on it.

Line up credible expert witnesses (in advance) *who are familiar with the industry.* Get their opinions contemporaneously! Read all of the facts in the 1993 Tax Court case carefully. The odds are greatly against most dealers having similar fact patterns and spectacular results as those achieved by the dealer in that case. Furthermore, read the Tax Court's last comments concerning blind adherence to a previously set bonus formula.

8. S CORPORATIONS: DON'T LET DOWN YOUR GUARD

Even in situations where the dealership is an S corporation for tax purposes, determining, documenting and defending the amount of the dealer's compensation requires careful attention. This could be particularly critical when the S corporation is paying little or no salary to its (key) employees and the S corporation inadvertently loses its election somewhere along the way.

9. BUILD A COMPENSATION DEFENSE FILE

The amount and type of information the IRS requires and the Tax Court ultimately analyzes is predictable. It can be most effectively reviewed and presented if it has been carefully accumulated over a period of time.

Most disputes between dealers and the IRS involving reasonable compensation never get to court. Observe how few dealer compensation cases there really are. The taxpayer has the burden of proof in these situations. But, as both *AID, Inc.* and *Superior Motors, Inc.* show, there are no secrets or mysteries concerning which factors the IRS and the Tax Court will target. To the extent this is predictable, develop and document your facts and case accordingly.

10. INVEST TIME IN A SPECIALIZED PLANNING EFFORT

Plan to have a special meeting with only the dealer's compensation as the topic for discussion. Have this compensation planning meeting on a regular basis. Review and analyze the suggestions and the articles above. Under appropriate circumstances, consider documenting this meeting as a special meeting of the Board of Directors...especially if it is held before year-end.

Many complex factors influence the amount finally paid out in any particular year as compensation to the dealer. There is presumed to be one absolute and determinable amount which is "reasonable." Beyond that amount, tax consequences are painful. Short of that amount, tax advantages are missed for lack of assertiveness.

You can best increase your chances of coming out on top if you regard (the determination, documentation and defense of) dealer compensation as an ongoing activity that requires a specialized planning effort. Anything less simply won't do.

IRS IN ACTION: EXTENDED SERVICE CONTRACTS

OVERVIEW

Until recently, most automobile dealers accounted for extended service contracts by reporting the net amount of taxable income from each sale (i.e., sales price less premiums). An early 1990 IRS draft Position Paper stated that dealers who were acting as principals in an extended service contract must include the full sales price of the extended service contract in income and amortize the premiums paid over the life of the contract. As a follow up, in 1992 the IRS issued Revenue Procedures 92-97 and 92-98 which address the tax treatment of service contracts in which the dealer is the party with primary liability (dealer-obligor service contracts). Extended service contracts under which the dealer operates only as an agent are not subject to these revenue procedures.

Revenue Procedure 92-97 provided for expeditious consent to change a method of accounting for the costs of multi-year insurance policies purchased in conjunction with the sale of multi-year dealer-obligor service warranty contracts. The IRS' position is that if a dealership purchases a multi-year insurance policy in connection with the sale of extended service contracts to customers by paying a lump sum premium in advance, then the dealership must capitalize the amount paid and deduct it by amortizing it over the life of the insurance policy. The practice most auto dealers had been following was to include the sales price of the service contract less (i.e., net of) the premiums paid in income in the year that the service contract was sold.

The deadline for applying for a change in method of accounting under this revenue procedure was the first taxable year ending on or after June 12, 1992. Any taxpayer who failed to file by that deadline is now required to apply for a change in method of accounting under the terms, conditions and limitations of Revenue Procedure 92-20.

Revenue Procedure 92-98 provides for the "Service Warranty Income Method" (SWIM) which offers an alternative to the way that dealer-obligor contracts are treated. The SWIM method allows a taxpayer to spread a portion of the extended service warranty income over the term of the contract and pay a non-deductible interest charge for the tax deferral which results. The SWIM method addresses the probable cash flow problem created by the IRS' view of the income tax treatment of dealer-obligor service contracts.

However, a dealer who wishes to elect the SWIM method must be in conformity with the IRS accepted method described in Revenue Procedure 92-97 (i.e., amortizing the premium paid over the life of the service contract rather than netting it against income from the sale of the service contract). If a taxpayer is not currently amortizing insurance costs over the life of the insurance policy, then the taxpayer must first adopt the restrictive method described in Revenue Procedure 92-97 before it will be permitted to change to the SWIM method.

Two recent developments have occurred in the area of extended service contracts. In Hinshaw's Inc. v. Commissioner, T.C. Memo 1994-327, the Court held that amounts collected for extended service contracts are gross income. In LTR 9417028 the Service held that the car dealer involved did not need to include in income amounts paid by car buyers for extended service insurance contracts sold by a third party because the dealer was an agent rather than the obligor.

HINSHAW'S, INC. V. COMMISSIONER T.C. MEMO 1994-327

Hinshaw's, Inc., an accrual basis taxpayer, is a Washington corporation which sells automobiles and motorcycles. Hinshaw's also offers extended vehicle service contracts to its customers under which its liabilities are insured by third parties, as required by law in the state of **Washington**. The insurance was provided by an insurance company and a separate but related company handled the administration of claims.

In 1988 and 1989, Hinshaw's participated in four extended service contract programs including PIPI (an insurance/administrator group). Hinshaw's paid over $250,000 to the four insurance groups in both 1988 and 1989. The IRS disallowed expense deductions claimed of $533,634 in 1988 and $474,926 in 1989 because it did not think that they were ordinary and necessary business expenses. The IRS also determined that all amounts collected for extended service contracts (not reduced by amounts paid to third-party insurers) from customers by Hinshaw's were includable in gross income.

The Tax Court held that all amounts collected for vehicle service contracts were includable in income and that they should not be shown net of amounts paid for the insurance protection required by state law. The Tax Court found that Hinshaw's earned the full amounts collected for the service contracts.

The Tax Court ruled that the fees that Hinshaw's paid for insurance and administration services were not deductible under Section 162, but were amortizable over the life of the vehicle service contracts. The Tax Court rejected the Service's determination that the PIPI reserve account was a self-insurance ac-

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count and not deductible until actual expense occurred. Because there was a shifting of risk, the Court concluded that the amounts paid to PIPI were amortizable.

LTR 9417028

The automobile dealer involved in this letter ruling offers extended service contracts to its customers. The contracts involve four parties (the buyer, the dealer, the administrator, and the insurance company). There are three contracts among these four parties. The administrator sought a ruling that the amounts the buyers pay for extended service contracts sold by the dealer on the insurance company's behalf are not included in the dealer's gross income, assuming that the insurance company will include the entire amount received in its gross income.

The first of the three contracts is the **warranty contract between the insurance company and the buyer**. The dealer enters into the contract on the insurance company's behalf and agrees to submit to the insurance company the buyer's claims under the contract. This contract provides that the dealer does not have any authority to control the funds claimed and that if the insurance company fails to reimburse the buyer, then the dealer is the party that would be liable to the buyer for reimbursement. Finally, the service contract indicates that the administrator (who is the middleman between the dealer and the insurance company) has no liability under the contract.

The second contract is the administrator contract between the administrator and the dealer. It provides that the insurance company will make commission payments to the dealer for selling the extended service contracts. The dealer retains his portion of the selling price and passes the remainder of the payment for the service contract to the administrator. The administrator then deducts its commission and transfers the balance to the insurance company.

The third contract is between the dealer and the insurance company. This last contract provides that the insurance company will pay the dealer as the customer's nominee all sums the buyer becomes legally entitled to receive as claims under the service contract. The dealer uses these funds and acts as an agent for the insurance company in repairing or replacing the covered warranty item on the buyer's automobile.

The Service held that the dealer does not have to include in gross income amounts that customers pay for extended service contracts sold by the dealer on the insurance company's behalf. The Service cited *Commissioner v. Bollinger*, 485 U.S. 340 (1988) and concluded that the dealer is acting as the insurance company's agent. The dealer was given authority by both the warranty contract and the administrator contract to bind the insurance company and was required to forward all amounts received less commission to the insurance company. Perhaps of greater significance, the Service noted that the insurance company treated the entire amount received from the dealer as income.

HINSHAW'S, INC. V. COMMISSIONER

ISSUES	HOLDINGS
Whether all amounts collected by the dealer from customers for long-term vehicle service contracts must be included in gross income in the year of receipt under Section 61.	All such amounts are includable in income in the year of receipt.
Whether payments made to third parties for insurance required by State law for the vehicle service contracts are: • Deductible at the time of payment to the insurance company (at the initiation of the contract) or • Amortized over the life of the vehicle service contracts.	Payments are to be amortized over the life of the vehicle service contracts.
Whether payments made to third parties to administer the vehicle service contracts are: • Deductible at the time of payment (at the initiation of the contract), • Amortized over the life of the vehicle service contracts, or • Deductible only at the end of the term of the vehicle service contract.	Payments are to be amortized over the life of the vehicle service contract.
Whether the reserve account that PIPI (insurance/administrator group the dealer contracted with) held for its benefit was a self-insurance reserve account.	It was not.
Whether $4,000 distributed by PIPI to the taxpayer's shareholder, was income to the taxpayer.	It was income. **T.C. MEMO 1994-327**

Cash Transactions

(Continued from page 3)

- Advise all new employees of the company's cash reporting policies. Obtain the signature of new employees on the written company policy.
- Retain a copy of each Form 8300 filed for at least five years (to be safer, retain them even longer).

MONEY LAUNDERING

No analysis of cash transactions would be complete without a discussion of money laundering. Violation of the money laundering regulations is a felony. Undercover operations have been conducted by the Justice Department, FBI and IRS to combat money laundering schemes. Some of these undercover operations have resulted in the arrest and prosecution of dealership employees. These undercover operations will continue as the agencies work to reduce money laundering activities.

The penalties for money laundering include fines of up to $500,000 per violation, criminal penalties of up to 20 years in prison, and the forfeiture of assets. The government may seize property believed to be involved in money laundering activities. Even the dealership itself may be seized! The property owner has the burden of proving that the property wasn't involved in the money laundering activity. Furthermore, the dealer may be held liable for employees' actions.

Due to the seriousness of the money laundering regulations and the accompanying penalties, dealers should protect themselves by implementing firm policies and procedures on money laundering.

- Establish a written money laundering policy and obtain the signature of each employee. This policy should address: the illegality of accepting money known to be derived from illegal activities, mandatory attendance at any informational meetings and termination of employment if company policy is violated.
- Hold frequent meetings with employees to discuss money laundering policies. These meetings and all other money laundering "education" should be documented.
- Explain company money laundering policies to all new employees. Require new employees to sign the written company policy.

ADDITIONAL CASH REPORTING AND MONEY LAUNDERING SUGGESTIONS

Some additional cash reporting suggestions were reported in the August, 1994 *Automotive Executive*.

- Do not deal with any buyer who asks for advice on how to avoid filing Form 8300.
- Beware of a buyer looking to trade up with a recently bought vehicle and cash.
- Refuse to deal with a buyer who indicates he is connected to the drug trade, is using illegal funds or is buying the car for anyone other than himself or a family member.
- Terminate a deal when a buyer is trying to buy with lots of cash down on a transaction that obviously won't be completed.
- Take a credit application on all large cash transactions.
- Give customer copies of IRS Form 8300 filing rules to avoid having discussions on cash reporting that might be construed as attempts at structuring - or restructuring - transactions.

Form 8300 software analysis coming next quarter

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De Filipps' DEALER TAX WATCH
Willard J. De Filipps, C.P.A., P.C.
317 West Prospect Avenue
Mt. Prospect, IL 60056

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