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 ACTIVITY. The IRS continues its audit activity with different degrees of impact and emphasis around the country. Attendees at the AICPA National Dealer Convention heard the top IRS auto dealer audit specialist say that TCMP (Taxpayer Compliance Measurement Program) audits were in the works for 1995. That's not news to cheer one up. Everyone is waiting while the IRS (National) gets ready to do something on the LIFO conformity issue.

Recent IRS activity also is evident in several Revenue Procedures covered in this issue: **94-49** regarding Cost Capitalization Rules, **94-61** regarding C to S conversions concerning LIFO inventories and **94-74** regarding disclosures in tax returns where problem areas are involved.

In connection with Revenue Procedure 94-74, be especially careful to consider the necessity of filing Forms 8275 and/or 8275-R where you are being aggressive in just about any situation. More severe taxpayer and preparer penalties are now in place.

#2. AICPA NATIONAL AUTO DEALER CONVENTION...A BIG HIT. First in Las Vegas (October 31-November 1) and again in New Orleans (December 5-6), almost 800 attendees received a lot of good information. The industry overviews presented by J.D. Power III and by Maryann Keller (see supplement) should provide many insights you can discuss with your dealer clients as you get together with them over the next few months.

Dealer speakers discussing how CPAs and auto dealers can work effectively together also provided ideas you and your staff can profit from.

#3. WANT TO KNOW MORE ABOUT DEALERSHIPS? Several tax and advisory service publications recently updated include NADA's Dealer Tax Guide (see page 6) and the AICPA's 1994 supplement to its Auto Dealership Engagement Manual (see page 7).

To further expand your expertise, consider purchasing some or all of the AICPA Auto Dealer Conference audio tapes, the AICPA Conference speakers' presentation outlines (available through the AICPA) and some of the NADA Dealer Convention Workshop cassettes.

The acid test: if you really want to expand your dealer practice, make your reservations now for the 1995 NADA Convention to be held in Dallas February 11-14. You will return to your practices with valuable current ideas and information. The most effective way you can get a dealer's attention and expand

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WATCHING OUT FOR

your dealership practice niche is to tell a dealer you'd like to discuss a great new idea you heard about at the NADA Convention you attended.

#4. COST CAPITALIZATION FOR AUTO DEALERS...LAST CHANCE. For many years, the IRS has been upset with taxpayers who have ignored Section 263A and made no effort to even try to capitalize inventory costs. This section was enacted as part of the Tax Reform Act of 1986 and some dealers...and practitioners...may not have taken it seriously or carefully enough. The IRS has now offered a "last chance" opportunity - good only for 1994 - to comply **without penalty**. This is discussed in our coverage of Revenue Procedure 94-49.

It is important to take appropriate action and file Form 3115 with a dealer's 1994 income tax return or else...many bad things can happen.

#5. COST CAP REGULATIONS FINALIZED FOR 1994. In addition to providing a last chance opportunity via the expeditious consent procedure mentioned above, the Treasury finalized the Cost Capitalization regulations effective January 1, 1994. This affects 1994 returns which you are about to prepare for your auto dealer clients.

A new and simplified historic absorption ratio method is available and it is explained in this issue along with other discussions of the new Simplified Resale Method (which is the same as the old Modified Resale Method) and the ever nebulous determination of Section 263A costs and "mixed service costs" that dealers are required to capitalize.

#6. DILEMMA FOR CPAS AND DEALERS NOT COMPLYING WITH SECTION 263A. In view of the finalization of the cost capitalization regulations making them applicable to 1994 and in view of the special opportunity provided by Revenue Procedure 94-49 for taxpayers not in compliance with Section 263A for any reason to make adjustments without penalty to come into compliance, there can be no doubt that the IRS will be tough on tax return preparers who fail to point out these changes to their auto dealer clients. Furthermore, Revenue Procedure 94-74 (issued shortly after 94-49) provides new procedures for identifying circumstances under which a disclosure on a taxpayer's return is necessary and whether that disclosure is adequate for purposes of reducing penalties for understatement of income tax and avoiding the preparer penalties as well.

Section 263A is part of the Internal Revenue Code. Failure to comply with it is a Category A method of accounting infraction, and will result in the most severe levels of sanctions and penalties against both taxpayers and preparers. Anyone preparing a tax return with costs that should be capitalized, but aren't, should consider attaching Form 8275-R (at a minimum) and it is doubtful that even attaching this Form would be sufficient to avoid penalties. Penalties for negligence and intentional disregard also must be of concern, and should be considered before finalizing any course of action other than compliance with Section 263A for 1994 tax returns.

PRACTICE POINTERS

- Ask for a copy of Form 3115 that was required to be filed.
- Ask for a copy of the IRS Section 263A **Checklist** that should have been completed, as required by IRS Notice 88-92.
- General rule: If the dealer or his CPA can't show you a copy of the 3115 and the Section 263A Checklist, chances are the CPA at that time didn't file it. This is just like asking to see the Form 970 for a LIFO election...they either have it or they don't...it's as simple as that!
- Watch out for "smaller" dealers who might have been below the $10 million average gross receipts requirement (and thus exempt from Section 263A Cost Cap) but who over a period of time have had gross receipts increase to the point where the average 3-year gross receipts exceeded $10 million and thus the dealer later became subject to the Section 263A Rules.

#7. AUTO DEALER LIFO FINANCIAL STATEMENT CONFORMITY. Highlight summary coverage is on page 20. For more details, consult the December, 1994 *LIFO Lookout.*

#8. IRS CLARIFIES IMPACT OF C TO S ELECTIONS ON LIFO COMPUTATIONS. Revenue Procedure 94-61 explains how C corporations electing S status should handle their LIFO computations. This will cause real problems if you either (1) thought switching from C to S terminated the LIFO election or (2) started all over with indexes at 1.000 for the first S year. Highlight coverage is included on page 22.

In addition to more complete coverage on the LIFO conformity issue, other articles in the December, 1994 *LIFO Lookout* include:

- 1994-1995 Model/Item Category Inflation Survey for Quick Year-End LIFO Estimates
- Projecting Year-End LIFO Reserve Changes
- Considerations in Evaluating a LIFO Election
- LIFO for Used Vehicles - Theory & Practice
- Other Recent LIFO Developments

Our "unofficial" list of "New Item Categories" for 1995 models in December 31, 1994 inventories is now available. Call if you'd like a copy.

ADEQUATE DISCLOSURE AVOIDS PENALTIES

REV. PROC. 94-74

Inevitably, there are times when aggressive dealers push their CPAs - or aggressive CPAs push their clients - to take positions in tax returns that they know (or should know) are contrary to official IRS positions. This may be proper, but the dealer and the CPA should be aware of the penalties that could result for both if the IRS position is eventually sustained. Penalties for substantial understatement of tax or for taking unrealistic positions depend, in part, on whether the taxpayer has adequately disclosed the contrary position in the tax return. If a taxpayer follows the IRS guidance for adequate disclosure, it is unnecessary to make any additional disclosure concerning a particular item.

Revenue Procedure 94-74 identifies the circumstances under which the disclosure on a taxpayer's return of a position with respect to an item is adequate for the purpose of reducing the understatement of income tax under Section 6662(d) which relates to the substantial understatement aspect of the accuracy-related penalty and for the purpose of avoiding the preparer penalty under Section 6694(a) which relates to understatements due to unrealistic positions.

This Revenue Procedure applies to any tax return filed on 1994 tax forms for a taxable year beginning in 1994 and to any return filed on 1994 tax forms in 1995 for short taxable years beginning in 1995.

Additional disclosure of facts relevant to, or positions taken with respect to, issues involving any of the items discussed in the Revenue Procedure is unnecessary for purposes of reducing any understatement of income tax under Section 6662(d) provided that the forms and attachments are completed in a clear manner and in accordance with their instructions. The money amounts entered on the forms must be verifiable, and the information on the return must be disclosed in the manner described below. A number is "verifiable" if, on audit, the taxpayer can demonstrate the origin of the number - even if that number is not ultimately accepted by the Internal Revenue Service - and the taxpayer can show good faith in entering that number on the applicable form.

SCHEDULE E: REASONABLENESS OF OFFICERS COMPENSATION

In connection with officers compensation, Form 1120, Schedule E, Compensation of Officers, must be completed when required by its instructions. The time devoted to business must be expressed as a percentage as opposed to "part" or "as needed."

SCHEDULE M-1 RECONCILIATIONS

An item clearly identified on Form 1120, Page 4, Schedule M-1, Reconciliation of Income (Loss) per Books with Income per Return, is adequately disclosed only if the amount of the deviation from the financial books and records is not the result of a computation that includes the netting of items; and the information provided reasonably may be expected to apprise the IRS of the nature of the potential controversy concerning the tax treatment of the item.

PRACTICE SUGGESTION

To minimize exposure to these penalties, designate one person in your firm to play "devil's advocate" by spending a few minutes reviewing each tax return and discussing it with the preparer before it is released. Just ask: "Are there controversial areas or positions taken in the return where you think we need to include Form 8275 or 8275-R to protect the firm or the taxpayer?" This should result in (1) a higher level of awareness of the penalty problem areas and (2) a greater consistency across the board.

FORM 8300 CUSTOMER NOTIFICATION... DUE JANUARY 31, 1995

Just a reminder not to overlook the Form 8300 requirement that by January 31, 1995, dealerships notify, in writing, all customers identified during 1994 on a cash reporting Form 8300. The notification must include the name and address of the dealership and the amount of cash reported. It is permissible to provide the written notice immediately after the transaction is complete and not wait until after year-end. Many commentators believe that it is not advisable to merely send the customer a copy of Form 8300. (Some have also suggested it might be wise to wait until after the customer has completed his/her CSI questionnaire for obvious reasons.)

Have the exact wording of the customer notification you use reviewed by the dealership's legal advisor/attorney. Use dealership letterhead and retain a copy for the dealership records. You may even want to send these out by certified mail, return receipt requested.

Sample wording

Dear (Customer):

We are required by Section 6050I of the Internal Revenue Code to report all transactions involving more than $10,000 in cash. Accordingly, we filed a Form 8300 with the IRS on (date, 1994), indicating that you gave us $(amount) in connection with your purchase of (make, model, year, VIN).

Sincerely,

(Dealership)

AICPA FIRST NATIONAL AUTO DEALERSHIP CONFERENCE - 1994

The First Annual AICPA National Auto Dealership Conference received far greater response than anyone anticipated with almost 800 attendees at Las Vegas (October 31 - November 1) and New Orleans (December 5-6).

PRESENTATION TOPICS

1. Overview of the automotive industry.
2. An update from the IRS by Robert C. Zwiers.
3. How the auto dealer and CPA can work together effectively.
4. How to read auto dealership financial statements.
5. LIFO update.
6. Succession planning for auto dealers.
7. NADA's perspective on national auto dealership issues.
8. How to develop your niche in auto dealerships.
9. How to analyze fixed operations.
10. Fraud and how to prevent it in your dealership.
11. Current legal and economic concerns affecting auto dealerships.
12. Getting the most out of your banking relationship.
13. The two sides of valuation - buyer and seller - are they different?
14. Computer utilization and the latest in technology for dealerships.

Mr. Zwiers' "Update From the IRS" and his discussion outline at the AICPA Conference were not different from the outlines he has previously used and his comments were very much along the same general lines. One of the most significant comments he made during a Question and Answer session and had to do with the LIFO financial statement conformity requirement. In reference to that, he indicated that he believed auto dealers would be violating the LIFO conformity requirement if the LIFO adjustment were not reflected in the valuation of their inventory accounts on their 12th and 13th statements going to the manufacturer (see page 20). In the June, 1994 issue of the *Dealer Tax Watch*, comments by Robert Zwiers, the IRS Automotive Industry Specialist, were presented in "Hot Dealer/Dealership Tax Issues" on page 6. Call if you missed this discussion or would like a copy of his 9-page Outline.

Another comment Mr. Zwiers made that upset some Conference attendees was that: "Yes...there will be TCMP (that's Taxpayer Compliance Measurement Program) audits in 1995."

Peter Kitzmiller, Senior Attorney with NADA, presented well-received comments summarizing NADA's activities and its interest in defending an increasing number of auto dealer tax issues in a variety of technical areas. Mr. Kitzmiller's comments are, in substance, reflected in the discussions in the June, 1994 *Dealer Tax Watch* relating to the 1994 NADA Conference Workshop on Auto Dealer Tax Issues.

As a member of the Conference Steering Committee, I thought it would be a real plus to have both Messers. Zwiers and Kitzmiller as Conference speakers and attendees were favorably impressed by both speakers.

The Conference Manual contains all of the Speaker Outlines and many of them are substantial enough to make the Speaker Outlines a valuable reference. Furthermore, at the Las Vegas site, all of the speakers' presentations - except Mr. Zwiers' - were audio taped and audio cassettes are available from the AICPA so that you can hear everything that was said for yourself.

Most attendees were very pleased with the Conference, finding it a good opportunity to hear knowledgeable speakers and to interact with other CPAs looking to benefit from this industry-specific focus.

Plan now to attend the 1995 AICPA Conference in Chicago on October 19-20, 1995.

FROM THE DEALERS' POINT OF VIEW:
HOW THE AUTO DEALER AND THE CPA CAN WORK TOGETHER EFFECTIVELY

At each of the AICPA Conference locations, a dealer speaker laid down quite a challenge for dealers' CPAs. In Las Vegas, Mario Murgado (Braman Automotive Group, South Florida) shared a vision of unlimited opportunities for CPAs and dealers to work together within a framework requiring an acceptance of change as inevitable and the need to adapt (quickly) to the results of change. He emphasized that the relationship between the CPA and the dealer "has to be a win-win relationship."

CHANGE AND CHALLENGE; PROACTIVE NOT REACTIVE

With the market rapidly changing, a "value driven" society, manufacturers entering into dealers' markets and continuing to diminish, by their efforts, dealers' grosses, the dealer and CPA together need to focus on "where the business is going." Mr. Murgado expects his CPA to:

1. Understand the needs of the dealership.
2. Communicate with all levels of management within the dealership.
3. Recommend, and then follow up by review to ensure that controls, checks and balances to safeguard dealership assets are in place. Develop preventative measures.
4. Behave in a progressive and proactive way.
5. Associate with other dealers and be able to show how your advice has helped other dealers.
6. Be a full service firm, with thorough, quality workmanship and a work product completed on a timely basis.
7. Be able to identify and track trends, behaving in a proactive way (anticipating the future and acting accordingly) instead of a reactive way (being taken by surprise and then looking for a way out).
8. Have an open mind and a willingness to accept change and then to be a catalyst within that change, helping to set business and corporate strategies for profit.
9. Be able to point out areas where the dealership can be more efficient and profitable.
10. Test accounting results, develop exception reports, understand the business thoroughly, including the wholesale business.
11. Be able to learn and understand the computer hardware and systems that the dealership has in-house and be able to use them to their maximum capabilities.
12. Provide a management letter so the dealer can review comments and receive assistance in implementing suggestions.
13. Provide a true evaluation of personnel - strengths, areas where more help is needed.
14. Review checks and balances for wire transfers and review sales and parts journals on a monthly basis.

SPECIFIC AREAS FOR SAVINGS

In New Orleans, Ray Brandt, a dealer for ten years who also is a CPA and an attorney, provided a list of areas where CPAs should pay special attention to cost saving and loss avoidance opportunities. As a CPA, Mr. Brandt has done all of these things for his own dealerships over the years.

1. Use floor plan offset accounts for the highest return on short-term cash flow.
2. Know your rights with respect to NSF checks.
3. Set up procedures for the management of contracts in transit.
4. Watch garage liability costs carefully. Different rates for different people often are confusing and much can be done to minimize this cost.
5. Workmen's Compensation: Pay careful attention to how employees are classified, reviewing these personnel classifications quarterly. Have the CPA handle workmen's compensation audits personally.
6. Set up an advertising agency and receive 15% commissions.
7. Watch Department of Labor issues, particularly week-to-week payments with a "settle up" check.
8. Monitor the content of all detail schedules by review and followup.
9. Review floor plan assistance and ad assistance from the manufacturer.
10. Use LIFO for new, used and parts and watch year-end levels where possible.
11. Look at the interaction of the new car department with the other departments to be sure they are closely integrated and consistent (not at cross purposes) with each other. Watch rent factors PNVR.
12. Compare the dealer's results with industry guidelines and statistics. "It's hard to fight these guidelines." The new term of art for this activity is "**Benchmarking.**"

NADA'S "DEALER GUIDE TO FEDERAL TAX ISSUES"

NADA's long awaited "Dealer Guide to Federal Tax Issues" has been released. It was prepared under the direction of J. Peter Kitzmiller, JD of the NADA Legal Group. The Guide is comprehensive, yet it is easy to read and very practical. It addresses most of the top tax issues dealers and CPAs are facing.

Portions of the "Dealer Guide" are based upon the 1994 NADA Convention workshops. See *Dealer Tax Watch* June, 1994 (page 7) for summary of NADA Convention Tax Issues Workshop. Other subjects have been added and several useful sample forms are included in the Appendix.

DEALER GUIDE TOPICS

- Money laundering & cash reporting
- Luxury tax
- Demonstrators
- LIFO and other inventory issues
- S corporations and C corporations
- Buying and selling dealerships
- Owner/shareholder compensation
- Advertising association fees
- Extended service contracts
- Environmental cleanup costs
- Preparing for an IRS audit

In reviewing both the NADA "Dealer Guide to Federal Tax Issues" and the AICPA Auto Dealership Engagement Manual 1994 Supplement within a short period of time, I compared a number of subject presentations in NADA's Guide with those in the AICPA Manual. In many subject areas, the NADA "Dealer Guide" is far more useful because it presents realistic examples to explain the text. Although both sources contain discussions on luxury tax implications, NADA's (page 10 through 13) contain numerous examples that are very helpful.

COMPENSATION

The reasonable compensation discussion includes a good summary of dealer tax cases. (Also see *Dealer Tax Watch* June, 1994 and September, 1994 issues for articles on "reasonable" dealer compensation.) One comment in NADA's discussion is that "surveys show that fixed compensation for CEO's (before bonuses) runs between $5,000 and $15,000 per month. Bonuses range from 15% to 40% of the pre-LIFO, pre-tax income. The 40% arrangement is frequently divided between the CEO and the General Manager, who is often the equivalent of a Chief Operating Officer. Dealerships vary, but anything within these ranges is not unusual."

Another interesting comment involving S corporations and "reasonable" compensation is that the IRS may consider the dealer's salary to be too <u>low</u> where excessive salaries are being paid to children. By disallowing some of a child's salary otherwise taxed to the child at lower rates or otherwise sheltering unearned income, the IRS increases the residual business profits which are taxable to the parent as an S corporation shareholder at higher individual rates.

LIFO INVENTORY

Pages 19 through 32 of NADA's Guide discuss LIFO and other inventory issues and if read in tandem with the AICPA Manual discussions, cover the area adequately. In discussing the question of "item" determination and the related questions of how far down in the manufacturer's price information one must go in determining item categories, an optimistic comment appears that formal guidance from the IRS on this question was expected before the end of 1994. Unfortunately, to date, there has been no guidance at all on this point.

A comment regarding the retention of LIFO records and workpapers balances "conservatives" who would retain all appropriate documents and computations going all the way back to the original LIFO election year against "more aggressive taxpayers" who might retain information only for a more limited period equal to the statute of limitations. In this regard, the comment often made by Robert Zwiers (the IRS auto dealer specialist) should be recalled that, in effect, taxpayers should retain their LIFO invoices and computations "for as long as the LIFO election has any value to them" ...(i.e., forever!).

I couldn't help but note a typographical error in the reference to the Letter Ruling in which a dealer was prevented from using replacement cost accounting for valuing parts for LIFO purposes. The correct reference to that Letter Ruling is 9433004.

OVERALL

The NADA "Dealer Guide to Federal Tax Issues" is an excellent, inexpensive reference that should be part of any CPA practitioner's library. A copy can be ordered by calling NADA (800) 252-6232. The cost: NADA members $30; others $60. NADA's Guide and the AICPA Manual discuss many of the same subjects and given the relatively low cost of both, it would be useful to read the technical discussion in both sources, as one tends to complement the other.

AICPA AUTO DEALERSHIP ENGAGEMENT MANUAL

The October, 1994 revision of the AICPA Auto Dealership Engagement Manual updates engagement planning and audit-related workpapers, checklists and guidelines, and "freshens up" discussions in several tax areas. For the CPA looking to expand his or her dealership services in new consulting areas, a chapter has been added on advisory services with suggestions and financial and operating ratios for "benchmarking" (the "in-word" for comparative analysis).

ENVIRONMENTAL CONCERNS

The "new" big area included in this revision relates to environmental liabilities and concerns, including a significant discussion related to the deductibility of - or capital nature of expenditures for - environmental cleanup costs. Environmental liabilities and cleanup costs are one of the major issues affecting all dealerships both directly and indirectly. Interesting comments are scattered throughout the current supplementation, including the suggestion that auditors ask management whether the dealership has been designated a potentially responsible party (PRP) by the Environmental Protection Agency or otherwise has a high-risk exposure to environmental liabilities. This may be evidenced by:

1. Participation in a real estate transaction or corporate merger involving properties with environmental risks.
2. The purchase of land at a price significantly below local market prices.
3. The acquisition of new or increased insurance coverage against environmental risks or liability to third parties.

LIFO DISCUSSIONS

LIFO discussions are found in several different chapters. These include the discussions at Sections 8.424 through 8.435 which discuss LIFO principles and practices, including the Alternative LIFO Method. At 9.300, a new section has been added discussing the LIFO conformity requirement, but it discusses the broader reporting requirements, with lesser emphasis on the severity of the current IRS audit positions.

The exhibits included in the AICPA Manual at Section 9.902 on the sample LIFO workpapers for the Alternative LIFO Method are internally inconsistent. The LIFO reserve increase for calendar 1991 in the 2-year example should be $84,720 based on the facts given and the prior year LIFO reserve should be $88,358.

More significantly, the Manual's example shown on page 9-52 of the combination of two LIFO pools having different base years is incorrect and inconsistent with the regulations. The example involves the combination of a pool having a base year of 1988 with a pool having a base year of 1987. In the AICPA Manual's example, the base dollars for each pool and the LIFO value for each pool are simply added together when increments exist for the same year, with no further adjustment to reflect the difference in purchasing power of the dollar in the base years of the two pools involved. This is incorrect! In fact, combinations of LIFO pools which have different base years should not be treated as simple exercises in addition and division. This error in the example was written up in the June, 1994 *LIFO Lookout* (pages 6 and 7...call us if you'd like a copy of the correct result) and the example in the AICPA Manual 1994 Revision is still incorrect.

SECTION 263A COST CAPITALIZATION

Section 9.316 contains a discussion of the Uniform Cost Capitalization Rules. Unfortunately, this only reflects the temporary regulations operative through December 31, 1993. These temporary regulations were replaced in August of 1993 by final regulations effective for 1994 and there is no discussion in the AICPA Manual of either the Simplified Resale Method as reconstituted in the final regulations or of the Historic Absorption Ratio election made available to dealers under the final regulations.

These Section 263A omissions render the discussions in the Manual out-of-date, and dangerous to anyone using it because of the omission of these 1994 developments.

RECORD RETENTION...DID YOU KNOW THAT...?

Some new, interesting material is included in a section on auto dealer record retention requirements, particularly as it relates to dealers having assets of $10,000,000 or more and the need for their record retention policies to comply with Revenue Ruling 71-20 and Revenue Procedure 91-59. An interesting comment is that for purposes of determining the $10,000,000 asset value which, in turn, determines whether compliance with these special record retention requirements is necessary, a controlled group of

see **AICPA AUTO DEALERSHIP ENGAGEMENT MANUAL,** page 8

 (Continued from page 7)

corporations is considered to be one corporation and all the assets of all members of the group are aggregated.

HERE'S ONE FOR THE IRS

One form that should be prepared on all audit engagements by the in-charge accountant is the "Summary of Possible Journal Entries" appearing at Section 10.904, which according to the AICPA has been revised "to make it more user-friendly." To the IRS?

This very useful (from an audit standpoint) form categorizes "possible" journal entries affecting the income statement in the categories of (1) known, (2) estimated and (3) projected misstatements, as well as indicating the computed overall materiality limit and amount over which misstatements should be posted to this form. At the bottom of the form, one can enter the results of a computation of the "tax effect on total unrecorded misstatements." Look for the IRS to request this form in upcoming audits on their Document Request forms.

ADVISORY SERVICES & DEVELOPING YOUR NICHE

The additions of an extensive discussion on "benchmarking" and the inclusion of various ratios for different dealership departments are noteworthy. Much of the material in this chapter corresponds with the presentation made by Marc Dickler on "How to Develop Your Niche in Auto Dealerships" at the First Annual AICPA National Auto Dealer Conference, which also is available on audio tape. This newly added Advisory Services chapter also discusses "regulatory reviews," designed to point out shortcomings in compliance practices before a state or Federal agency picks them up and sample correspondence with clients. All of this material should be very helpful to practitioners looking to expand their services to auto dealer clients beyond the traditional financial statement and tax return preparation parameters.

OVERALL: TAX "QUALIFICATION"

The AICPA Auto Dealership Engagement Manual should to be a valuable resource and reference for CPAs looking to expand their technical expertise and service potential in connection with dealer clients. However, in my opinion, it has some glaring technical errors and oversights in some of the tax discussions which one would not have expected. The user is advised to supplement any reading of the technical discussions related to taxes with comparative tax research elsewhere.

SUGGESTED REFERENCES

1. AICPA Auto Dealership Engagement Manual.
2. NADA Management Guide: A Dealer Guide to Federal Tax Issues.
3. AICPA National Auto Dealership Conference (1994) Speaker Outlines and Audio Tapes.
4. NADA Convention (1994) Workshop Cassettes.
5. IRS Industry Specialization Program: Motor Vehicle Industry: Proposed Coordinated Issue Papers.
6. What Do You Suggest? Let us know!

LAST CHANCE RELIEF FOR DEALERS TO ADOPT COST CAP WITHOUT PENALTY

REV. PROC. 94-49

As most experienced CPAs working with auto dealerships know, the Section 263A Cost Capitalization Rules do apply to automobile dealers with one exception...and this exception is usually not applicable to the "average" size dealership. Auto dealers, as resellers, are subject to the Cost Cap Rules unless their average gross receipts for the last three years was less than $10,000,000. Most dealerships are above this exception level, and compliance with Section 263A is a requirement.

Unfortunately, many dealerships may not have received proper guidance on this point and Revenue Procedure 94-49, issued June 28, 1994, offers last-chance relief to make necessary adjustments and corrections. In general, taxpayers may use Revenue Procedure 94-49 if they previously did not capitalize any costs under Section 263A or if they mistakenly thought they were exempt, but in fact were not. Consequently, it is a last chance, "no questions asked" opportunity to clear up substantial exposure to both the dealership and the CPA if in prior years Section 263A was ignored. Estimates of non-compliance vary, with some reports indicating non-compliance as high as 90% of most small businesses with under $10,000,000 total assets. Since Revenue Procedure 94-49 is intended to encourage taxpayers not in compliance with Section 263A to now properly conform - it is not intended to be used for a variety of other changes which do not relate to prior Section 263A non-compliance.

It is not intended to be used for electing the "Historic Absorption Ratio" under the Simplified Resale Method because procedures for making this election are set forth in the final regulations. Also, it may not be used if the taxpayer had a "Section 263A issue pending" on June 28, 1994.

This article discusses Revenue Procedure 94-49 as a "bail out" technique to protect both CPAs and dealers who were not complying with Section 263A for years prior to 1994.

HOW REV. PROC. 94-49 CHANGES WORK

Under the revenue procedure, the Commissioner's consent is automatically granted to a taxpayer to make the change to reflect Section 263A adjustments so long as the taxpayer complies with certain provisions:

1. A Section 481(a) adjustment must be computed and the computation must cover all prior years.
2. The amount of the Section 481(a) adjustment must be taken into account (i.e., into income) equally over four taxable years, regardless of whether the adjustment is positive or negative.
3. A special rule applies that allows taxpayers, if the Section 481(a) adjustment amount is less than $25,000, to take the adjustment into income in a single year. If taxpayer elects to do this, it must attach to its original Form 3115 a statement indicating that it is electing the de minimis rule pursuant to Section 4.04 of Revenue Procedure 94-49.
4. LIFO layers that are required to be revalued are not further changed by establishing a new base year unless the taxpayer is not using the Simplified Resale Method. Accordingly, a taxpayer who revalues its LIFO layers is generally not permitted to establish a new base year for computation purposes.

Other special rules apply in more limited situations; these are beyond the scope of this article.

Accordingly, for the first taxable year beginning after January 1, 1994, permission does not have to be requested to comply with Section 263A. Instead, permission to change will automatically be granted if the taxpayer:

CONDITIONS

1. Restates its beginning inventory as if compliance with Section 263A had occurred in previous years.
2. Takes the Section 481(a) amount into taxable income over a four-year period, regardless of whether the amount is positive or negative...subject to the $25,000 "take it all in one year" de minimis rule.
3. Files an original Form 3115 attached to its first tax return for a year beginning on or after January 1, 1994. This must be a timely filed return, including extensions.
4. Files a copy of the Form 3115 with the IRS National Office at the prescribed address no later than when the original Form 3115 is filed with the Federal income tax return.
5. Attaches a written statement to Form 3115 stating that it agrees to all the terms and conditions of Revenue Procedure 94-49.

see **LAST CHANCE RELIEF FOR DEALERS**, page 13

COST CAPITALIZATION FOR AUTO DEALERS

SEC. 263A COST CAP

For many auto dealers and their CPAs, the enactment of Section 263A in 1986 was regarded as "much ado about nothing" or "plenty of paperwork for peanuts." That is not to say that Code Section 263A is unimportant, or can be ignored - but, rather it is to say that the amount of additional Section 263A costs required to be capitalized in year-end inventories by an automobile dealer is (1) usually not a large amount and (2) it is very often overshadowed by the disproportionately larger time, effort and cost of making the computations.

Two developments during 1994 in the Section 263A Cost Capitalization Rules need to be considered before filing 1994 tax returns. These developments are (1) the finalization of the regulations which became effective for years beginning in 1994 and (2) the issuance of Revenue Procedure 94-49 (discussed in a separate article) as a "last chance opportunity" for auto dealers/taxpayers who have not previously complied with Section 263A to do so penalty-free as part of filing their 1994 returns.

OVERVIEW

The Cost Capitalization Rules became applicable to auto dealer inventories for the first taxable year beginning after December 31, 1986. Essentially, calendar 1987 was the first year subject to Section 263A and certain adjustments were required to be made to the December 31, 1986 inventories for Section 263A purposes as that inventory became the opening inventory for tax returns filed for 1987.

The new rules applied to all auto dealers with an average gross receipts for the last three years of under $10,000,000. This was meant to be the first of two "relief" provisions that Congress granted to smaller businesses to soften the impact of the Section 263A Rules. The second "relief" provision was allowing dealers to elect to use simplified computation methods - instead of going through more complex and time-consuming cost capitalization procedures. It has always been clear that the Section 263A Rules were intended to apply to all automobile dealers except those small enough to have less than an average of $10,000,000 of gross receipts on a 3-year computation basis.

Part of the trickery by which Section 263A was enacted included the presumption that the taxpayer (not Congress and not the IRS) was initiating this change in accounting method! As a result, with this change in method of accounting, it is necessary to compute the dollar impact of the change, and this impact is measured (as of the first day of the year of change) by applying the new computation approach to all prior years to determine the amount which represents the difference between the results under the former (old) method and the results under the new method - as of the date of change. The difference is called the Section 481(a) adjustment.

Therefore, all taxpayers, including auto dealers, subject to the Section 263A Rules were required to make a computation revaluing their opening or beginning inventory in the year of change (i.e., that would be the January 1, 1987/December 31, 1986) inventory amount as if the new rules of Section 263A had been in effect during all prior years. Special rules were provided for LIFO and for non-LIFO taxpayers effectively allowing them to substitute a shorter number of years than their entire existence in making this Section 481(a) adjustment to their opening inventory.

Any additional income as a result of the Section 481(a) adjustment restating the opening inventories generally was to be taken into income at the rate of 25% per year, over a 4-year period, starting in 1987. In other words, the typical calendar year dealer complying with Section 263A would have spread the opening inventory adjustment over 1987-1988-1989-1990, 25% each year, and by 1991, no further Schedule M-1 adjustment for this would be necessary.

Proposed regulations were issued in March of 1987 and were clarified in some respects in August of 1987. These regulations were extremely complex, and in some instances impractical and controversial. They were supplemented by many IRS Notices, including 88-86, 88-78, 88-92 and 89-67. In August of 1993, final regulations were issued effective for tax years beginning after December 31, 1993 - in other words, effective for tax years beginning in 1994. These final regulations for 1994 limit the application of the Proposed regulations to the years 1987-1993.

For most auto dealerships, the most practical way to calculate the additional Section 263A costs is on worksheets prepared after the end of the year with the net result of the computations reflected in the tax return by means of Schedule M-1 reconciling adjustments and entries. Since the additional costs required to be capitalized by Section 263A are not "booked," differences are created between the inventories for tax purposes (referred to as "tax basis inventories") and the financial statement or book inventory amounts which do not reflect the additional 263A costs. These differences have to be accounted for and reconciled every year.

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COSTS REQUIRED TO BE CAPITALIZED

These rules applicable as early as 1987 represented a major departure from prior practices where the only inventory costs directly capitalized were essentially acquisition cost plus freight, plus any dealer add-ons. Auto dealers who do not meet the $10,000,000 average annual gross receipts exception are required to capitalize the following costs:

COSTS
- Off-site storage.
- Purchasing.
- Handling and processing costs.
- General and administrative expenses allocable to each of the above.

As indicated previously, simplified alternative procedures would have been elected instead of going through the even more burdensome detail work that would otherwise be required. These simplified methods would have been elected by auto dealers with the election to use the Simplified Resale Method (or one of its alternatives) being the most common. Also, dealers were required to notify the IRS as to that election by filing copies of Form 3115 and completing a "Section 263A Checklist" in accordance with IRS Notice 88-92.

Unless an election had been made to use the Simplified Resale Method (or the Alternative Simplified Resale Method or the Modified Resale Method), more complicated rules which required even greater allocations applied...and that is why one of the simplified methods was typically preferable. Regardless of which simplified allocation method is selected, the four cost categories (off-site storage, purchasing, handling and process, and allocable general and administrative expense) must be analyzed and appropriately capitalized.

Note that costs that do not have to be capitalized under Section 263A include on-site storage costs, Section 179 depreciation, marketing expenses, selling expenses, advertising, interest and general and administrative expenses and compensation allocable to these non-capitalizable costs.

For auto dealers, on-site storage costs are currently deductible...but off-site storage costs are not. Congress intended that only off-site storage costs must be treated as inventoriable and the Regulations provide a "trick wording" definition. An off-site storage facility (i.e., one for which costs must be capitalized) is defined as any facility that is "not an on-site storage facility." An on-site storage facility is a facility that is physically attached to, and an integral part of, a retail sales facility where the taxpayer sells merchandise stored at the facility to retail customers (i.e., to the final consumers of the goods) physically present at the facility (on-site sales). The final regulations include an example stating that two lots of an automobile dealership physically separated by an alley or an access road would generally be considered one retail sales facility, provided customers routinely shop on both of the lots to select the specific automobiles that they wish to acquire.

A facility where sales are made to both (1) retail customers physically present at the facility and (2) to persons acquiring the goods for resale, is a dual function facility for which special rules are provided. Essentially, if 10% or less of the gross sales from the facility are attributable to on-site sales, then the entire storage facility located at the site is deemed to be an off-site facility. Alternatively, if 90% or more of the gross sales is attributable to on-site sales, then the entire storage facility located at the site is treated as an on-site facility...making all of the storage costs deductible.

Purchasing Activities: Costs attributable to purchasing activities are required to be capitalized unless the person spends less than one-third time or activity involved with the purchasing function. If less than one-third is involved, then none of the labor costs attributable to that person are allocated to the purchasing function. If a person spends more than one-third but less than two-thirds of his time, then whatever percentage of time is spent must be allocated with costs capitalized proportionately. If more than two-thirds of a person's time/activity is allocable to purchasing functions, then 100% of his time is considered allocable. This test is made on an individual-by-individual basis. Typically, many dealerships will not have capitalizable purchasing activity costs because of this one-third de minimis rule.

Handling (and Other Similar Activity) Costs: The labor costs attributable to handling, including transportation and loading and unloading costs, are required to be capitalized. However, labor costs for sales clerks, incurred in displaying goods and handling them in the course of waiting on customers, do not have to be capitalized.

Allocable General and Administrative Expense: The procedures for allocating mixed service G & A costs to off-site storage, purchasing and handling activities are generally as follows: Where less than 10% of the predominant nature of the service cost relates to off-site storage, purchasing or handling, none of the allocable G & A costs are required to be capitalized. Typically, in reviewing the operating statement of a dealership, "mixed service costs" may include data processing costs, outside services, a portion of general supervision compensa-

see **COST CAPITALIZATION FOR AUTO DEALERS**, page 16

SECTION 263A COST CAPITALIZATION UNDER OLD SIMPLIFIED RESALE METHOD
ADDITIONAL SECTION 263A RESALE COSTS

A.	Beginning Inventory (excluding Section 263A amounts)	$ 6,085,337
B.	Ending Inventory (excluding Section 263A amounts)	4,707,325
C.	Cost of Goods Sold (Sales Revenue Less Gross Profit)	37,403,202
D.	Cost of Goods Sold + End. Inventory - Beg. Inventory = Purchases	36,025,190
E.	Labor Allocable to Purchasing Function: $105,505	-
F.	Labor in Body Shop $150,000 and Service Department $275,000	-

G.

Selling and Administrative Expenses	Total	Selling Expense	Under 10% De Minimis	Mixed Service Costs
Salaries - Owners	$ 104,600	$	$ 104,600	$ 0
Salaries - Supervisors	670,000			670,000
Salaries - Clerical	257,807		257,807	0
Salaries - Other	601,499		601,499	0
Absentee Compensation	29,714		29,714	0
		Subtotal	993,620	
Employee Benefits	111,674			111,674
Pension Plan	5,000			5,000
Repossession Losses	110,685		110,685	0
Compensation - Sales	753,302	753,302		0
Depreciation	330,269		330,269	0
Advertising	495,165		495,165	0
Interest	743,833		743,833	0
Payroll Taxes	252,257			252,257
Outside Services	130,082			130,082
Insurance	188,481		188,481	0
Rent	227,127		227,127	0
Commissions	40,064	40,064		0
Real Estate Taxes	90,062		90,062	0
Telephone	134,775		134,775	0
Office Supplies	177,560		177,560	0
Other Expenses	211,576		211,576	0
Delivery Expense	114,062	114,062		0
Utilities	82,938		82,938	0
Policy Work	101,627	101,627		0
Repairs and Maintenance	44,057		44,057	0
Seminars	29,669	29,669		0
Travel and Entertainment	15,248		15,248	0
Legal and Accounting	106,334		106,334	0
Bad Debts	17,462	17,462		0
Training	51,362		51,362	0
Dues and Publications	4,749		4,749	0
Company Vehicle Expense	43,614		43,614	0
Other Taxes	25,834		25,834	0
Totals	$6,302,488	$1,056,186	$4,077,289	$1,169,013

	Memo Labor Excluding Labor in MSC
	$993,620
	753,302
Body Shop	150,000
Service Dept.	275,000
	* $2,171,922

H. Inventoriable Portion of Mixed Service Costs

$$\frac{\text{Purchasing Labor}}{\text{Total Labor}} \quad \frac{\$105{,}505}{\$2{,}171{,}922\,*} \times \$1{,}169{,}013 = \quad \$\ 56{,}787$$

I. Allocation Ratio & Additional Section 263A Resale Costs:

$$\frac{\text{Addtl. Section 263A Costs}}{\text{Purchases}} \quad \frac{\$105{,}505 + 56{,}787}{\$36{,}025{,}190} = .00450 \times 4{,}707{,}325 = \quad \$\ 21{,}183$$

J. Ending Inventory as Adjusted to Include Additional Section 263A Costs:

Ending Inventory at Cost (Non-LIFO)	$ 4,707,325
Additional Section 263A Costs	21,183
Total Ending Inventory, Including Section 263A Costs	$ 4,728,508

(Continued from page 9)

It is necessary to type or print at the top of each Form 3115 the following legend: "Automatic Change with Positive/Negative Section 481(a) Adjustment Under Rev. Proc. 94-49."

The usual signature requirements are also involved. No user fee is required and the IRS will not acknowledge receipt of the copy of the Form 3115 filed with the National Office.

THE HEADACHE: REVALUING THE INVENTORIES: THE SECTION 481(a) ADJUSTMENT

It is important to note that the Section 481(a) adjustment must be made revaluing the opening inventory of the year of change. Typically, that would be the December 31, 1993 inventory...since that is the opening inventory on January 1, 1994, the first day of the year of change.

The Section 481(a) adjustment is necessary to prevent amounts from being either duplicated or omitted when a change in accounting method occurs. Accordingly, the Section 481(a) adjustment is measured by applying the new method to all prior years to determine the amount (either positive or negative) which represents the difference between the results under the former or old method (i.e., not reflecting Section 263A) and the results under the new method (i.e., reflecting Section 263A adjustments) as of the date of change. Taxpayers subject to Section 263A for the first time (whether back in 1987 when Cost Cap was enacted as part of TRA '86 or under the new change rules) are required to make their accounting changes by revaluing their opening or beginning inventory in the year of change as if the new rules of Section 263A had been in effect during all prior periods. The four-year spread period is intended to minimize, to some extent, the impact of adjusting inventory methods.

The revaluation procedures are extremely technical and are set forth in the Section 263A regulations. Only a general summary is provided below. In this regard, IRS Notice 88-92 contained a checklist of questions, number 8 of which contains a very good general discussion of the opening inventory revaluation requirements.

REVALUING TECHNIQUES... DIFFERENT STROKES...

There are essentially three different opening inventory revaluation procedures, only one of which will be used:

1. Facts and circumstances.
2. Weighted average method.
3. Three-year average method. This method may only be used by dollar-value LIFO taxpayers.

Generally, the determination or revaluation of inventory must be based on all of the facts and circumstances of the direct and indirect costs which are to be assigned to each item of inventory under the Section 263A capitalization rules. This "facts and circumstances" revaluation is required for every prior period or year relevant in determining the total restated balance as of the year of change - unless a permissible variation or sub-variation is used. Congress anticipated that information may be lost or unavailable for prior years and that taxpayers might have to use reasonable estimates from existing data in making Section 481(a) adjustments.

Accordingly, dollar-value LIFO inventories are permitted to be revalued or restated under Section 481(a) by either (1) an actual "facts and circumstances" recomputation applying the more detailed and specific rules to all years or (2) estimating restatement amounts under a three-year average method. Most dollar-value LIFO taxpayers used the three-year average method under which:

1. The three-year average method may be used **only** for inventories for which the dollar-value LIFO method was used. Note, this may present some difficulties for auto dealers with dollar-value inventories using the LIFO method for new vehicle inventories and not using LIFO for used vehicles and parts inventories.
2. The taxpayer must use the three most recent taxable years for which there is sufficient information to calculate the revaluation factor, regardless of whether increments were incurred in those years.
3. If it is beneficial to the taxpayer, the taxpayer may use additional years (but only if such years are consecutive) beyond the most recent years in calculating the revaluation factor.

For taxpayers not using LIFO (or for taxpayers using specific goods LIFO), the mandatory Section 481(a) revaluation is to be made by applying the more comprehensive "facts and circumstances" recomputation, supplemented by a more limited weighted average method where "sufficient data" is lacking.

Although a thorough discussion of each of the revaluation methods is beyond the scope of this article, it is important to be aware that the need to revalue the opening inventory cannot be avoided... and at least "good faith" computations and workpapers should be prepared and retained in this respect.

SIMPLIFIED RESALE METHODS
UNDER SECTION 263A PROPOSED REGS. (PRE-1994)

SIMPLIFIED RESALE METHOD
(ORIGINAL - UNDER PROPOSED REGS.)

$$\frac{\text{Off-Site Storage Costs, Purchasing Costs, Handling Costs, \& Allocable G \& A}}{\text{Purchases}} = \text{Fraction} \times \text{Purchases during the year remaining in ending inventory (i.e., ending inventory balance for FIFO; inventory increment at current cost for LIFO)}$$

ALTERNATIVE SIMPLIFIED RESALE METHOD
(NOTICE 88-86, SECTION 888(A)(2))

Involves 2 formulas:

#1: $$\frac{\text{Off-Site Storage Costs, Handling Costs, and Allocable G \& A}}{\text{Beginning Inventory plus Purchases}} = \text{Fraction} \times \text{Ending Inventory}$$

#2: $$\frac{\text{Purchasing Costs \& Allocable G \& A}}{\text{Purchases}} = \text{Fraction} \times \text{Purchases during the year remaining in ending inventory}$$

> **Comment:**
> The benefit of this method is that less off-site storage and handling costs will be capitalized under Section 263A because of the inclusion of beginning inventory balances in the denominator. The disadvantage for LIFO taxpayers is that the entire ending inventory balance is used for the storage and handling costs formula, not just the LIFO increment (if any) for the year.

MODIFIED RESALE METHOD (TAMRA 1988) & "NEW" SIMPLIFIED RESALE METHOD UNDER FINAL REGULATIONS EFFECTIVE FOR 1994

Involves 2 formulas:

#1: $$\frac{\text{Off-Site Storage Costs, Handling Costs, and Allocable G \& A}}{\text{Beginning Inventory plus Purchases}} = \text{Fraction} \times \text{Purchases during the year remaining in ending inventory}$$

#2: $$\frac{\text{Purchasing Costs \& Allocable G \& A}}{\text{Purchases}} = \text{Fraction} \times \text{Purchases during the year remaining in ending inventory}$$

> **Comment:**
> This method is similar to the Alternative Simplified Resale Method, except that for LIFO taxpayers only the inventory increment, if any, is used. This makes it beneficial to both LIFO and to non-LIFO taxpayers.

SECTION 263A "NEW" SIMPLIFIED RESALE METHOD FOR YEARS STARTING IN 1994 (I.E., POST-1993 YEARS)

The final regulations for 1994 provide a new Simplified Resale Method which is essentially the same as the old Modified Resale Method. The allocation formulas contained in the Simplified Resale Method, however, may be modified by a reseller to yield allocations of additional Section 263A costs which will produce results substantially equivalent to those that would have resulted under any of the old methods.

For the Simplified Resale Method under the final regulations, the Additional Section 263A Costs allocable to ending inventory are equal to the product of the "Combined Absorption Ratio" multiplied by the Section 471 costs incurred during the year that remain in inventory at the end of the year. "Section 471 Costs" are costs, other than interest, capitalized under the taxpayer's method of accounting immediately prior to the effective date of Section 263A. For LIFO taxpayers, Section 471 costs remaining on hand at the end of the year are equal to the amount of the inventory increment (if any) as valued at current cost.

$$\text{Allocable additional Section 263A costs} = \text{Combined Absorption Ratio} \times \text{Section 471 costs remaining in inventory at end of year}$$

The Combined Absorption Ratio is the sum of two ratios: (1) the ratio of the current year's storage and handling costs to the sum of beginning inventory plus current year's purchases and (2) the ratio of the current year's purchasing costs to the current year's purchases.

$$\#1:\ \text{Storage and Handling Costs Absorption Ratio} = \frac{\text{Current year's storage and handling costs}}{\text{Beginning inventory plus current year's purchases}}$$

$$\#2:\ \text{Purchasing Costs Absorption Ratio} = \frac{\text{Current year's purchasing costs}}{\text{Current year's purchases}}$$

Example:

Beginning inventory (before Section 263A costs)	$ 200,000
Purchases for the year	$1,000,000
Storage costs (including allocable mixed service costs)	$ 19,000
Handling costs (including allocable mixed service costs)	$ 17,000
Purchasing costs (including allocable mixed service costs)	$ 50,000

$$\text{Storage and Handling Costs Absorption Ratio} = \frac{\$19{,}000 + \$17{,}000}{\$200{,}000 + \$1{,}000{,}000} = \frac{\$36{,}000}{\$1{,}200{,}000} = 3.0\%$$

$$\text{Purchasing Costs Absorption Ratio} = \frac{\$50{,}000}{\$1{,}000{,}000} = \underline{5.0\%}$$

Combined Absorption Ratio (sum of these ratios) $\underline{\underline{8.0\%}}$

- If ABC uses LIFO, the Combined Absorption Ratio of 8% is multiplied by ABC's LIFO inventory increment (valued at current cost) for the year to arrive at the Additional Section 263A Costs that are allocable to its total ending inventory.

- If ABC excludes its $200,000 beginning inventory from the denominator of the storage and handling costs absorption ratio, the ratio would be 3.6% ($36,000/$1,000,000). Its Combined Absorption Ratio would equal 8.6% - a result similar to the Simplified Resale Method described in the temporary regulations.

- If ABC were to determine its capitalizable storage and handling costs by multiplying the storage and handling costs absorption ratio by the total Section 471 costs included in its ending inventory (rather than by the inventory increment for the year), this would produce a result similar to the Alternative Simplified Method described in Notice 88-86.

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tion, and a miscellany of other costs. This is one area where many accountants do not agree on which costs should be considered mixed service costs and quite often many are not included because they are determined or considered to be less than 10% related to inventory functions.

To the extent there are mixed service costs required to be capitalized, the allocation is made based on labor costs in each category to the overall total labor costs in the dealership (excluding labor in Mixed Service Costs). See the sample computation attached, which is not an official "example," but merely one of countless approaches.

THREE "SIMPLIFIED" METHODS

Simplified Resale Methods: "In the beginning," there was only one "Simplified Resale Method." Over time, three different simplified methods appeared.

- Simplified Resale Method
- Alternative Simplified Resale Method
- Modified Resale Method

SIMPLIFIED RESALE METHOD

Under the Simplified Resale Method, the ending inventory is valued just as it would have been if there had been no change in the Section 263A rules and the effect of the Section 263A capitalization rules is superimposed on the inventory balance by means of an allocation ratio. This allocation ratio is derived from the analysis and quantification of off-site storage, purchases, handling and general and administrative costs allocable to the resale activity. The "additional Section 263A resale costs" to be capitalized in ending inventory is determined by multiplying the allocation ratio times the amounts in the ending inventory which are treated as purchases made during the current year under the taxpayer's method of accounting. For non-LIFO taxpayers, this amount would be the entire amount of the ending inventory; for LIFO taxpayers, it would only be the amount of the current year's increment as valued at current cost. The computation of the allocation ratio is shown below:

1.	Off-site storage and warehousing	\$40,000
2.	Purchasing	50,000
3.	Handling and processing	30,000
4.	Mixed service (G & A) costs, as allocated	20,000
	Total add'l Section 263A resale costs	\$140,000

$$\text{ALLOCATION RATIO} = \frac{\text{Total add'l Section 263 resale costs for the year}}{\text{Total purchases for the year}} = \frac{\$140{,}000}{\$8{,}000{,}000} = 1.75\%$$

ALTERNATIVE SIMPLIFIED RESALE METHOD

The "Alternative Simplified Resale Method" involves two computations of allocation ratios. The first involves a separate allocation ratio for handling and storage costs (and related mixed service costs) that includes both beginning inventory balances and purchases in the denominator of the allocation ratio and multiplying that allocation ratio by all amounts included in the taxpayer's ending inventory (including purchases made during the year as well as amounts also present in beginning inventory for the year under the taxpayer's method of accounting).

In addition, under the **alternative simplified resale method**, the taxpayer (i) calculates a separate allocation ratio for purchasing costs (and related mixed service costs) that includes only purchases in the denominator of the allocation ratio; and multiplies that allocation ratio by (ii) all amounts included in the taxpayer's ending inventory that are viewed as purchases made during the taxable year under the taxpayer's method of accounting.

Taxpayers electing to use the **alternative simplified resale method** would separately determine the amount of mixed service costs related to their off-site storage ("storage"), purchasing, and handling activities by multiplying the total amount of mixed service costs incurred by a separate ratio for each particular activity that consists of:

(i) The labor costs allocable to each particular activity (i.e., storage, purchasing, and handling) excluding labor costs that are included in mixed service costs, to

(ii) The total of all labor costs incurred excluding labor costs that are included in the mixed service costs.

IRS Notice 88-86, Section III(A)(2), contained examples/illustrations of this computation. The Alternative Simplified Resale Method would not be attractive to LIFO taxpayers because the entire ending inventory balance is used for the storage and handling costs formula, and not just the LIFO increment as valued at current cost.

MODIFIED RESALE METHOD

Not content to have a Simplified Resale Method and "only" a second "Alternative" Simplified Resale Method, the Technical & Miscellaneous Revenue Act of 1988 provided a third simplified method, called the "Modified Resale Method." In calculating the allocation ratios under the Modified Resale Method, the beginning inventory amount is included in the denominator of the fraction computation for storage and handling costs, but it is not included in the denomina- →

tor of the fraction computation for purchasing costs. Accordingly, the two allocation fractions in the Modified Resale Method are similar to those in the Alternative Simplified Resale Method. Where the Modified method differs from the Alternative method is that, for LIFO taxpayers, the allocation fractions in the Modified method are multiplied by only the amount of LIFO increment (valued at current cost) instead of the full (non-LIFO) inventory amount. This Modified Resale Method could be adopted retroactively for 1987 and 1988 if amended tax returns had been timely filed to do this.

FINAL REGULATIONS FOR 1994

NEW SIMPLIFIED RESALE METHOD EQUALS OLD MODIFIED RESALE METHOD

Under the final regulations, effective for 1994, what is now referred to as the "Simplified Resale Method" is identical to the former Modified Resale Method described in IRS Notice 89-67. Apparently, the old "Modified Resale Method" was brought forward as the more applicable method in the final regulations because it was more widely used. Note: It is possible that many auto dealers' Section 263A computations simply have retained the old, original "Simplified Resale Method" as the method of choice. This appears to be an acceptable alternative because the final regulations permit resellers to modify the formulas provided under the "new" Simplified Resale Method to yield allocations equivalent to the other two simplified allocation methods that were not specifically retained in the final regulations.

Thus, the final regulations effective for 1994 provide only one simplified allocation method for retailers - and it is referred to as the "Simplified Resale Method" but it is essentially the same as the old Modified Resale Method set forth in Notice 89-67 (which many dealers probably did not adopt). Almost all adjustments that will be required to conform post-1993 Section 263A computations to the new rules effective in 1994 will be changes in accounting method requiring the filing of Forms 3115 with the 1994 tax returns when they are filed and with the National Office of the IRS at approximately the same time as the tax returns are filed.

The exception for "small retailers" having a 3-year average gross receipts under $10,000,000 has been retained in the final regulations.

HISTORIC ABSORPTION RATIO ELECTION

Because of considerable complaints about the costly and time-consuming computations that had to be made every year, the final regulations permit an election to use the historic absorption ratio in connection with the Simplified Resale Method or one of the former Simplified Methods. The election to use the historic absorption ratio must be made in first, second or third taxable year beginning after December 31, 1993.

This liberalization is intended to reduce repetitive annual computation costs. By making an election to use the historic absorption ratio, an auto dealer will be able to minimize continued compliance costs. However, the new rule will require sixteen years to explain (just kidding; actually, it can be explained using an illustration that spans a 16-year time frame).

The essence of the rule is that a 3-year test period is used to determine the allocation ratio that will be applied for the following five years. After five years, a new calculation is made to see how close the absorption ratio in that year (i.e., the sixth year) is to the ratio that has been used for the previous five years. If it is close enough (i.e., within plus or minus one-half of one percentage point), that same rate used in the preceding five years can continue to be used for the next five years. If it is not within plus or minus one-half of one percentage point, a new 3-year test period is required to determine the absorption ratio that will be used for the subsequent five-year period, with individual/annual computations required to determine the rate to be used in those years.

Historic Absorption Ratio Terms

- Election year
- Recomputation year
- Test period
- Qualifying period
- Extended qualifying period
- Updated test period
- New qualifying test period
- Historic absorption ratio (sometimes referred to as CAR/combined absorption ratio)

In the timeframe illustrated, assuming the election to use the historic absorption ratio is made in 1994, the test period is the preceding 3-year period consisting of 1991-1992-1993. The combined allocation ratio determined for this period will be used for the 5-year qualifying period consisting of 1994 through 1998. In 1999, a recomputation must be made (i.e., 1999 is the recomputation year) during which the taxpayer must compute its actual combined absorption ratio. If the computed combined absorption ratio for 1999 is within one-half of one percentage point of the previously used combined absorption ratio, then the previously computed combined absorption ratio will be used for the years 1999 through 2004. Note,

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in this case, the same rate would be used for eleven (11) years; i.e., 1994 through 2004.

For example, if the combined absorption ratio computed with reference to the 1991-1992-1993 test period were 5.0%, that rate would be used through 1998. In 1999, an actual absorption ratio would have to be computed. Assuming the actual computed rate for 1999 were 5.25%, that would be within plus or minus one-half of one percentage point and the taxpayer would be required to continue to use its historic absorption ratio of 5.0% throughout the extended qualifying period (of six years) consisting of the recomputation year (1999) and the following five taxable years ending in 2004.

Alternatively, if the taxpayer's actual computed combined absorption ratio for 1999 were not between 4.5% and 5.5%, its qualifying period would end and it would be required to compute a new historic absorption ratio with reference to the 3-year test period of 1999-2000-2001. In other words, in each of these three years, a specific annual calculation would have to be made. On the basis of the result of these three years, a new historic absorption ratio would be determined from this updated test period (i.e., 1999-2000-2001) and this new historic absorption ratio would be used throughout the 5-year new qualifying period beginning with the year 2002 and running through 2006.

Note that for auto dealers, who typically have very low absorption ratios (these previously were called *allocation* ratios in the proposed regulations), the tolerance of plus or minus one-half of one percentage point is extremely generous.

The final regulations provide the general rule that the election to use the historic absorption ratio method is to be made on a cut-off basis, and consequently, no adjustment under Section 481(a) is required or permitted.

One technical glitch in the whole procedure is that, as explained previously, the method described as the "Simplified Resale Method" in the final regulations is not the same method as that described as the "Simplified Resale Method" in the proposed regulations. Consequently, dealers who elected to use the "Simplified Resale Method" in 1987 or 1988 in the computation format set forth in the proposed regulations will be required to make a recomputation for the test period years (i.e., 1991-1992-1993 if 1994 is the first year of the election to use the historic absorption ratio) if they elect the new Simplified Resale Method under the new Regulations. The final regulations provide that taxpayers are eligible to make an election to use the historic absorption ratio method under transition rules regardless of whether they previously used the exact same procedure as that set forth in the final regulations as the "Simplified Resale Method" therein. A taxpayer electing to use the historic absorption ratio is required to recompute its additional Section 263A costs, and thus, its historic absorption ratio for its first test period as if it had used the computation approach for the new "Simplified Resale Method" under the final regulations in each of the three years included in its test period.

ELECTION STATEMENT REQUIRED IN 1994 RETURN

The taxpayer desiring to make this election must attach a statement to its Federal income tax return for the taxable year in which the election is made showing the actual combined absorption ratios determined under the Simplified Resale Method during its first test period. This statement must also disclose the historic absorption ratio to be used by the taxpayer during its (first) qualifying (5-year) period. A similar statement must be attached to the Federal income tax return for the first taxable year within any subsequent qualifying period.

OTHER CONSIDERATIONS

One other aspect of the introduction of the historic absorption ratio in the final cost capitalization regulations is that an election to use this method may be made in either the first, second or third taxable year beginning after December 31, 1993. Therefore, it may be advantageous to take a close look at the allocation ratios computed for 1991-1992-1993 and if any one of them is particularly high, and there is the possibility of a significantly lower allocation ratio being computed for 1994 or 1995 (and thus replacing one of the earlier higher allocation ratios in the 3-year test period (which moves forward each year on a sliding scale in relation to the first year in which the method is elected), there may be a benefit to delaying the election for one year or two. For many auto dealers, as a practical matter the allocation ratios and the amounts to be capitalized may be relatively small and not warrant otherwise postponing the initial election of the historic absorption ratio method.

In connection with the use of the historic absorption ratio method, the taxpayer must "maintain all appropriate records and details supporting the absorption ratio until the expiration of the statute of limitations for the last year for which the taxpayer applied the particular absorption ratio in determining additional Section 263A costs capitalized to eligible property." This record keeping requirement means that records will have to be kept longer than they might otherwise have to be in connection with the use of this election.

see **COST CAPITALIZATION FOR AUTO DEALERS**, page 24

SECTION 263A: HISTORIC ABSORPTION RATIO ELECTION

		Year	Yr. #	Within ± .05		Not Within ± .05		
Test Period (3 Years)	T.P.	1991	-3					
	T.P.	1992	-2					
	T.P.	1993	-1					
Year of Election & Qualifying Period	Q.P.	1994	1					
	Q.P.	1995	2					
	Q.P.	1996	3					
	Q.P.	1997	4					
	Q.P.	1998	5					
Recomputation Year	*	1999	6 *	EQP 1999	**	1999	***	Updated Test Period 1 of 3
		2000	7	EQP 2000	**	2000	***	UTP 2 of 3
		2001	8	EQP 2001	**	2001	***	UTP 3 of 3
		2002	9	EQP 2002	**	2002	****	NEQP
		2003	10	EQP 2003	**	2003	****	NEQP
		2004	11	EQP 2004	**	2004	****	NEQP
		2005	12	-		2005	****	NEQP
		2006	13	-		2006	****	NEQP

* 1999 is Recomputation Year. Recompute Section 263A costs for 1999 and compare with average used for the preceding 5 years (which was based upon 1991-92-93). If recomputed ratio for 1999 is not within plus or minus one-half of one percentage point of the ratio used, then must also compute for years #7 and #8 and from years 6-7-8 (i.e., 1999-2000-2001) compute an updated absorption ratio. That updated absorption ratio will then be used for each of the next five years: #9-13 (i.e., 2002 through 2006).

** Extended Qualifying Period (6 years) if within plus or minus one-half of one percentage point.

*** Updated Test Period (UTP).

**** New Extended Qualifying Period (NEQP...5 years) - if recomputation for 1999 not within plus or minus one-half of one percentage point - during which new actual combined/updated absorption ratio (determined from 1999-2000-2001) must be used.

LIFO TERMINATION TRAPS IN DEALERS' FACTORY FINANCIAL STATEMENTS

A major portion of the December, 1994 *LIFO Lookout* was devoted to a series of articles on this most troublesome subject for auto dealers and their CPAs. Because of the importance of this subject, we have condensed one of the articles for inclusion in the *Tax Watch*. The complete article discussed the general financial statement conformity requirements related to year-end financial statement reports issued by CPAs and it included a catalog of conformity nightmares pointing out the numerous ways a LIFO election may be lost if the IRS enforces its very restrictive interpretations.

The Regulations contain several LIFO reporting restrictions which the IRS interprets to apply to the Factory-prescribed format financial statements sent by a dealership immediately after year-end to the Factory/Manufacturer/Supplier. These restrictions pose fatal LIFO traps that are potentially more perilous than those for year-end reports issued by CPAs.

In this regard, the Regulations provide that any income statement that reflects a full year's operations must report on a LIFO basis. This would apply regardless of whether the income statement is the last in a series of interim statements, or the December statement itself which shows two columns - one for current month and one for year-to-date figures.

The Regulations provide that a series of credit statements or financial reports is considered a single statement or report covering a period of operations if the statements or reports in the series are prepared using a single inventory method and can be combined to disclose the income, profit, or loss for the period. This is sometimes referred to as the "aggregation" theory: If one can combine or aggregate a series of interim or partial-year statements to disclose the results of operations for a full year, then the last statement must reflect income computed using LIFO to value the inventory.

Literally interpreted, this wording applies to an auto dealer's 12th statement (i.e., December - unadjusted) as well as to the 13th statement. The 12th statement is usually issued on a preliminary basis, before accruals are refined by detailed adjusting entries. The 13th statement is usually issued several weeks after the 12th statement, and it reflects year-end accrual adjustments and other computations not otherwise completed by the tight timeframe for the issuance of the December or 12th statement (usually the 10th day of the following month).

FIRST YEAR AND EVERY YEAR

This conformity requirement means that to remain eligible to use LIFO, ***EVERY YEAR*** the dealership's December (or last monthly) statement must reflect an estimate of that year's change in the LIFO reserve if the actual change cannot be computed before the statement has to be released.

If the dealer is considering or planning to make a LIFO election for the year, an ***ESTIMATE*** of the LIFO reserve must be placed in the year-end statements issued to the Factory/Manufacturer or issued to any other party in order to preserve the ability to elect LIFO for the year by filing Form 970 when the tax return is filed at a later date.

If a dealer already has new vehicles on LIFO and is considering extending LIFO to other inventories, such as used vehicles or parts, the dealer's year-end statement going to the Factory should also reflect an estimate of the LIFO reserve expected by extending the LIFO election(s) to the additional class of goods under consideration.

A NADA Bulletin in December, 1985 stated that the inadvertent violation of the LIFO conformity requirement cannot be retroactively corrected and that once the violation has occurred, the only thing that can be done at the present time is for the dealer to make sure that the problem does not reoccur and to hope that the statute of limitations runs on the year(s) of violation without discovery by a revenue agent. Many practitioners believe that a revenue agent can only terminate LIFO if the conformity requirement has been violated in a so called open year and that once the statute of limitations has run on the year(s) of violation, a revenue agent may not terminate LIFO. Unfortunately, this "belief" by many practitioners is unsupported and many IRS agents are now aggressively going all the way back to examine the Factory statements for the initial LIFO year to see if they "properly reflected LIFO."

DIFFERENT YEAR-ENDS FOR BOOK AND TAX PURPOSES (FISCAL YEARS)

LIFO conformity problems are multiplied where the dealer has a different year end for reporting to the Factory/Manufacturer/Supplier (calendar year - Dec.

→

31) than the fiscal year used for income tax return purposes. For these fiscal year taxpayers, in order to satisfy another **strict** conformity requirement, the Regulations require the financial statements to reflect LIFO at the end of **both** twelve month annual reporting periods or years.

This regulation states that the conformity rules also apply to the determination of income, profit or loss for a one-year period other than a taxable year and credit statements or financial reports that cover a one-year period other than a taxable year, **but only if the one-year period both begins and ends in a taxable year or years for which the taxpayer uses the LIFO method for Federal income tax purposes**. For example,...in the case of a calendar year taxpayer, the requirements...apply to the taxpayer's determination of income for purposes of a credit statement that covers the period October 1, 1981, through September 30, 1982, if the taxpayer uses the LIFO method for Federal income tax purposes in taxable years 1981 and 1982.

PLACEMENT OF LIFO CHANGE IN THE STATEMENT OF INCOME

The top IRS LIFO specialist for dealerships recently said that on the twelfth statement the LIFO adjustment had to go through cost of goods sold (via the beginning-of-the-year and end-of-the-year inventory valuations) rather than through an other deductions account...or else dealers would not be complying with the LIFO year-end conformity requirement. The IRS specialist said he believed the regulations could be interpreted to support the agents on this point.

Under this interpretation, where and how the LIFO adjustment is run through on the income statement becomes critical. This current position will result in even more LIFO election terminations where the projected change in the LIFO reserve was run through an "Other Income/Other Deductions" account.

EITHER WAY, DEALERS CAN'T WIN

Many manufacturers' prescribed statement formats either do not permit or strongly discourage putting the LIFO adjustment in any (Cost of Goods Sold) account that affects gross profit determinations because that destroys or greatly impedes their ability to analyze gross profit by line items/models. Accordingly, the IRS' LIFO conformity requirement and the manufacturers' statement preparation requirements are not compatible with each other - and the dealer stands to lose either way.

This incompatibility is heightened tremendously because the Factory prescribed formats do not allow for a typical or conventional "Statement of Income" presentation which includes separate disclosure of the beginning-of-the-year inventory and the end-of-the-year inventory amounts. The Factory prescribed format for the Statement of Income begins with Gross Profit. Gross Profit is also shown in a supporting schedule by model/line item only, with corresponding sales revenue by model/line items. There is no "traditional" Cost of Goods Sold detail on the Factory prescribed statement (in the sequence: Beginning Inventory plus Purchases minus Ending Inventory equals Cost of Goods Sold). The amount corresponding to "Purchases" is simply a "plugged" or forced differential amount. This explains some of the contortions in attempting to comply with the vague requirements in the regulations.

Almost all dealers will have a hard (if not impossible) time reporting to the factory at year-end and keeping their LIFO elections by not violating the conformity requirements. So...according to the IRS, LIFO elections are invalid where the twelfth statement LIFO adjustment - or the thirteenth statement adjustment - is not placed in the inventory valuations in Cost of Goods Sold.

CAN'T REPAIR DAMAGE (ONCE OUT, TOO LATE)

CPAs and their clients should be especially careful to monitor the release of all year-end financial statements. The position of the IRS is that once financial statements have been issued or released on a non-LIFO basis, it is too late to recall them and reissue statements on a LIFO basis.

"QUALITY" OF ESTIMATES

The IRS is aggressively on the attack: some agents now are asking for proof that all financial statements at year-end were not in violation of the LIFO conformity requirements, and they are asking to see detailed computations in support of any year-end estimated changes. In other words, they're looking at the "quality" of the estimate placed on year-end statements as well.

The more complete coverage in the *LIFO Lookout* also addressed practitioner liability concerns and included information for use in connection with quick year-end projections to satisfy the IRS by placing the LIFO reserve estimate on the 12th statement.

LIFO RECAPTURE TAX IN C TO S CONVERSIONS REVENUE PROCEDURE 94-61 PROVIDES GUIDANCE

REV. PROC. 94-61

Revenue Procedure 94-61 provides clarification and instruction for handling the LIFO recapture tax and mechanics in C to S conversions. This Revenue Procedure applies to S elections made after December 17, 1987 except to the extent that special collapsed layer adjustments are required for pre-S years.

The IRS confirmed that a LIFO election is not terminated upon a switch from C to S status. All prior C corporation LIFO layers are to be rolled up - i.e., "collapsed" - into one single layer having an average weighted LIFO index valuation. The way to make the appropriate adjustments to the base inventory is to "collapse" any pre-S year LIFO layers and add the LIFO recapture amount to the LIFO value of the ending inventory as of the end of the taxpayer's last year as a C corporation.

The index for the Special Collapsed Layer (for the last C corp year) is relevant only for the purpose of computing the LIFO carrying value of a decrement in the event there is a decrement experienced in a later S year which has to be carried back to the LIFO inventory as of, or prior to, the last C corp year. Thus, this adjusted index (for the Special Collapsed Layer) would be used only if the end-of-year inventory, expressed in terms of base-year cost, for a taxable year subsequent to the last C corp taxable year (i.e., in an S year), is less than the base-year cost of the inventory as of the last day of the last C year.

If a taxpayer didn't quite adjust the pre-S years LIFO layers the way the IRS shows in an example, the Service "will accept as appropriate any reasonable method used by the taxpayer for adjusting its LIFO inventory to reflect the LIFO recapture amount"... for a taxable year ending before September 19, 1994.

Taxpayers might have significantly short-changed themselves if they started over with a LIFO inflation index of 1.000 on the first day of the first S year. Rev. Proc. 94-61 clearly states that the cumulative inflation index as of the end of the last C year carries over! Accordingly, refund claims may be in order because cumulative inflation indexes for the S years will be understated.

OTHER QUESTIONS ANSWERED ☺ ☺ ☺

1. If the LIFO method has been used for less than four taxable years prior to a taxpayer's first year as an S corporation, it is not necessary to reduce either the number of installments or the period for their payment.
2. An S corporation's obligation to pay an installment of tax resulting from the LIFO recapture amount does not need to be taken into account in determining the amount of estimated tax an S corp is required to pay.
3. A net operating loss (NOL) carryover may be applied against the LIFO recapture amount included in the gross income of a C corp.
4. If the amount of the inventory under the LIFO method exceeds the amount of its inventory under the FIFO method (i.e., a "negative LIFO reserve" situation), the taxpayer may not reduce gross income by the amount of the difference.
5. If an S corporation files a final return, any unpaid annual installments of the Section 1363(d) increase in tax becomes due and payable with the S corporation's final return.
6. If a taxpayer makes the appropriate adjustment to the tax basis of its inventory, but does not make such adjustment for financial reporting purposes, the taxpayer does not violate the LIFO conformity requirement.

UNANSWERED QUESTIONS ☹ ☹ ☹

1. What will the IRS accept for years ending before September 19, 1994 as "any reasonable method used by the taxpayer for adjusting its LIFO inventory to reflect the LIFO recapture amount" in cases where the taxpayer has experienced a decrement in the previous years? (The Revenue Procedure merely says the IRS will accept "any reasonable method" without giving any further clarification or illustration.)
2. Where an acceptable different method was used, are the net LIFO layers remaining as of the end of the first year ending before September 19, 1994 required to be collapsed into a Special Collapsed Layer as of that date in accordance with the principles of the Rev. Proc. example?

see **LIFO RECAPTURE TAX IN C TO S CONVERSIONS**, page 24

LIFO RECAPTURE TAX & MECHANICS IN C TO S CONVERSIONS SPECIAL "COLLAPSED LAYER" FOR PRE-S YEARS

REV. PROC. 94-61

Taxpayer elected LIFO in 1988. On December 31, 1991, the LIFO carrying value is $1,600 and the inventory is valued at $1,900 under the FIFO method using cost or market, whichever is lower. If the taxpayer elected to be taxed as an S corporation effective January 1, 1992, the LIFO recapture amount is $300 ($1,900 less $1,600).

The appropriate adjustments are made by collapsing the LIFO layers and adding the $300 LIFO recapture amount to the LIFO carrying value of the ending inventory as of the end of the 1991 taxable year. The index is then changed/adjusted to reflect the adjusted relationship between the new LIFO carrying value ($1,900) and base-year costs ($1,500). The base year and base-year costs do **not** change.

		BEFORE			AFTER		
		Base Year Cost	Index	LIFO Carrying Value	Base Year Cost	Index	LIFO Carrying Value
Jan. 1, 1988	Base-year	$ 1,000	100%	$1,000	—	100%	—
Dec. 31, 1988	Layer	200	110%	220	—	110%	—
Dec. 31, 1989	(Decrement year)	—	115%	—	—	115%	—
Dec. 31, 1990	Layer	100	120%	120	—	120%	—
Dec. 31, 1991	Layer	200	130%	260	—	130%	—
Dec. 31, 1991	Special Collapsed Layer Resulting From Section 1363(d) Adjustment	—	—	—	1,500	126.67%	1,900*
Totals		$ 1,500		$1,600	$ 1,500		$ 1,900

* ($1,900 = $1,600 LIFO value + $300 recapture amount)

Note that the beginning inventory is $1,900 for the 1992 taxable year, which is the first year the taxpayer is taxed as an S corporation. Also, note that for a taxpayer using the link-chain method the cumulative index is not recomputed. The cumulative index at December 31, 1991 is 130 percent, even though the adjusted index for the special collapsed layer resulting from the Section 1363(d) adjustment is 126.67 ($1,900 divided by $1,500) percent. The cumulative index at December 31, 1992 will be the product of 130 percent and the annual link for the December 31, 1992 taxable year.

If, in 1992, the taxpayer's ending inventory at base-year cost is $1,400 (a decrement of $100), the LIFO carrying value of the Special Collapsed Layer Resulting From Section 1363(d) Adjustment will decrease by $126.67 ($100 x 126.67%) to $1,373.33 ($1,400 x 1.2667, ignoring rounding).

If a taxpayer has experienced a decrement in its LIFO inventory for a taxable year ending before September 19, 1994, the Service will accept as appropriate any <u>reasonable</u> method used by the taxpayer for adjusting its LIFO inventory to reflect the LIFO recapture amount.

The index for the Special Collapsed Layer (for the last C corp year) is relevant only for the purpose of computing the LIFO carrying value of a decrement in the event there is a decrement experienced in a later S year which has to be carried back to the LIFO inventory as of, or prior to, the last C corp year.

Thus, this adjusted index for the Special Collapsed Layer would be used only if the end-of-year inventory, expressed in terms of base-year cost, for a taxable year subsequent to the last C corp taxable year (i.e., in an S year), is less than the base-year cost of the inventory as of the last day of the last C year.

Cost Capitalization for Auto Dealers (Continued from page 18)

Under the Simplified Resale Method as described in the final regulations, the computational approach will be slightly different from many auto dealers' cost capitalization procedures in prior years. In anticipation of the possibility that some taxpayers might prefer to continue using their prior cost capitalization methods and procedures, the final regulations indicate that permissible variations of the "Simplified Resale Method" as per the final regulations will include computations that are essentially equivalent to the original "Simplified Resale Method" as prescribed in the proposed regulations or to the Alternative Simplified Resale Method as prescribed in Notice 88-86, Section III(A)(2).

By this time, most CPAs have a fairly slick workpaper routine for gathering information and computing costs to be capitalized under Section 263A. As a result, it is possible that the present "efficiency" in computing Section 263A costs each year may be such that the advantages inherent in the historic absorption ratio election may be less attractive.

Finally, even a taxpayer who has not previously reflected 263A should be able to elect to use the historic absorption ratio method provided the change is made in accordance with Revenue Procedure 94-49. The regulations provide that "taxpayers are eligible to make an election under these transition rules whether or not they previously used the Simplified Resale Method." If the change is made in accordance with Rev. Proc. 94-49, the absorption ratios for the three-year test period will have been computed in connection with the opening inventory revaluation.

LIFO Recapture Tax in C to S Conversions... (Continued from page 22)

3. If the taxpayer has used some method other than that illustrated in the example, is the taxpayer required to initiate any action or file any form or schedule to receive approval from the IRS of its alternative treatment?
4. What should a taxpayer do if it mistakenly concluded that its LIFO election as a C corp was simultaneously terminated by its S election? Should amended returns be filed for all S years to recompute continuing LIFO reserves? How are these taxpayers now to disclose their unauthorized termination of their LIFO election?
5. What if a taxpayer began its LIFO computations for its first S year using an index of 1.000 instead of using the cumulative index as of the end of the last C year? **This throws off all LIFO calculations for all S years.** Should amended tax returns be filed? Even for years beyond the normal 3-year statute of limitations? Can taxpayers apply the *Hamilton* result (i.e., no statute of limitations on inventory adjustments) and make the net cumulative adjustment for all closed years in the earliest open year?
6. How should auto dealers who use specific identification (and do not value their inventory at <u>FIFO</u>) determine their Section 1363(d) adjustment amount? May a "shortcut" method be used to approximate FIFO?

The *De Filipps' Dealer Tax Watch* newsletter is a quarterly publication of essential tax information by Willard J. De Filipps, CPA, P.C., 317 West Prospect Avenue, Mt. Prospect, IL 60056. It is intended to provide accurate, general information on tax matters and it should not be construed as offering accounting or legal advice or accounting or legal opinion on any specific facts or circumstances. The contents are intended for general information purposes only. Readers should consult their certified public accountant, attorney and/or other competent advisors to discuss their own situations and specific income tax questions. Mechanical or electronic reproduction or photocopying is prohibited without permission of the publisher. Annual subscription: $325. Back issues available for $70 each. Not assignable without consent. Any quoted material must be attributed to *De Filipps' Dealer Tax Watch* published by Willard J. De Filipps, CPA, P.C. Editorial comments and article suggestions are welcome and should be directed to Willard J. De Filipps at (708) 577-3977; FAX (708) 577-1073. *De Filipps' Dealer Tax Watch* format designed by *Publish or Perish,* (708) 289-6332.

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SPECIAL SUPPLEMENT

De Filipps' DEALER TAX WATCH

A Quarterly Update of Essential Tax Information

OVERVIEW OF THE AUTOMOTIVE INDUSTRY

Keynote speakers at the First Annual AICPA National Auto Dealership Conference providing an overview of the automotive industry were J.D. Power III in Las Vegas and Maryann Keller in New Orleans. Each commented on past developments and trends and on future expectations as they affect auto dealers...and, indirectly, their CPAs. Their comments suggest that CPAs, as tax planners, will have their hands full as they continue to advise dealers caught in their volatile environment.

MEGATRENDS: J.D. POWER III

J.D. Power indicated that the industry was moving forward, but not as fast as he thought possible. The reason for this slower than expected movement was because, in his opinion, there is excessive reaction against - and resistance to - change.

An "information revolution" has been underlying all the changes that have been going on in the industry for many years. There has also been an exponential growth in technology. The accelerated increase in the rate of change has resulted in an "overload" which has had the effect of really freeing up consumers ...and this information is being spread among all consumers. As consumers become more informed on an overall basis, they have developed into the force that is driving the economy.

There is plenty of change going on and many organizations and dealerships are struggling to survive by maintaining the status quo...and that just won't do.

Industry has been rapidly globalizing, creating inter-dependency among all manufacturers. J.D. Power expects this trend will continue and increase in the future. The manufacturers now have open minds to arrangements and joint ventures to fill product needs that literally were unheard of in the past. This global production pressure will continue with the technology transfer happening at a rapid pace. This, in turn, will require realignments to achieve economies of scale among the first, second and third tier level of suppliers.

As a result of these fundamental overall changes, it is no longer possible for a manufacturer to control the market. It is also very difficult for the manufacturers to adapt to the new realities of the marketplace and dealers, for the most part, are also reluctant to change. Nevertheless, the consumers' demand for value - as they define value - has resulted in their being freed up by the events of the last 15 years. Consumers now have plenty of choices, especially because of the parity in designs and styles, product dumping that was going on in the late '80's, rebate and interest financing incentives and programs and advertising that kept customers well informed. All of these resulted in a "decline in the brand image." In addition, others were offering lower prices and alternative price arrangements so that the consumer ended up with even more choices...and the consumer is exercising those choices...and the press keeps the consumer well aware of these choices.

For the near term, J.D. Power projects steady sales, which are likely to be increasing. However, there will be continuing pressure on margins and pressure for consolidation at the retail level. He believes it will be necessary to wring distribution costs out of the system because the ratio of distribution costs to manufacturing costs is now too high as a result of the new technology at the manufacturing level. Consequently, consolidation is expected to occur all along the line. Right now, 5% of the dealer principals control 25% of the new vehicle volume and manufacturers are adding more and more models

see **OVERVIEW OF THE AUTOMOTIVE INDUSTRY**, page S-2

just to survive. However, in adding more models, manufacturers did not increase volume - they just increased the per unit cost of distribution. Unfortunately, dealers have no recourse but to participate financially in this tremendous inefficiency.

According to J.D. Power, "we have far too many dealers for today's market needs." But, according to dealers, it's always the other guy that needs to leave. Power predicts that margins will become even tighter in the future and he believes that a single point dealer/ franchise cannot survive in the future!

In the past, manufacturers had to protect the "franchise system" and this was done by protecting dealers who were just selling cars and not servicing them. "But we still are fixed on our facilities requirements...it just doesn't make any sense."

As manufacturers merge and consider joint venture and advantageous product and market agreements, they clearly don't want to have their power shifted to the retailers. According to J.D. Power, what the manufacturers don't realize is that the power has already shifted...past the retailer...all the way down to the consumer level! Accordingly, consumers are no longer willing to listen to the manufacturers at all. Consumers in our economy are the most competitive and most demanding anywhere.

LEASING: "Leasing is a situation that has developed to replace the program cars." Discounts are being provided under the guise of a leasing program. Approximately 80% of the people who have leased cars have gone back into the market for another lease. But, somebody has to pay for leasing which is simply an alternative way of financing and is most attractive to only certain types of consumers. However, the second time around the lessee won't have much to go in with and by the time a lessee comes in on the third lease, the leasing cycle consequences will be terribly and irrevocably evident.

LIGHT TRUCK MARKET: Light trucks now have over a 40% share of the market. The design of sport utility vehicles has made them more like passenger vehicles. Power expects the market will remain strong for another year or so, but by the time all of the manufacturers have their sport utility vehicles in place, there probably will be a glut among them...which may even reach down to the minivan level.

ONE PRICE/NO HAGGLE PRICING: This development has been based on consumer wants and demands. It is hard for many dealers to change the way they run their dealerships to accommodate these new consumer demands. However, demand clearly has caught on. Some dealers claimed they were doing one price or no haggle pricing, but they were really still trying to treat the customer the same way they always had been. That behavior has set the "one price/no haggle" movement back somewhat...but not rendered it ineffective. It does have a place in the retail environment since approximately 80% of the consumers are absolutely disgusted with the negotiating process. (Incidentally, Power's research indicates that those macho types who claim they got the best deal on their vehicles actually turn out to have paid more for their vehicles!)

VALUE PRICING: Value pricing is here to stay...and it's working primarily for the consumer. Dealers who recognize this will be able to make more money at it. The MSRP doesn't really set the price...(who even looks at it these days?)...the customer really sets the price.

AUTO MALLS AND AUTO CENTERS: These are just a step in the direction of consolidation. It helps the customers to have a destination and these auto malls and centers draw from a wider circle of buyers. However, as such, today's auto malls and centers aren't the pure answer because of the system out there. What customers really need is an auto mall where all of the pickups or all of the sport utility vehicles or all of the vehicles of any particular style (i.e., where all of the brands) are placed side-by-side...so that comparative shopping is made easier...for the customer! That's the way people really shop!

UNBUNDLING OF USED CARS: Power anticipates that there will be a split-off of the used vehicle business from the new vehicle business over a period of time. This may even be accompanied by an unbundling of the parts and service departments. Customers actually will get better service out of facilities that are primarily dedicated to service. He even looks for "Factory authorized service centers" - but not for quite a while.

CAN A SINGLE POINT DEALER/FRANCHISE SURVIVE IN THE FUTURE? J.D. Power thinks not! Query: What does this mean for CPAs with relatively small single-point dealer automotive practices?

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EVOLUTION OF AUTO RETAILING: MARYANN KELLER'S SUMMARY

First, The rate of wholesale price increase has been greater than the rate of increase in dealer invoice prices.

Second, Special value pricing, whereby the manufacturers build specific cars with specific features, has been perceived as less expensive. What dealers selling these special value priced vehicles lose in profit margin, they make up in volume.

Third, Dealer gross margins have been going down and average gross profit per car has been declining over the years...from 9.2% in 1983 to 8.4% in 1987 down to 6.7% in 1993.

Fourth, Sources of "other income" have all shrunk: F & I income, long a source of good income, has been drying up... also: gap insurance, extended warranty protection, changes in the way people are purchasing shifting from conventional purchasing to leasing.

Fifth, Growth of leasing, with the entrance of the Japanese into leasing, and more recently with leasing spreading to all makes and models and to all income groups. If the lease is a manufacturer set lease, the opportunity for dealer profit goes down. Maryann Keller expects leasing to grow over the years, but with that growth to take place in fits and starts.

Sixth, Dealers are under increasing competitive pressures to deal with the after-market services. As a result of pressure from the manufacturers to increase CSI, many are open longer hours. Vehicle quality is increasing... so the need for warranty work is decreasing. Normal/ routine maintenance, lengthening cycles of maintenance and increasing intervals between maintenance all adversely affect dealer revenue from these sources.

Seventh, Used car market and used car prices have been increasing. Many program cars are simply new car substitutes. Cars coming off lease are going into used car inventories. Households have become "blended populations" with new, used and wagons or vans all sharing the same driveway. Less credit worthy purchasers are getting some attention by Buy-Here, Pay-Here and other efforts.

Manufacturers are preferring to have fewer dealers, which is cheaper for the manufacturers to administer, thus concentrating more business into the hands of a smaller number of better dealers.

Within dealerships, specialist personnel functions have developed, capital investments have increased and management information systems have had to be upgraded. Customers are travelling greater distances to purchase vehicles. Auto malls are enticing people to come in and see more vehicles in a shorter period of time.

see **OVERVIEW OF THE AUTOMOTIVE INDUSTRY**, page S-4

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When asked whether she thought a single point dealer could survive in the near future, Maryann Keller's answer was: "That depends on the brand and the market." She does expect single point dealers to come under increasing pressure in the future. As more independent institutional financing dollars come in, the ability to spread costs over larger volumes will favor larger dealers.

MAKE COMMENTS

Maryann Keller calls it like she sees it:

Chrysler	A clear winner from the product standpoint. The company/manufacturer against which others benchmark themselves because it made real changes instead of superficial changes. But the question is: Can Chrysler maintain its momentum?
Ford	Starting worldwide reorganization shortly.
General Motors	Stagnated, unresponsive to the world around it. Hasn't demonstrated the ability to launch a new car efficiently.
Japanese manufacturers	Not at their peak; however, there is a clear distinction of winners and losers.
Toyota	Clearly head and shoulders a giant above all the others because it is behaving in a very non-Japanese manner in not trying to protect its cartel.
Mazda and Nissan	Both very financially troubled companies, with Mazda effectively taken over by Ford. Nissan struggling with more than $20 billion dollars in debt, ultimately to end up selling fewer cars.
Volkswagen	Ignored the U.S. for about a decade to its peril. It also ignored the Japanese. Now it will pay more attention to the U.S. market and make a commitment to products that will be salable here.

CONCLUSION

Both J.D. Power III and Maryann Keller provided thought-provoking comments that can lead to productive discussions and strategy sessions with dealers in reviewing the impact of these changes... as well as in considering how to best plan for, cope with, and manage changes that are already on their way.