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. NADA AUTO DEALER CONVENTION & EXPOSITION. The 1995 NADA Convention in Dallas (February 11-14) was well worth attending. Many tax and dealership profitability subjects were discussed in application oriented workshops by highly qualified experts. You can get full benefit from these workshops by purchasing the Convention tapes and the presenters' outlines. We have selected four workshops and summarized them in this issue.

The day before the Convention, the February 10 *Wall Street Journal* had a front-page article about many dealerships on the verge of being combined into large retail chains. And some of these emerging chains are publicly-held corporations.

The *WSJ* article includes the observation that a crucial factor in this "trend" - if it is a trend - is that many mega-dealers who went into auto sales during the post-war boom are now in their '60's and are thinking about retirement. But, many of these dealers' children are not interested in coming into the business and helping run it - if anything - they seem to be more interested in running away from it. So...these dealers, with no qualified successors to run the business, are looking for an "exit strategy." It will be interesting to see just how strong this trend towards large retail chain consolidation really becomes.

Another trend, somewhat more ominous and seemingly less speculative, is that for many dealers the more recent months of robust activity and profitability may be coming to an end as consumer spending declines and more businesses continue downsizing and rightsizing.

#2. FINANCIAL STATEMENT CONFORMITY REQUIREMENT FOR AUTO DEALERS USING LIFO. This is still the hottest IRS audit issue for auto dealers using LIFO and Peter Kitzmiller picked up on it immediately in opening his Tax Update Workshop at the NADA Convention. This controversy has been covered extensively in the *LIFO Lookout* and repeatedly summarized here in the *Dealer Tax Watch*.

There have been absolutely no new developments in the last 3 months reflecting any progress toward any resolution of this issue.

Unfortunately, the IRS is not anxious to jump right in and solve the LIFO conformity problem...especially since NADA recently indicated that its limited survey showed that 85% of the dealers on LIFO had financial statement conformity violations. That adds up to one heck of a lot of revenue!

In some instances, examining agents are now going back into dealerships looking for ways to toss out a LIFO election on the basis of conformity infractions. If you are interested in more information on

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WATCHING OUT FOR

this, see the March, 1995 *LIFO Lookout* or call us and we'll be happy to send you our reprints on this escalating mess.

#3. CURRENT IRS ACTIVITY. The IRS continues its audit activity with different degrees of impact and emphasis around the country. Recently, a major case involving the taxation of service contract revenues was argued in Chicago. The Service position was that the dealer should be taxed sooner on all of the revenues and allowed a deduction later for actual expenses. When the Court's opinion and decision is made final, we will cover it in detail.

In the meantime, the recent case of *Martin L. Springfield d/b/a Douglas Motors* (decided December 9, 1994) in the U.S. District Court, Southern District of California, emphasizes the extreme importance of proper worker classification for automobile dealerships - as well as for all other businesses.

In this case, the dealer's treatment of salespersons as independent contractors was overturned by the IRS and resulted in significant assessments for unpaid employment taxes, interest and penalties. This taxpayer was assessed back taxes, interest and penalties for five years - 1983 through 1987 - because he treated used car salespersons as independent contractors (instead of employees) even though Forms 1096 and 1099 were filed for all of the years involved! Because no employment tax returns (Forms 940 and 941) were ever filed, the statute of limitations was never started.

This recent case provides the basis for our in-depth, technical analysis of problems relating to proper worker classification. A major part of this case addressed the Section 530 safe harbor relief provisions which generally are not available to many dealers. We have included — and hope you will find useful — several practice aids for helping dealers understand the risks and ramifications of treating workers as independent contractors.

#4. DEALERSHIP UNIFORM CHART OF ACCOUNTS. At the NADA Convention, there was considerable discussion about the prospects of NADA's introducing a uniform chart of accounts for dealership financial statements and operating reports. There are currently 22 different charts of accounts that controllers and dealers (as well as CPAs) have to contend with. This creates many unnecessary burdens, as well as the possibility of errors, for many dealerships which have to prepare reports for several different manufacturers.

NADA tried to interest the IRS in accepting a uniform chart of accounts for automobile dealerships, in part as a way of trying to cope with the current LIFO conformity problems. The IRS wasn't interested. Therefore, this uniform Chart of Accounts project, at the present time, if it proceeds will have to do so without IRS approval or blessing.

#5. USED VEHICLE LOTS: BUY HERE, PAY HERE. The IRS is continuing to raise questions regarding used car buy-here, pay-here activities...particularly where related parties and tax entities are involved and notes are being transferred or sold at heavy discounts.

One *DTW* reader reported a very successful resolution of major audit issues at the Appeals level. The *Car Dealer Insider* recently reported that there is still significant IRS interest in discounts being claimed in situations where a related finance company holds reserve account balances.

#6. SALE OF S CORP STOCK AND LIFO INVENTORIES. Several callers have raised the same question regarding what happens to a dealer's LIFO reserve when stock is sold in an S corporation dealership valuing its inventories at LIFO. Is there a recapture of the LIFO reserve when the stock of the dealership is sold? ...Obviously there is LIFO reserve recapture when assets are sold.

There appears to be no specific statutory or regulatory requirement — nor is one implied from other sources — when the sale of stock in an S corporation occurs. Accordingly, it would seem that a stock sale would not trigger the recapture of the LIFO reserve under these circumstances. However, it would not be surprising if some theory-happy IRS agent were to come along and raise the issue citing as authority at least the general rationale underlying the enactment of Section 1363(d).

If readers have had any recent experiences or intensively researched this issue, your comments would be appreciated and will be shared with other readers. This is another very common situation for which there appears to be nothing directly on point in print in black and white.

An even more interesting variation would occur if, in negotiating the price of the S corporation dealership's stock, the purchaser took into account the potential tax liability and paid a reduced price for the S corporation stock. It is not uncommon for a knowledgeable purchaser to acquire stock, anticipating and discounting the potential tax liability that goes along with the lower-than-actual-cost tax basis of the LIFO inventory. Readers comments would be welcome.

#7. MORE IRS ACTIVITY COMING THIS SUMMER. MSSP activity is in evidence everywhere and the commencement of those dreaded "every-line-on-the-tax return" TCMP (Taxpayer Compliance Measurement Program) audits is upon us.

NADA CONVENTION: AN OVERVIEW

The 1995 NADA Convention and Exposition was held in Dallas on February 11-14, 1995. We took our own advice and attended the NADA Convention in search of commercial, educational and inspirational benefits. Reflections on the Convention are strongly influenced by one's reflections on the Workshops attended and the thoughts stimulated over the four-day period. I attended several Workshops including Ken Blanchard's "Raving Fans" and "The Future is Closer Than You Think." More Workshops were offered than one could attend or absorb. But, attendance at workshops is only part of the experience of attending a Convention and Exposition such as NADA's.

In order to maintain our perspective on things, it helps to understand that "life is what happens when we're making other plans." It also helps to realize that that oft-seen bumper sticker, interpreted in light of our current experiences involving business down-sizing, right-sizing and re-engineering is more appropriately translated: "Shift happens." And we are forced, literally, to reckon with an increasing acceptance of technology and shifts in customer attitudes, as well as our own. Technology - the "deity of the 80's" - has become the "tool of the 90's." Einstein's "theories" have now become accepted and recognized as laws and Keynesian theory has, to a significant extent, been replaced by game theory. Individuals affluent enough to purchase whatever they would like have to deal with "winners dilemma" - the paradox that when you get what you want, you're afraid you paid too much for it!

The Convention notebook filled with speakers' outlines offers much technical, practical and inspirational information: From cartoons of characters pulling and pushing wagons with square wheels to all types of diagrams to inspirational quotes ("Do not let what you cannot do interfere with what you can do")..., there is much to absorb your thoughts over the summer months.

Regardless of one's background or experience, it is impossible not to find at least a few Workshops where you can simply listen and learn new insights on what is going on around you as you labor intensively in your own specialized pursuits. I became acquainted with the "buzz words" for different leadership styles including the "mushroom theory," the "seagull theory" and, most graphically: the "Grand Canyon theory" (that's where the leader sits on his ___ (rhymes with grass) and rides the business into a hole in the ground).

Other new definitions encountered included that of the "true conservative" - defined as the man with a teenage daughter. And new insights on today's emphasis on structuring shopping "experiences" to appeal to the public's overwhelming dissatisfaction with shopping experiences in general, replacing what used to be emphasis on quality, services, style and selection with an activity that simply maximizes the "experience" of purchasing a product, as if the product itself were of lesser importance.

ADVICE FOR CPA FIRMS SPECIALIZING IN DEALERSHIPS

Borrowing from Blanchard's SuperWorkshop presentation, CPA firms looking to expand their auto dealership clientele might consider three ways to compete and decide which is best suited to their own styles and personalities.

- Organizational efficiency — compete on price. These days, it is difficult to build an overall strategy on price alone...let alone a fair price...when competitive pressures are as strong as they are.
- Product innovation — based on quality and based on the quality of the product or service offered. In today's consumer-oriented environment, quality is almost a given, assumed by the potential consumer to be there as an integral part of the "package."
- Customer intimacy/service. According to Blanchard, you can't just satisfy customers, "you have to blow them away." Reach out to the customer/dealer in your efforts to gain their acceptance and confidence. Send out a "picture" of the perfection in what you are trying to be or to accomplish and have a set of operating values that you will use to implement that view. If you don't aim for perfection, you don't have a shot at excellence. Values should be rank ordered because when a conflict occurs, you've got to know what to do. Discover what the customer/dealer client wants by listening and then Explore, Acknowledge and Respond...and be tenacious in the implementation.

That's enough to hold anyone for many months...but it's not too soon for those who plan ahead to block out February 10-13, 1996 so you can attend the 1996 NADA Convention in Las Vegas.

BUSINESS SUCCESSION & CONTINUITY PLANNING FOR DEALERS

NADA WORKSHOP

Bucky de Vries broke the ice in his Workshop presentation on dealership succession and continuity planning by observing that estate planning is seldom a choice between good and bad. More accurately, it requires choices between uncomfortable and unacceptable actions that must be taken. Ironically, these days, many dealers spend more time planning their vacations than they spend planning their estates.

The big "enemy" out there is the Government, with its confiscatory estate tax rates reaching as high as 55%. And, when you're really into more sophisticated planning techniques, the incremental rate can be as high as 82%!

QUIZ

- What percentage of American families pay estate taxes? (Answer: Less than 2%)
- If I have a will or trust, is my estate planning okay? (Answer: Not necessarily)
- Does my will or trust include a plan for the business? (Answer: Usually it does not)
- What percentage of businesses pass successfully from the first to the second generation? (Answer: ± 50%)
- What percentage of businesses pass successfully from the second to the third generation? (Answer: Not more than 10%)
- Are life insurance proceeds always income and estate tax free? (Answer: No)
- Would you have heart surgery done by a general practitioner? (I think we get the point!)

This Workshop was presented using a case study involving a typical dealer/spouse situation in which there are two adult children already working in the dealership and two other children not working in the dealership (one a successful doctor earning ample income from his medical practice and the other child married to a school teacher who is hardworking, but not earning more than enough to barely get by on and who seems to feel that maybe they should be "entitled" to some additional consideration).

In the estate planning balance sheet presented, the business real estate rough appraisal valued at $5,000,000 comprises approximately one-third of the total net assets, including insurance. The dealership real estate will be one of the key factors in the overall planning process.

USE OF UNLIMITED MARITAL DEDUCTION

Under the presentation of the estate distribution "before planning" or "as is," the old 50% marital deduction was being used in the dealer's will...instead of the unlimited marital deduction that has been available for many years.

Accordingly, the most obvious planning change suggested is for the dealer to defer all estate tax until the death of his spouse because there is no good economic reason to pay any estate tax at the death of the first spouse (assuming the dealer's marriage is stable). If the spouse survives the dealer by at least three or four years, then the assumed appreciation in the estate assets and property over that period of time will more than compensate for the fact that the projected total estate taxes (combining the estate taxes projected to be paid on both estates over both deaths) is slightly greater than the estate tax projected under the original, as-is situation reflecting a 50% marital deduction. The key strategy that is intended to make this work is based upon the expectation that the surviving spouse will eagerly and energetically participate in major gifting activities during the remainder of her lifetime.

DEALER OBJECTIVES

- Assure themselves that their current, ample standard of living can be continued for the rest of their lives,
- Remove themselves from the on-going personal guarantees required by the Bank in connection with financing the dealership operations,
- Provide the opportunity for the dealership to be continued by the children already working in the business (i.e., there is a mindset here to continue the business),
- Treat their children equally both during their lifetimes and after their deaths, and
- Attempt to do something for one of the children not working in the business and that child's spouse to alleviate their constant struggles with financial pressures.

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OTHER SPECIFIC PLANNING SUGGESTIONS

A second change suggested was to transfer the insurance for the benefit of the wife to an irrevocable insurance trust, giving her the right to income for life, but without burdening her estate with the principal value. It is, of course, necessary for the dealer/donor setting up the insurance trust to outlive the gift by three years or else the gift will be brought back into his estate as a gift in contemplation of death.

In addition to these major changes, a credit equivalent exemption trust of $600,000 is provided for, along with a Q-TIP trust under Section 2056(b)(7).

BUSINESS CONTINUITY CONSIDERATIONS

A number of problem areas relating to dealership continuity and management problems were isolated and discussed. These included considering which family members were willing and which were really capable of making management decisions and whether there were conflicts among any of the family members. To the extent conflicts were made known and subject to discussion, could these conflicts be reconciled or were these conflicts irreconcilable? Understanding and attempting to work with these issues is the very heart of the estate planning process. These problems may require years to identify, resolve and — hopefully — work out. In many instances, they are totally overlooked because the "estate planning professional" is completely blind to this aspect of the practice.

These issues are followed by more practical questions: How should stock be distributed? To whom should stock be distributed? What type of taxable entity should be the recipient of gifted stock? What should be the timing of the gifts? Answers to each question spawn variations and alternative planning scenarios.

DEALERSHIP VALUATION

In the Workshop case study, the dealer's balance sheet valued the dealership stock at net book value. Regarding the valuation of the dealership stock, is book value really appropriate as the measure of the dealership's fair market value? Usually...and obviously...it is not.

Various definitions of fair market value were discussed, including that commonly parroted by IRS agents, CPAs and attorneys having to do with reasonably informed buyers and sellers possessing all relevant facts, not being under any compulsion to buy or sell, etc.

Mr. de Vries put forth a "more realistic, real life". definition of fair market value:

FMV

"That value determined by an unwilling tax attorney and an unwilling IRS agent, neither having direct knowledge of the real experience of buying, selling or operating dealership businesses, and both being under pressure to settle the dispute."

Most of us can relate far better to that than to the pat definition most agents and CPAs have memorized for "fair market value." Sometime, try putting that one in your "Dealership Valuation Report."

Other areas considered were the effect on estate costs resulting from valuing the dealership stock at amounts greater than "book value" and the impact on the available liquidity of the estate.

In working through several of the other continuity concerns, it is interesting to note that the hypothetical dealership was a C corporation - not electing S for any number of reasons. In the real life situation on which the Workshop dealership case study was based, the banks refused to let the dealer principal get off of the personal guarantees on the bank loans. So in this regard, one of the dealer's overall planning objectives could not be satisfied. However, that should not - and it did not - prevent other estate planning actions from being taken.

As to the dealer's desire to treat the four children equally, the conflict is obvious between (1) the dealer and dealer spouse's need for income and their mandate that their current standard of living should not be impaired and (2) the desire to treat all four children equally. It was suggested that one approach to reasonable resolution of these "equality" conflicts is to consider the entire issue along the lines of trying to keep things/results "fair"...not necessarily equal for all of the children. This is particularly difficult where some of the children are active in the business and others are not, but all of whom have their own family needs, responsibilities and demands.

PROVIDING FOR THE DEALER'S SURVIVING SPOUSE

In addressing the income needs of the surviving spouse - or if not "needs," the possibilities of providing her with additional income - a variety of different dealership situations and facts and circumstances will be found. If the dealer's spouse has also worked in the business and contributed measurably to the success of the business, then the spouse's continuing to draw a salary after the dealer's death would

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seem to be reasonable. On the other hand, if the dealer's spouse never worked in the dealership - and especially if an argument for estate tax purposes will be made that the dealership is not worth much more than book value (and therefore, it cannot afford to pay salaries of any major amount to family members) - planning strategies will have to change and supporting rationales will vary.

In order for the dealership to provide a fixed amount of income on an annual basis to a non-working spouse, a highly profitable regular C corporation would have to earn $3 in order to be able to pay out $2 (after corporate tax) to the surviving spouse. In the hands of the surviving spouse, this $2 will be subject to regular income tax as ordinary income in the form of a dividend from the dealership corporation.

UNFUNDED SALARY CONTINUATION PLAN

One strategy to side-step a good portion of the unfavorable result discussed above might be to have the corporation adopt an unfunded salary continuation plan. Under such a plan, the corporation - in recognition of services previously rendered to the dealership by the dealer - agrees to pay the dealer's spouse for 10 years an annual amount equal to the dealer's annual salary. One attractive feature in this arrangement is that the surviving spouse/wife does not have to provide services to the dealership in consideration for the payment; the services for which payment will be made have already been rendered by the dealer during his lifetime.

A further advantage of this arrangement is that, assuming the payments are "reasonable" in amount, the corporation will be entitled to deduct these payments as compensation for services rendered. Thus the corporation does not incur the adverse non-deductible "dividend" tax treatment for these payments.

PLUNDERERS VS. PARASITES

In discussing the "equalization" of the estate in terms of attempting to treat the children equally, Mr. de Vries presents an interesting shift in thinking in terms of how the children relate to each other: Those children not working in the business are viewed as "parasites" by those working in the business. Conversely, the children working in the business are viewed as "plunderers" by those children not working in the business. To the plunderers (children working in the business), the dealership stock has value because it represents future opportunity; to the parasites (children not working in the business), the dealership stock is regarded as a liability because of the estate tax burden associated with it.

Distributions to the children working in the business (i.e., the plunderers) in the form of salaries and bonuses will be tax deductible by the corporation. Distributions to the children not working in the business (i.e., the parasites) will be non-deductible dividends, subject to double taxation (thus putting a crimp in the dealership after-tax cash flow).

In reflecting further on these terms, I can recall many conversations over the years with dealer's children working in the dealership who regarded their siblings outside the dealership as the "plunderers" who were trying to drain as much as they possibly could out of the dealership by placing the cash needs of the dealership secondary to their own "insatiable" need for more funds. I can also recall many conversations with the children not working in the dealership who regarded their siblings working in the dealership as the "parasites" draining everything they could out of the dealership and leaving very little available for distribution to the inactive shareholders. I guess these "parasite" - "plunderer" labels depend on whether you're an "insider" or an "outsider." Ah! Semantics.

OTHER PROBLEM AREAS

Equal is not always fair and it may be best to try to approach fairness first.

1. Should all the children be allowed to purchase stock equally? Some may feel they should be allowed to do this and others may strenuously object to allowing siblings outside the business the opportunity to acquire (by gift or otherwise) stock in the dealership.
2. Should the stock be sold or gifted? If sold or gifted, at what value? The observation was made that a reputable appraisal firm should be hired to provide a valuation for the dealership and that firm generally should not be the current CPA firm. There may be conflicts of interest present in the valuation process which the CPA either overlooks or does not even realize are present.
3. How should the real estate be treated? The real estate in this situation has great potential for a variety of planning techniques.
4. What methods should be employed for controlling estate growth: gifting, family (limited) partnerships, charitable trusts, various other trusts of the GRIT, GRAT and GRUT variety...as well as generation-skipping trusts.

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THE INDIRECT TAX OF INFLATION & WAYS TO AVOID IT

After discussing various ways and methods of paying estate tax (by cash, sale of assets, bank borrowing, use of Section 6166 for installment payments of certain estate tax obligations and amortization during one's lifetime by the purchase of insurance), the Workshop discussion turned to the indirect tax of inflation that hits many dealers' estates. In the Workshop case study, if the $14,000,000 estate grows over a few years to $20,000,000, the net additional spendable amount the children eventually receive will be astonishingly small:...less than $1,000,000. The $6,000,000 increase in the overall estate values will result in only a meager net increase in funds ultimately passing to the children. Question: Why grow at all? Why not control the estate growth through a variety of available techniques?

Under the GRIT, GRAT or GRUT arrangements, there are specific time frames which the dealer/donor must outlive in order for the desired results to be obtained. In other words, each of these trust arrangements has a set time frame which the donor must outlive. A GRIT is a Grantor Retained Income Trust which can only hold a donor's residence or vacation home. A GRAT is a Grantor Retained Annuity Trust which must have income producing property in it. A GRUT is a Grantor Retained Unit Trust which pays out a fixed percent return each year. If a dealer is going to set up a GRIT, GRAT or GRUT, it is necessary to select a term of years that the dealer/donor has a reasonably good chance of outliving.

Charitable trusts are another means of controlling estate growth, but the motivation underlying the creation of charitable trusts should be to benefit the charity involved rather than to save estate taxes. Generation-skipping trusts allow a dealer to pass up to $1,000,000 (with a second $1,000,000 for the dealer's wife) to the second generation (thus, skipping the first generation). It is important to stay below the $1,000,000 exception because any amounts in excess of $1,000,000 passed in a generation-skipping trust or arrangement will be subject to an 82% tax rate.

CONTROLLING ESTATE GROWTH BY MAKING GIFTS

The final emphasis in the Workshop was placed on gifting as the best way to beat the direct tax/estate tax as well as the indirect tax/inflation.

Generally, it is inadvisable for a dealer to make gifts of cash or property that is less likely to appreciate. Usually, it is better make gifts of stock in the dealership corporation because that stock is expected to appreciate, or to make gifts of interests in real estate that is expected to appreciate. If a dealer can do so without affecting his/her life style or sense of security, gifts can be made of up to $600,000 without incurring any current estate/gift tax liability. In addition to this, it is also possible to make gifts of up to $10,000 per year per donee by the dealer and by the dealer's spouse.

Of all of the assets that are owned in the typical dealership situation, the only asset that cannot be put into a family limited partnership would be stock in an S corporation, if the dealership is run as an S corporation. In the Workshop case study, it was suggested that the dealer by setting up a family limited partnership could maintain control by retaining as little as a 2% interest (as general partner) while giving away as much as 98% of the value in the form of limited partnership interests. In the process of valuing gifts of these family limited partnership interests, significant discounts can be claimed for lack of marketability and lack of control. All of this has to be structured very carefully, but in the proper hands, these results can be approximated and/or accomplished.

EXPENSE CONTROL:
HOW TO CUT COSTS IN *EVERY* DEPARTMENT

NADA WORKSHOP

This Workshop, subtitled "Expenses: A Different Perspective," was conducted by Carl Woodward, an amply qualified CPA from Bloomington, Illinois. His "different perspective" is simply that

A DIFFERENT PERSPECTIVE

if a dealer is contemplating spending $1,000 on an expense item and his net profit as a percentage of sales is 3%, then the dealer should be thinking that it will take an additional $33,334 of sales just to offset or pay for the $1,000 expense item being contemplated.

Woodward suggests that it will be necessary for many dealers to correct their attitude about expenses because unless they have the discipline to cut expenses when volume changes, they will not be able to survive the next business downturn. He urges dealers to stop procrastinating and to not put off doing what they know they need to do. In many instances, it is important to know what's good or what's bad or to have an idea of what's "out of line," and various comparative expense ratios can provide this information.

In a very real sense, this Workshop employs a "benchmarking" approach to get dealers to compare and question their own expenses in relation to published averages. Great stress (Carl good-naturedly calls it "beating on dealers") is placed on urging the dealer to not settle for just being average...why work long hours, invest great amounts of capital, and incur significant risk...just to be "average?"

The Workshop began by allowing attendees a few minutes to complete an "automobile expense survey." From their own input and estimates, dealers could go back home and check their numbers against (1) "averages" drawn from larger group experience as interpreted by Carl Woodward and (2) a host of checklists included in the presentation outline and Carl's incisive, analytical comments.

NET PROFIT AS A % OF SALES

The single best indicator of how good an operator a dealer is: **net profit as a percent of sales**. As compiled last year by NADA, this was 2.3% before tax. In the group of approximately 150 dealers serviced by the Workshop moderator, that group realized 2.6% as net profit before taxes as a percentage of total sales. However, if you drop off the bottom 20% in that dealer group, reducing the group to 120 dealers, the net profit percentage goes up to 3%.

In analyzing costs and expenses, Woodward suggests that the dealer use his November statement (not the December statement) because LIFO adjustments and bonus and compensation adjustments tend to distort the December year-end statement for expense analysis purposes. Being a few percentage points or dollars different from the overall pattern may result in some people feeling complacent; it may result in others feeling like they need to tighten up considerably.

Woodward's overall philosophy regarding expenses is easy.

WOODWARD ON EXPENSES

- **SHIFT THEM,**
- **SHARE THEM,**
- **REDUCE THEM**
- **...OR BEST OF ALL, GET RID OF THEM!**

In working through a list of 40 suggestions, one by one, each of which had been applied (rather than theorized), Woodward's main emphasis to the dealers was that "if you're below average, don't be innovative...follow the pack...you can't afford to try to be innovative."

NEW VEHICLE INTEREST EXPENSE

One major indicator is gross new vehicle interest expense as a percentage of total vehicle gross profit. This is now up to about 28% with the interest rate up and many dealers experiencing a rising days supply of cars. This is a critical factor to be watching at this time. In emphasizing the control of floor plan interest expense, particularly by reviewing the days supply and monitoring it carefully, a "typical" dealer last year had a 2 months supply and paid 7% interest or a total of $222 per unit. This year, that typical dealer in 1995 will probably have his 60 day supply go up to 75 days, and with an increase in the interest rate from 7% up to 10% will pay $395 in interest per new retail vehicle. This will eat up a lot of gross profit, especially for import dealers who do not have interest credits.

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WOODWARD ON CONTROLLING COSTS

DEMONSTRATORS — Charge employees for demos if they do not meet minimum performance standards. Tell them that when they sell 8 cars, the next car will be worth $300 to them (providing them with a "free" demo at that point only).

SALESPERSONS — Settle up with salespersons once a month - not once a week - for their compensation and commissions. This will offset the possibility of bunching car sales in one period and alternating minimum wage checks with large commission checks. It may also help avoid minimum wage problems down the road.

F & I PERFORMANCE — The F & I person's performance is the most easy to measure in a dealership. It is not a function of CSI; it is a function of skill level. Less than $200 per retail deal is generally unsatisfactory...get rid of that poor performer. Carl adds, with a smile on his face: "Don't let the door hit 'em in the backside on the way out."

LIFO — To those auto dealers who are not using Last-In, First-Out (LIFO) for their inventories:

- Thanks for paying **MORE** than your share of taxes.
- **YOU'RE** keeping taxes lower for all the rest of us.

HOSPITALIZATION INSURANCE — If the dealership is currently paying 100% of the cost of employee hospitalization insurance, consider freezing the plan at the present time and telling employees that they will start to pay a portion of any future increase in hospitalization coverage costs.

TAX DISPUTES — In connection with unemployment taxes and property tax disputes, obtain the services of specialized advisory services where you need them to review assessments or claims.

BIG TICKET PURCHASES — For computer system purchases, the standard discount off list is sometimes as high as 70% and 50-60% discounts have been "regularly seen."

BANK F & I CHARGEBACKS — Banks don't always compute F & I chargebacks correctly. Get a chart and train somebody to double-check all chargeback calculations.

SERVICES — For all services, including professional services, call every (yes, **EVERY**) service provider and ask them: "What can we do to help keep this in line?...or to make it lower?"

For any dealer (or CPA) who critically analyzes expenses and applies even a few of the suggestions provided in this Workshop, the rewards will be tremendous and the discipline of the process should become contagious.

BENCHMARKING FOR PROFITS

NADA WORKSHOP

Benchmarking is defined as "the process of measuring a dealership's performances and practices with the best practices in existence and then implementing those practices in the dealership to achieve superior performance." This activity can be applied to both financial and customer satisfaction areas with significant results.

The Workshop presenters (Messrs. Robert Frawley and Kevin Machell-Cox) emphasized that it is important not to compare with "averages" because an average represents the best of the worst and the worst of the best. An "Average" truly represents a nonexistent dealer situation. Instead, benchmarking should involve a process of looking only at the best...then striving to diminish the "performance gap" existing between the dealer's current results and the results obtained by the best performer in the group.

If you decide to benchmark a dealership, the dealership of comparative reference should be of approximately the same size and preferably it should be in the same market. The "key" is to pick the best and most appropriate benchmark.

PHASES

- Planning
- Data Gathering
- Analysis
- Implementation
- Staying the Course (Monitoring Results).

In the initial phase of planning the benchmarking process, selection of the areas needing improvement that can be benchmarked is important and CPAs can readily assist here. Expense results should be benchmarked just as intensively as "gross" performance indicators, since both revenues and expenses make up the total equation of interest. Carl Woodward's workshop on Cutting Costs in Every Dealership Department provided plenty of specifics on how this could be done.

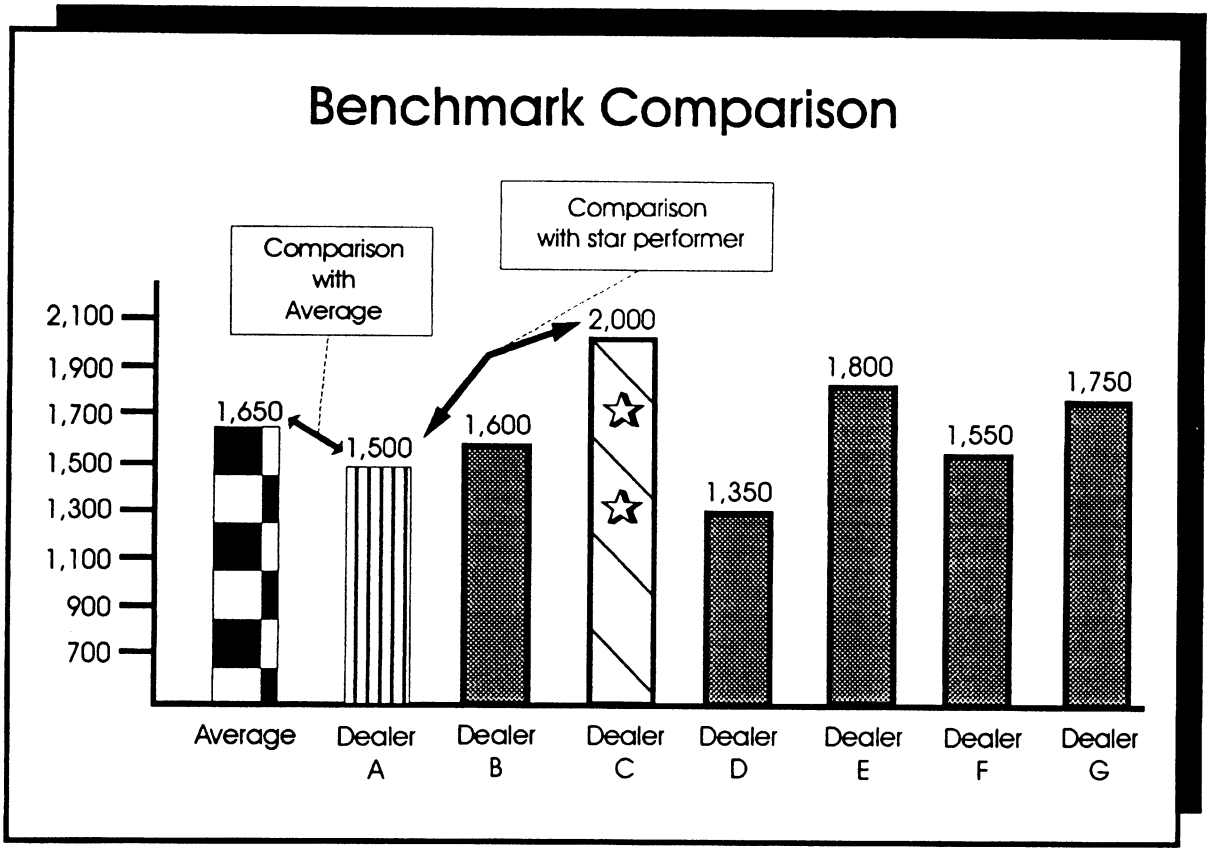
It was suggested that a "benchmarking team" should be set up within the dealership. This team should include the general manager, dealer principal and/or department managers. This is where the CPA's role can be critical and catalytic not only in planning, but in monitoring and "staying the course" throughout the process.

DATA GATHERING

There is plenty of information available against which all types and kinds of benchmarking comparisons may be drawn. Dealer 20 Group composites, information published annually in surveys by NADA and by NCM Associates, and *Dealer Business*' Database 2000 composite information all provide ready information broken down in countless ways, in departmental detail and in make/franchise detail.

The *AICPA Auto Dealership Engagement Manual* (reviewed in the December, 1994 issue of the *Dealer Tax Watch*) includes an extensive discussion on "benchmarking" and the information presented in the *AICPA Manual* on benchmarking is consistent with the NADA Workshop presentations.

With so much detailed information readily available, it would seem to be grossly inefficient for any CPA firm on its own to "reinvent the wheel" in the data collection process. Many other organizations with superior resources have great head starts in compiling and arraying this information. The major service CPAs can provide for their dealer clients is in the comparative interpretation and review of the efforts made to reduce "performance gaps" where appropriate.



If Dealer A uses the group's average of $1,650 as its benchmark target, its performance gap is only $150. If the star performer is used as its benchmark, the performance gap in $500.

Dealers may face difficulty in trying to implement efforts to achieve the best practices in their own dealership's environment. In this regard, the Workshop presenters pointed out that employees must be convinced that they are not being asked to achieve the impossible and that it is necessary to set time aside out of very busy schedules to sit down and understand the benchmarking process and what goals and objectives are intended to be achieved. The process of setting specific and realistic goals and working up a timetable for the accomplishment of those goals offer CPAs golden opportunities to contribute to the process.

Although the application focus of the benchmarking Workshop (and process) may be either financial or customer (CSI) oriented applications, the disciplined approach will apply and pay dividends to either application. The final phase of benchmarking - "staying the course" - is possibly the hardest phase because change is not a straight line process. It is important to keep employees motivated, to tell them often what they should be doing and to show them how they should be doing it. The importance of persistence and perseverance is obvious, as is the need to reinforce people and to provide them with performance incentives. These are yet other areas where the CPA can provide valuable assistance.

Benchmarking is <u>not</u> simple, competitive analysis. It is about discovering and implementing superior performance and Best Practices in order for the dealership to become the best that it can be. Benchmarking provides wonderful, open ended opportunities for CPAs to help their dealership clients!

Who could ask for <u>anything more</u>?

SPRINGFIELD D/B/A DOUGLAS MOTORS VS. U.S.A. USED CAR SALESPERSONS ARE NOT INDEPENDENT CONTRACTORS

A recent case (decided December 9, 1994) in the U.S. District Court, Southern District of California, emphasizes the importance of proper worker classification for all businesses, including automobile dealerships.

This case hits close to home insofar as the taxpayer, Martin L. Springfield d/b/a Douglas Motors, was assessed back taxes, interest and penalties for the years 1983 through 1987 because used car salespersons were treated as independent contractors (instead of employees) even though Forms 1096 and 1099 were filed for all of the years involved.

FACT PATTERN

Martin Springfield d/b/a Douglas Motors purchased a used car business in 1981 which he operated as a sole proprietorship. The business operated out of a warehouse location which included both indoor and outdoor space for displaying vehicles to the public. The business primarily consisted of purchasing autos at wholesale auctions and reselling those vehicles at other wholesale auctions, with sales to retail customers in between.

Mr. Springfield entered into agreements with several persons, in what were "typically long term relationships," allowing them to sell used automobiles to retail customers and provided them with business cards. These salespersons had keys to the warehouse and applied their extensive experience in the used automobiles sales industry in the course of displaying and negotiating the sales transactions with retail customers. Retail customers were attracted to the used car facility by advertising Mr. Springfield placed on a weekly basis.

These salespeople were paid on a commission only basis, receiving no fixed salary. The commission these salespeople received was 30% of the net sales price reduced by the cost of the vehicle and a "pack" to cover overhead. Retail customers made their checks payable to Douglas Motors, and not to the individual sales representative. The used vehicles had been detailed and/or reconditioned at the expense of Mr. Springfield/Douglas Motors who also made the final determination as to which used vehicles would be sold at a wholesale auction and which used vehicles would be sold at retail.

The salespersons were on the business premises during normal business hours and negotiated trade-in values. They negotiated trade-in value amounts which were subject to Mr. Springfield's approval and to his final determination. If any customer complaints arose, they were handled initially by the salespersons unless a "major problem" arose after the sale of the vehicle. If a "major problem" arose, it was handled by Mr. Springfield who carried a beeper so that he would be on call if he was needed to clear anything major concerning the business activity.

The salespeople were paid the total amount of their commissions earned at various intervals, averaging once every two weeks. Workers' compensation insurance was provided for the salespeople by Mr. Springfield who retained the right to terminate the relationship of any or all of the salespeople at any time as well as retaining the right to have them "turn in their keys to the warehouse" at any time.

Detailed statements of the seven issues and the District Court's conclusion are on the facing page.

WORKER CLASSIFICATION DISPUTE

The used car salespersons were classified or characterized as independent contractors - rather than as employees - by the business. Accordingly, the business did not file employment tax returns nor did it pay any employment taxes. Interestingly enough, although Mr. Springfield had entered into written agreements with at least three of the salespeople, these agreements were never placed in evidence for the Court's review.

Each year from the inception of the business through 1988, the business did file Forms 1099 information returns with the Internal Revenue Service. Thus, the business had been consistently treating the salespersons as independent contractors insofar as the business was concerned. Beginning with the taxable quarter ending June 30, 1989, the business began treating these salespeople as employees.

During the first quarter of 1991, an IRS audit commenced in which the classification of the salespeople as independent contractors — as distinguished from "employees" — was questioned. The IRS ultimately made assessments for withholding taxes, interest and civil penalties.

see **SPRINGFIELD D/B/A DOUGLAS MOTORS VS. U.S.A...**, page 14

INDEPENDENT CONTRACTOR STATUS DENIED FOR USED CAR SALESPERSONS

MARTIN SPRINGFIELD D/B/A DOUGLAS MOTORS VS. U.S.A. - DECEMBER 9, 1994

ISSUES	DISTRICT COURT HOLDINGS
1. Does the statute of limitations bar the IRS from collecting assessments for (a) Social Security taxes, (b) unemployment taxes, (c) civil penalties, (d) failure to file penalties and (e) interest...for the years 1983, 1984, 1985, 1986, 1987?	1. No; the statute of limitations does not bar collection of taxes, penalties and interest. The filing of Forms 1096 and 1099 did not start the running of the statute of limitations. The proper forms that should have been filed were Forms 940 and 941.
2. Were the assessments of civil penalties under IRC Section 6652, 6676 and 6722 proper in this case?	2. Yes; the assessment of civil penalties was not improper. The taxpayer did not establish a legal basis for relief.
3. Were the salespersons employed (during the years in issue) common law employees for Federal employment tax purposes?	3. Yes; the salespersons were common law employees - and not independent contractors.
4. Is taxpayer entitled to relief from liability for tax assessments under the "safe harbor" provisions of Section 530 of the Revenue Act of 1978 (as amended by the TEFRA - Tax Equity and Fiscal Responsibility Act of 1982)?	4. No; taxpayer was not entitled to relief under any of the "safe harbor" provisions of Section 530.
5. Were taxpayer's rights violated by the IRS in asking for and reviewing his business records and personal tax returns prior to an audit being opened?	5. Taxpayer's rights were not violated. Taxpayer's contention that the failure of the IRS to follow certain unspecified procedures in its Internal Revenue Manual did not violate his rights. The Internal Revenue Manual was adopted for the internal administration of the IRS, rather than for the protection of the taxpayer,...and the Manual does not confer any rights upon the taxpayer.
6. Should the doctrine of equitable estoppel be applied under the circumstances in favor of the taxpayer?	6. No; that doctrine is not applicable under the evidence in this case.
7. Are various sections of the California Vehicle Code applicable and relevant regarding the salespersons' status as employees and/or applicable to the analysis of relief under Section 530 of the Revenue Act of 1978?	7. No; various provisions of the California Vehicle Code are inapplicable and irrelevant in these analyses.

(Continued from page 12)

The Court's Findings of Fact (31-33) recognized that a distinction is drawn in the used automobiles sales industry between retail salespersons and wholesale salespersons and that retail salespeople have traditionally been treated as employees. While some distinction may exist between franchise dealers and independent dealers, there does not appear to be a long-standing practice of a significant segment of the used automobile sales industry in treating retail salespersons as independent contractors. The Court found that the weight of evidence supports the factual finding that retail salespeople are treated as employees.

Another Finding of Fact was that the taxpayer did not conduct a thorough investigation into the relevant law and practice at the time he began hiring these salespersons.

FILING FORMS 1099 DID NOT START THE STATUTE OF LIMITATIONS

The taxpayer argued that filing Forms 1099 started the running of the statute of limitations on the assessment of the taxes in this case. Unfortunately for the taxpayer, the Court upheld the position of the IRS which was that the proper tax returns, Forms 940 and 941, had to be filed with the Internal Revenue Service in order to begin the running of the statute of limitations. Because such tax returns (i.e., Forms 940 and 941) were not filed, the statute of limitations never began to run. In looking at relevant case law, the Court pointed out that the filing of the Form 1099 did not trigger the 3-year statute of limitations because the information returns were not "the returns" contemplated by the statute. The "Forms 1099 were simply not the proper returns to have been filed in this context."

This holding was made over the taxpayer's argument that the filing of Forms 1099, along with the filing of his own 1040 and a Schedule C (this business was operated for tax purposes as a sole proprietorship) should have been sufficient to alert the IRS to the fact of the mischaracterization of employees. In a prior case (*Gintner*), the Form 1099 was not sufficient in and of itself to alert the IRS officials as to the worker classification problem.

The Court stated that: "Neither Plaintiff's Form 1040 with its Schedule C, nor the Form 1099s would show the facts in which liability would be predicated in this case. Those documents do not provide any clues that the recipients are in actuality employees. While they demonstrate the existence of claimed independent contract workers, standing alone they do not show a mischaracterization issue nor the basis upon which additional tax liability would be predicated."

ADDITIONAL PENALTIES

Additional civil penalties were assessed because the IRS Examination Report previously provided to the taxpayer did identify the need to file Forms W-2 for the salespersons involved and extended time for compliance with this filing requirement. However, the taxpayer did not file W-2's as requested and by not filing the forms (which would have mitigated the penalties somewhat) left the door open for these penalties to be assessed.

SALESPERSONS WERE EMPLOYEES UNDER COMMON LAW

The factors which the Court analyzed and the relevant case law selected as the basis for its opinion is summarized on the facing page. These "7 factors" (as well as the overall 20 factors in Revenue Ruling 87-41) were discussed in the context of the fact pattern presented.

The Court stated that the salespersons involved did not "profit" because they had no investment of their own in the vehicles sold...despite the fact that they were obviously renumerated or paid a commission based upon each sale that was made. Any special negotiating skills or sales experience that these workers might possess and employ in persuading a perspective retail customer to buy an automobile at a negotiated price was not considered at all. The Court noted that most of the sales personnel had long-term relationships with the business and they were subject to the will and control of the taxpayer as to how and what should be done, thus they were working in an employer/employee relationship.

The Court completely discounted the physical dimensions of the car lot and the size of the inventory as factors in determining whether the salespersons were employees, looking instead to the "nature of the association between Springfield and the salespersons in determining the automobile salespersons were employees rather than independent contractors."

see **SPRINGFIELD D/B/A DOUGLAS MOTORS VS. U.S.A...**, page 16

FACTORS THE COURT CONSIDERED IN DETERMINING EMPLOYEE STATUS

MARTIN SPRINGFIELD D/B/A DOUGLAS MOTORS - DECEMBER 9, 1994

SEVEN CRITERIA

1. If the person receiving the benefit of a service has the right to control the manner in which the service is performed, the person rendering the service may be an employee.
2. If a person rendering a service has a substantial investment in his own tools or equipment, he may be an independent contractor.
3. If a person performing a service undertakes a substantial cost, say by employing and paying his own laborers, he may be an independent contractor.
4. If a person performing a service has an opportunity to profit depending on his management skill, he may be an independent contractor.
5. If a service rendered requires a special skill, the person rendering it may be an independent contractor.
6. If the relationship between a person rendering a service and the person receiving it is permanent, it may be an employment relationship.
7. If a person rendering a service works in the course of the recipient's business, rather than in some ancillary capacity, he may be an employee.

The Court indicated that no one single factor listed above is dispositive, rather, the determination of whether an employer - employee relationship exists depends "upon the circumstances of the whole activity." It also cited:

REGULATION SECTION 31.3401(c)-1(b)

> "Generally the relationship of employer and employee exists when the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished. That is, an employee is subject to the will and control of the employer not only as to what shall be done but how it shall be done. In this connection, it is not necessary that the employer actually direct or control the manner in which the services are performed; it is sufficient if he has the right to do so. The right to discharge is also an important factor indicating that the person possessing that right is an employer. Other factors characteristic of an employer, but not necessarily present in every case, are the furnishing of tools and the furnishing of a place to work, to the individual who performs the services. In general, if an individual is subject to the control or direction of another merely as to the result to be accomplished by the work and not as to the means and methods for accomplishing the result, he is not an employee...
>
> "Whether the relationship of employer and employee exists under the usual common law rules will...be determined upon an examination of the particular facts in each case."

SIX CASES CITED AS PRECEDENT BY THE DISTRICT COURT

1. Avis Rent-A-Car System v. U.S. 503 F. 2d 423, 427 (2nd Cir. 1974)
2. United States v. Silk 331 U.S. 704 (1947)
3. Bartels v. Birmingham 332 U.S. 126 (1947)
4. General Investment Corp. v. United States 823 F. 2d 337 (9th Cir. 1987)
5. Real v. Driscoll Strawberry Associates, Inc. 603 F. 2d 748, 754 (9th Cir. 1979)
6. Rutherford Food Corp. v. McComb 331 U.S. 722, 730 (1947)

(Continued from page 14)

NO "SAFE HARBOR" RELIEF UNDER SECTION 530

The taxpayer alternatively claimed that it should be afforded relief under Section 530 of the Revenue Act of 1978. This Section provides that a worker shall not be deemed to be an employee unless the taxpayer has no reasonable basis for not treating the worker as an employee. Three "safe harbors" form the basis for an objective "reasonable basis" standard. These are:

SAFE HARBORS

- Reliance on judicial precedent, published rulings or technical advice or a letter ruling to the taxpayer,
- Reliance on a past favorable IRS audit on the same issue, or
- Treating the particular workers as independent contractors was the long-standing, recognized practice of a significant segment of the industry in which the individual was engaged.

In addition to requiring a reasonable basis for failing to treat a worker as an employee, Section 530 requires that a taxpayer must have filed all applicable Federal tax returns (including Forms 1099). The taxpayer has the burden of showing that he satisfies the requirements for relief under Section 530.

Although there has been much debate and uncertainty over quantifying one's eligibility for "safe harbor" treatment, this case of *Springfield D/B/A Douglas Motors* provides very interesting and objective information which all automobile dealerships can expect or should expect to be applied in any situation where they classify workers as independent contractors.

The "similar segment of the industry" requirement involves similar sized operations located in the same geographic region as the taxpayer as constituting the proper "segment of the industry" for review. Accordingly, the applicable industry segment for comparison in the *Springfield/Douglas Motors* case was the San Diego metropolitan area, "the geographic area in which the plaintiff operated his retail car sales business." In this regard, the Court "reviewed the practice of similar companies within that area based on the evidence submitted by the parties." The taxpayer was found to have failed to prove that it was a long-standing, recognized practice of a significant segment of the used automobile sales industry in the metropolitan San Diego area to treat retail salespersons as independent contractors during the periods in issue.

The Court found, on the contrary, that retail salespersons had, for the most part, been traditionally treated as employees in that San Diego area, although it acknowledged "some contradictory practice in that community." It is most important to take warning from the Court's comments that although the plaintiff presented evidence that some used car businesses treated salespersons as independent contractors, that evidence does not allow the plaintiff to qualify for the "industry practice" safe haven since Section 530 only protects individuals who follow the "long-standing practice of a significant segment of an industry." Where various segments of an industry are using contradictory practices, logic and the law dictate that there is no "long-standing recognized practice." Thus, the fact that different members of the industry were treating salespersons differently mandates a finding that the "industry practice" safe haven relief of Section 530 is unavailable.

This should be fair warning for many automobile dealerships taking a "more aggressive" position relative to worker classification in questionable situations.

The Court also made a point of emphasizing the fact that the taxpayer failed to demonstrate that it had a "reasonable basis" for treating salespersons as independent contractors. The Court pointed out that "misunderstanding or confusion about the law is not a defense for failing to properly characterize employees or pay employment taxes." Mr. Springfield testified that he had never consulted with attorneys, CPA's, representatives of the IRS or of the Employment Development Department concerning the applicable standards and requirements. He simply relied on things he had heard from others, rather than making his own inquiry.

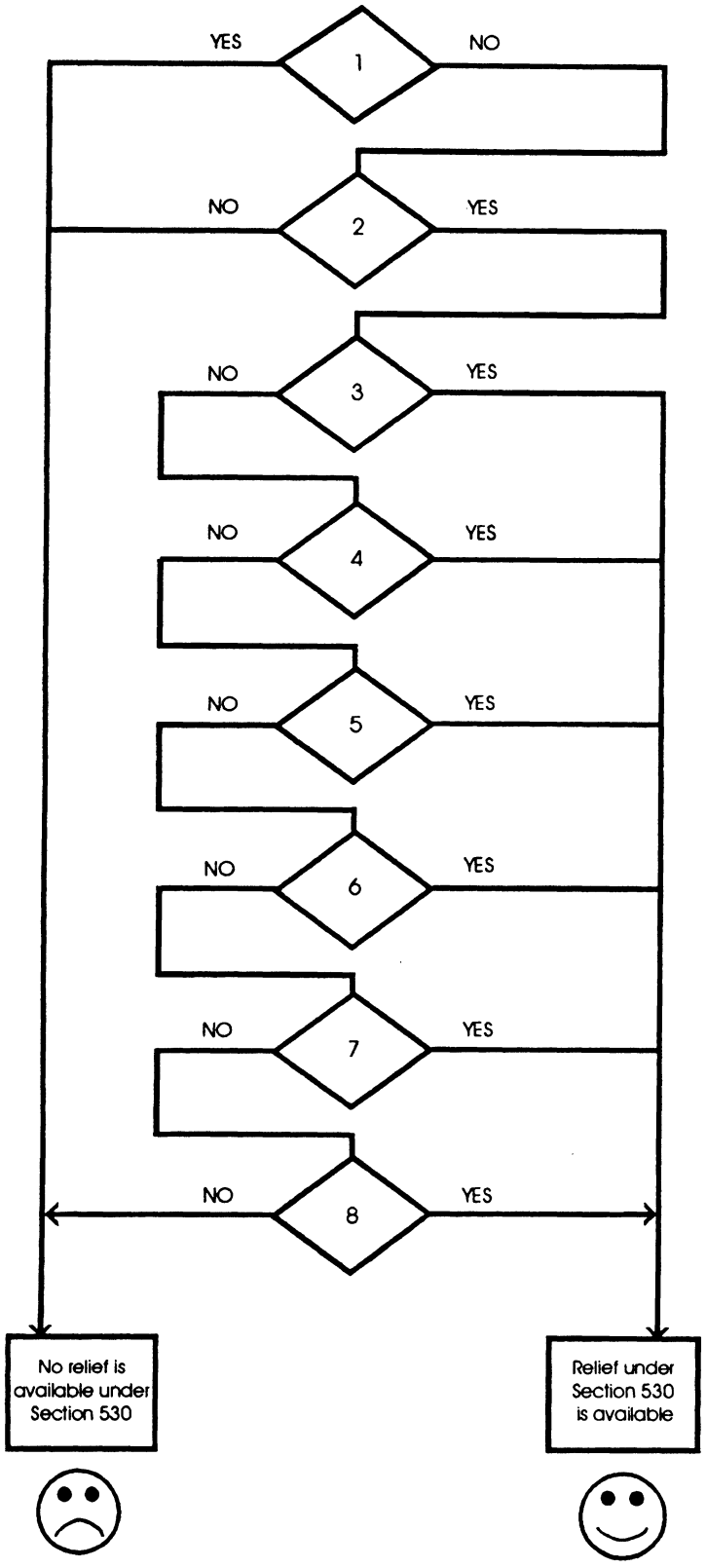
Insofar as the taxpayer claimed that the IRS failed to follow certain procedures in its own manual, the Court noted that "it is clear that the IRM does not create substantive rights in favor of the plaintiff."

CAN ANYBODY REALLY WEIGH 20 FACTORS & REACH A CONCLUSION? COULD YOU?

The *Springfield/Douglas Motors* employment tax case raises major concerns for a dealership taking virtually any position classifying workers as independent contractors, rather than employees. This is not

see **SPRINGFIELD D/B/A DOUGLAS MOTORS VS. U.S.A...**, page 18

Section 530 Safe Harbor Relief Flowchart *



Answer the 8 questions:

1. Has the taxpayer "treated" the individual or any other individual holding a substantially similar position as an employee during the period under examination or a prior period?
2. Were all Federal tax returns (including information returns, Form 1099) required to be filed for the period under examination by the taxpayer with respect to the individual filed on a basis consistent with treating the individual as not being an employee?
3. Is there a judicial precedent or published ruling under which the individual may reasonably be considered as not being an employee?
4. Has technical advice or other determination been issued with respect to the taxpayer indicating the individual (or a class of individuals) should not be treated as employees?
5. Does the taxpayer have a letter ruling indicating the individual (or a class of individuals) should not be treated as employees?
6. Was there a prior IRS examination for a period in which the taxpayer employed the individual (or the class of employees) in question and employment taxes were not an issue?
7. Is it a long standing recognized practice of a significant segment of the industry to treat such individuals as not being employees?
8. Did the taxpayer have any other reasonable basis for treating the individual as not being an employee?

* Source: Internal Revenue Manual

(Continued from page 16)

to say that independent contractor status may be inappropriate in all cases; it is to say that relief under Section 530 is extremely limited and that the "20 common law factors" set forth in Revenue Ruling 87-41 in many instances seem to create a presumption that employee status will be found in most grey area or "borderline" situations.

One of the big problems with Revenue Ruling 87-41 is that the 20 factors are not given any weighting or ranking or priority and that classification decisions are "facts and circumstances oriented." Judge Battaglia in the Southern District of California decision involving *Martin Springfield d/b/a Douglas Motors* referred to the fact that the taxpayer did not seek professional advice in advance of classifying workers as independent contractors. But what advice might Mr. Springfield have received if he had first inquired from professional advisors on this point?

One recent study observes that "research in cognitive psychology states that individuals are not capable of assessing the relative importance of as many as 20 factors in making a decision...this points to the need to identify a smaller sub-set of factors determined to be relatively more important to the decision and/or to attach weights of importance to the factors under consideration." In a *Tax Notes* (December 13, 1993) Special Report, three associate professors did a study on this very specific subject, collecting information from 107 volunteer CPA tax professionals who attended the AICPA National Tax Education Program in July, 1992. From 93 valid responses from tax professionals who "had experience with and knowledge of employee/independent contractor issue," these professors compiled a set of tables indicating the "relative importance of 20 common law factors."

The results indicate that for the total sample, five different factors received substantial weights in the following order:

FIVE IS ENOUGH

- Realization of profit or loss.
- Significant investment.
- Full-time requirement.
- Making services available to the general public.
- Working for more than one firm at a time.

Interestingly enough, the first two factors evidence the economic relationship between the parties, the last two factors evidence the operational relationship between the parties and the one in the middle (i.e., full-time required) is a factor evidencing control by the service recipient.

SUMMARY: EMPLOYEE VS. INDEPENDENT CONTRACTOR STATUS

- Any IRS examining agent reviewing worker classification status literally has any one of 20 choices from which to glean the emphasis necessary to support his or her opinion that employee (rather than independent contractor) classification is appropriate.
- Every situation where a worker is not treated as an employee should be carefully examined and reevaluated in light of the specific analysis applied by the District Court in the *Springfield/Douglas Motors* decision.
- In each instance where dealership workers are not treated as employees, Forms 1096 and 1099 should be filed by the dealership. The dealership should be advised that the filing of Forms 1099 does not start the statute of limitations running as a protective measure against the assessment of employment tax liabilities. Query: Should Forms 940 and 941 be filed showing zero/no tax liability in order to try to get the 3-year statute of limitations running?
- The dealership should have in its permanent file a properly completed Form W-9, Payer's Request for Taxpayer Identification Number and Certification, from every worker treated as an independent contractor. Persons not treated as employees should also be informed that failure to properly complete the form and return it will result in the dealership's withholding 20% of their compensation as back-up Federal withholding tax.
- Situations that may represent borderline cases in dealerships where special caution should be exercised in reviewing and documenting the facts include (1) used car detailers, (2) security personnel and (3) drivers/hikers and other delivery personnel.
- Written agreements with workers establishing their independent contractor relationship may afford additional protection to the dealership. These agreements should contain representations and statements relative to the working relationship that will support independent contractor status. All such agreements should be prepared and/or approved by dealership counsel and retained permanently.

TAX UPDATE: IRS "SHORT LIST"

NADA WORKSHOP

At the 1994 NADA Tax Update Workshop, a panel of speakers discussed a long list of IRS hot topics. This was summarized in the June, 1994 *Dealer Tax Watch.* In contrast this year in Dallas, the "Tax Update - IRS Short List" took only four subjects that were selected based on the number of calls that NADA had received from dealers during the past year.

Peter Kitzmiller, Assistant Director of Regulatory Affairs for NADA, presented this Workshop and discussed only the four topics below. Much of the Workshop time was questions and answers — and anyone interested in good "nuts and bolts," down to basics discussions can pick up the details by simply listening to the Workshop tape. As an alternative, you can look them up in NADA's recently issued *Dealer Guide to Federal Tax Issues.*

LIFO CONFORMITY REQUIREMENTS

Much has been written about this subject (in the *LIFO Lookout* and in summary form in prior issues of the *Dealer Tax Watch*) and the importance of this issue was further emphasized by Peter Kitzmiller's attention to it in the Tax Update Workshop. He reviewed the conformity requirements, what IRS agents are requiring to be done in order to satisfy them and presented an update of the efforts undertaken by NADA recently in working with the IRS to try to resolve this issue.

The impact of a conformity violation will be the termination of the LIFO election with an immediate payment of the tax attributable to the LIFO reserve, interest and possibly penalties. In some instances, the result may be termination of the business if the dealer can't pay the tax deficiency! Recently, the IRS announced a very restrictive interpretation requiring that the current year impact of a change in the LIFO reserve should only be reflected through the Cost of Goods Sold section on the dealer's financial statements which are sent to the manufacturer. Any other disclosure - such as in "Other Income" or "Other Expenses" - would not be acceptable to the IRS.

Although Kitzmiller expressed guarded optimism regarding the possibility of the IRS providing relief for dealers on this issue, to date nothing has been forthcoming and in some jurisdictions it even appears that the IRS has stepped up its audit activity scrutinizing LIFO conformity problem areas.

Kitzmiller reported on a meeting held in early February with the IRS at which NADA presented its views that this was an industry-wide problem for dealers using LIFO and pointed out that various manufacturers have different reporting requirements in place for their dealer body financial statements. Kitzmiller indicated that a recent limited survey conducted by NADA "found" that almost 85% of all dealers on LIFO would have conformity problems - that's invalid LIFO elections in plain language - under the IRS' more recent interpretations of the Regulations.

TAXATION OF DEMONSTRATOR VEHICLES

This area has also received a lot of attention in recent IRS audits and many dealership controllers are confused by the general rules. The major issues discussed were the $3 a day commuting rule, recordkeeping requirements imposed upon salespersons, the application of the salesperson exemption to sales managers and the need for written demo policies.

LUXURY TAX

In connection with the luxury tax, Peter observed that now almost every dealership in the U.S. has to deal with this tax. Attention was given to many basic computational questions, as well as to luxury tax issues in connection with lease and trade-in transactions.

CASH TRANSACTION REPORTING

The last areas covered in the Workshop related to cash reporting and money laundering. Kitzmiller indicated that NADA expects another round of audits because the IRS thinks there is a decrease in compliance because fewer Forms 8300 have been filed recently. Kitzmiller suggested that dealers order the Cash Reporting tape from NADA and have their sales people view it and then sign an affidavit that they have viewed the tape on such and such date and reviewed it again on a second date ...and that they agree to comply with all of its conditions.

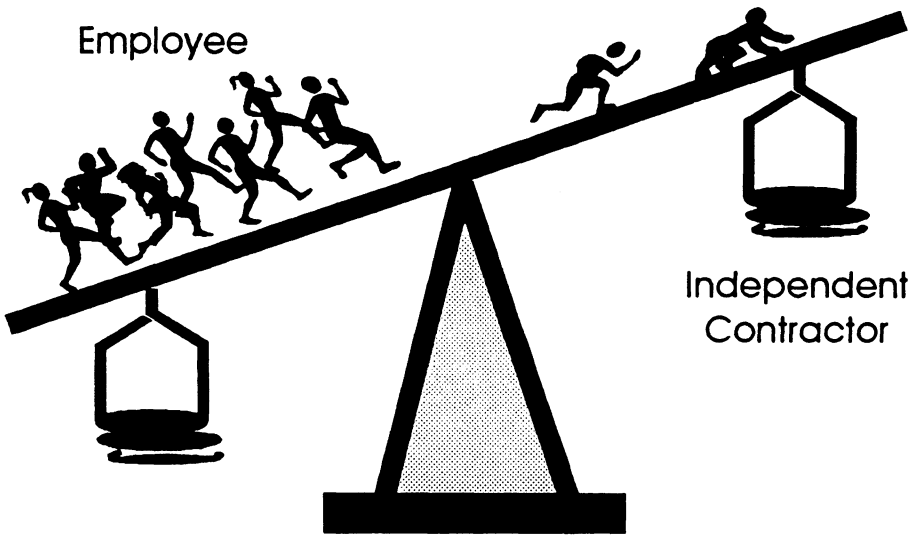
REVENUE RULING 87-41: 20 FACTORS - LONG FORM

WORKER CLASSIFICATION: EMPLOYEE VS. INDEPENDENT CONTRACTOR

20 factors or elements "designed only as guides for determining whether an individual is an employee."

1. **INSTRUCTIONS.** A worker who is required to comply with other persons' instructions about when, where, and how he or she is to work is ordinarily an employee. This control factor is present if the person or persons for whom the services are performed have the **right** to require compliance with instructions.
2. **TRAINING.** Training a worker by requiring an experienced employee to work with the worker, by corresponding with the worker, by requiring the worker to attend meetings, or by using other methods, indicates that the person or persons for whom the services are performed want the services performed in a particular method or manner.
3. **INTEGRATION.** Integration of the worker's services into the business operations generally shows that the worker is subject to direction and control. When the success or continuation of a business depends to an appreciable degree upon the performance of certain services, the workers who perform those services must necessarily be subject to a certain amount of control by the owner of the business.
4. **SERVICES RENDERED PERSONALLY.** If the services must be rendered personally, presumably the person or persons for whom the services are performed are interested in the methods used to accomplish the work as well as in the results.
5. **HIRING, SUPERVISING AND PAYING ASSISTANTS.** If the person or persons for whom the services are performed hire, supervise, and pay assistants, that factor generally shows control over the workers on the job. However, if one worker hires, supervises, and pays the other assistants pursuant to a contract under which the worker agrees to provide materials and labor and under which the worker is responsible only for the attainment of a result, this factor indicates an independent contractor status.
6. **CONTINUING RELATIONSHIP.** A continuing relationship between the worker and the person or persons for whom the services are performed indicates that an employer-employee relationship exists. A continuing relationship may exist where work is performed at frequently recurring although irregular intervals.
7. **SET HOURS OF WORK.** The establishment of set hours of work by the person or persons for whom the services are performed is a factor indicating control.
8. **FULL TIME REQUIRED.** If the worker must devote substantially full time to the business of the person or persons for whom the services are performed, such person or persons have control over the amount of time the worker spends working and impliedly restrict the worker from doing other gainful work. An independent contractor, on the other hand, is free to work when and for whom he or she chooses.
9. **DOING WORK ON EMPLOYER'S PREMISES.** If the work is performed on the premises of the person or persons for whom the services are performed, that factor suggests control over the worker, especially if the work could be done elsewhere. Control over the place of work is indicated when the person or persons for whom the services are performed have the right to compel the worker to travel a designated route, to canvass a territory within a certain time, or to work at specific places as required.
10. **ORDER OR SEQUENCE SET.** If a worker must perform services in the order or sequence set by the person or persons for whom the services are performed, that factor shows that the worker is not free to follow the worker's own pattern of work but must follow the established routines and schedules of the person or persons for whom the services are performed. Often, because of the nature of an occupation, the person or persons for whom the services are performed do not set the order of the services or set the order infrequently. It is sufficient to show control, however, if such person or persons retain the right to do so.
11. **ORAL OR WRITTEN REPORTS.** A requirement that the worker submit regular or written reports to the person or persons for whom the services are performed indicates a degree of control.
12. **PAYMENT BY HOUR, WEEK OR MONTH.** Payment by the hour, week or month generally points to an employer-employee relationship, provided that this method of payment is not just a convenient way of paying a lump sum agreed upon as the cost of a job. Payment made by the job or on a straight commission generally indicates that the worker is an independent contractor.

(continued)



13. **PAYMENT OF BUSINESS AND/OR TRAVELING EXPENSES.** If the person or persons for whom the services are performed ordinarily pay the worker's business and/or traveling expenses, the worker is ordinarily an employee. An employer, to be able to control expenses, generally retains the right to regulate and direct the worker's business activities.

14. **FURNISHING OF TOOLS AND MATERIALS.** The fact that the person or persons for whom the services are performed furnish significant tools, materials and other equipment tends to indicate an employer-employee relationship.

15. **SIGNIFICANT INVESTMENT.** If the worker invests in facilities that are used by the worker in performing services and are not typically maintained by employees (such as the maintenance of an office rented at fair value from an unrelated party), that factor tends to indicate that the worker is an independent contractor. On the other hand, lack of investment in facilities indicates dependence on the person or persons for whom the services are performed or such facilities and, accordingly, the existence of an employer-employee relationship.

16. **REALIZATION OF PROFIT OR LOSS.** A worker who can realize a profit or suffer a loss as a result of the worker's services (in addition to the profit or loss ordinarily realized by employees) is generally an independent contractor, but the worker who cannot is an employee. If the worker is subject to a real risk of economic loss due to significant investments or a bona fide liability for expenses, such as salary payments to unrelated employees, that factor indicates that the worker is an independent contractor. The risk that a worker will not receive payment for his or her services, however, is common to both independent contractors and employees and thus does not constitute a sufficient economic risk to support treatment as an independent contractor.

17. **WORKING FOR MORE THAN ONE FIRM AT A TIME.** If a worker performs more than de minimis services for a multiple of unrelated persons or firms at the same time, that factor generally indicates that the worker is an independent contractor. However, a worker who performs services for more than one person may be an employee of each of the persons, especially where such persons are part of the same service arrangement.

18. **MAKING SERVICE AVAILABLE TO GENERAL PUBLIC.** The fact that a worker makes his or her services available to the general public on a regular and consistent basis indicates an independent contractor relationship.

19. **RIGHT TO DISCHARGE.** The right to discharge a worker is a factor indicating that the worker is an employee and the person possessing the right is an employer. An employer exercises control through the threat of dismissal, which causes the worker to obey the employer's instructions. An independent contractor, on the other hand, cannot be fired so long as he or she produces a result that meets the contract specifications.

20. **RIGHT TO TERMINATE.** If the worker has the right to end his or her relationship with the person for whom the services are performed at any time he or she wishes without incurring liability, that factor indicates an employer-employee relationship.

Worker Classification Analysis Worksheet
Employee (E) vs. Independent Contractor (I/C) Status

Factors	*Facts*	*Comments*	*E*	*I/C*
1. Instructions				
2. Training				
3. Integration				
4. Services Rendered Personally				
5. Hire, Supervise and Pay Assistants				
6. Continuing Relationship				
7. Set Hours of Work				
8. Full Time Required				
9. Working on Employer's Premises				
10. Order or Sequence Set for Work Activity				
11. Oral or Written Reports				
12. Payment by Hour, Week or Month				
13. Reimbursement of Expenses				
14. Furnishing of Tools & Materials				
15. Significant Investment				
16. Realization of Profit or Loss				
17. Working for More Than One Business				
18. Services Available to General Public				
19. Right To Discharge				
20. Right To Terminate Without Penalty/Liability				
Other Questions: 1. How Were 1099's and 1096's filed?				
2. How many years has this activity been going on/or has service been provided?				
3. Has an opinion been expressed (in writing) on worker classification by a CPA attorney/IRS representative?				

* To be used in connection with more complete discussion in Revenue Ruling 87-41.

WORKER CLASSIFICATION QUESTIONNAIRE

EMPLOYEE	REVENUE RULING 87-41: SHORT FORM	INDEPENDENT CONTRACTOR
YES		NO
	1. Must the worker comply with the employer's instructions about the work?	
	2. Does the worker receive training from or at the direction of the employer?	
	3. Does the worker provide services that are integrated into the business?	
	4. Must the worker personally provide the services to be rendered?	
	5. Does the worker hire, supervise and pay assistants for the employer?	
	6. Does the worker have a continuing working relationship with the employer?	
	7. Must the worker follow prescribed hours of work?	
	8. Does the worker work full-time for the employer?	
	9. Does the worker do his/her work on the premises of the employer?	
	10. Must the worker do the work in a sequence that is set by the employer?	
	11. Must the worker submit regular reports to the employer?	
	12. Does the worker receive compensation in regular amounts at set intervals?	
	13. Does the worker receive reimbursement for business and/or traveling expenses?	
	14. Does the employer furnish tools and materials used by the worker?	
	15. Has the worker made little or no investment in facilities used to perform the services?	
	16. Is the worker unable to make a profit or suffer a loss from his/her services?	
	17. Does the worker work for only one employer at a time?	
	18. Does the worker offer his/her services only to this employer and not to the general public?	
	19. Can the worker be fired by the employer?	
	20. Can the worker quit at any time without incurring liability?	

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