



De Filippis'

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. FINANCIAL STATEMENT CONFORMITY REQUIREMENT FOR AUTO DEALERS USING LIFO.

This is still the hottest IRS audit issue for auto dealers using LIFO and it has been covered extensively in the *LIFO Lookout* as well as summarized here in the *Dealer Tax Watch*.

During recent months, the IRS has issued adverse Technical Advice throwing out dealer LIFO elections for conformity violations. These technical advice/letter rulings will be available under the Freedom of Information Act fairly soon.

Expect the worst from these rulings and expect auto dealers to be confused and angry when conformity generalizations are carelessly tossed around in "press releases" short on space and concern for technical accuracy.

#2. IRS AUDIT ACTIVITY...IT'S HERE. With the help of input from our readers (THANK YOU), we have focused this issue of the *Dealer Tax Watch* on emerging IRS audit developments and techniques...including the controversial "economic reality" questions that the IRS has recently been asking. We have also looked a little more closely at the scary concept of "COMPLIANCE CHECKS."

For those of you who want the "real thing," we have two very recent IRS audit document requests—one for a C corporation, and one for an S corporation—along with commentary to give you an idea of what's involved with an audit...if you're not already undergoing several of your own right now.

You may want to use this information to start assembling necessary backup...if the dealership doesn't already have it in place.

IRS/MSSP activity is in evidence everywhere and those dreaded "every-line-on-the-tax return" TCMP (Taxpayer Compliance Measurement Pro-

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gram) audits are scheduled to start soon. We've discussed all of this and brought you up-to-date on two newer developments: Market Segment Understandings (MSUs) and DORA databases... which may be the wave of the future.

#3. MORE BAD NEWS FROM THE IRS. The IRS has turned thumbs down on two subjects close to every dealer's heart: demo writedowns and factory incentive payments.

LOOKING FOR ADDITIONAL & "VALUE ADDED" SERVICES FOR DEALER CLIENTS?

Look no further... Just use the *Dealer Tax Watch* for a head start in golden consulting opportunities and activities to help dealer clients - and, in the process, to help yourself.

see DEALER TAX WATCH OUT, page 2

In Letter Ruling 9522002, the IRS said that dealers cannot write down demonstrator vehicles at the end of the year.

In Letter Ruling 9525003, the IRS has held that FICA taxes apply to the incentive payments made directly by manufacturers to salespersons (which in many cases may include dealers themselves) for achieving selling objectives. Indirectly, this means that dealerships are responsible for the corresponding employer's share of the payroll taxes and reporting burden that goes along with it.

#4. FORM 8300 CASH REPORTING...STILL DISASTROUS FOR DEALERS WHO

DON'T COMPLY. As document requests included in this issue show, the IRS continues to carefully check up on dealers' Form 8300 cash transaction reporting. One New York dealer was reportedly hit with a \$600,000 fine when the IRS checked his Form 8300 backup. Customer Social Security numbers were missing on many forms and deal folders did not have copies of bank checks and the IRS presumed that customers were paying more than \$10,000 in cash.

Fines can vary between \$50 and \$25,000 depending on how much effort the dealer expended in trying to get required information. The IRS has indicated that subjecting dealers to maximum fines seems to be the exception, rather than the rule.

Dealers and their sales personnel have to be on guard not only to have all the details in their files, but also in case the IRS tries an undercover sting operation trying to entice anyone in the dealership to make a sale without following all the cash reporting requirements.

#5. SECTION 263A COST CAPITALIZATION—MORE GUIDANCE: REVENUE PROCEDURES

95-25 & 95-33. The December, 1994 *Dealer Tax Watch* covered the 1994 major changes affecting dealers who wanted to adopt Cost Capitalization without penalty and the Regulations finalized for 1994, including the historic absorption ratio alternative calculation.

The mechanics of the election statement required in the 1994 return for "eligible" or "qualifying" dealers is discussed on page 18 of the December issue.

Recently, the IRS issued two revenue procedures covering other possible dealer Cost Capitalization situations. Revenue Procedure 95-25 provides

the exclusive procedure for a taxpayer on a Simplified Resale Method of accounting for fewer than three taxable years to obtain consent to make a historic absorption ratio election under the Cost Cap transition rules. This procedure is applicable only for a taxpayer's first, second or third taxable beginning on or after January 1, 1994 and, if followed, will result in the taxpayer being deemed to have obtained the consent of the Commissioner to make a historic absorption ratio election.

Revenue Procedure 95-33 provides the exclusive procedure for a small reseller, "formerly small reseller," or a "reseller-producer" to obtain consent to change its method of accounting for costs subject to Section 263A. This revenue procedure does not apply to taxpayers making a historic absorption ratio election. Revenue Procedure 94-49 did not apply to Section 263A method changes by taxpayers who subsequently qualify or cease to qualify for the \$10 million small reseller exemption. Revenue Procedure 95-33 provides deemed consent for taxpayers complying with its provisions. Section 4.02 of Revenue Procedure 95-33 states that it does not apply to a taxpayer making a historic absorption ratio election.

#6. IRS - "NEW" ITEMS LISTS. For auto dealers using the Alternative LIFO Method, the IRS recently made available lists of new item categories for 1994 calendar year dealers. Each page of the IRS listing states that it is not an official list and it is not Service Position. (Query: What does that really mean?)

A more thorough analysis of the IRS' new item categories list appears in the June, 1995 *LIFO Lookout* if you are interested. Other articles in the June *Lookout* include:

- Voluntary LIFO Change Requests:
 - Why Bother to Change?
 - Summary of Terms and Conditions
 - Form 3115 Filing Requirements and Mechanics
- Form 970: How Not to Elect LIFO
...You Can't Be Too Careful...LTR 9515001
- The IRS' Unofficial New Item List for 1994 Calendar Year Dealers
 - What is the Status of IRS/MSSP Lists?
 - Table Summarizing Differences in Lists
 - Sample Pages From IRS List



DEMONSTRATOR VEHICLE WRITEDOWNS AT YEAR-END: THE IRS SAYS... "NO"

LTR
9522002

Many dealers not using the LIFO method for their new vehicle inventory at the end of the year will write down their demos to amounts determined from the *NADA Official Used Car Guide* or some other "official" car guide. (This practice is not followed by auto dealers using LIFO because writedowns are not permitted in connection with any inventory subject to a LIFO election.)

In Letter Ruling 9522002, the IRS recently concluded that a dealer may not write down the value of demonstrator vehicles at year-end by referring to the wholesale values of used cars in the *NADA Official Used Car Guide*. This includes new truck demonstrators as well as new auto demonstrators.

FACTS

In this case, the auto dealership purchases new cars and light-duty trucks from the manufacturer and markets them as new vehicles. Consistent with general industry practice, some of the new vehicles are driven by sales and management personnel (and probably corporate officers, relatives and shareholders, as well). These vehicles are known in the industry and to the general retail buying public as "demonstrators."

Generally, demonstrators are driven less than 6,000 miles and then sold to retail customers. Demonstrators are not normally sold at auction, nor otherwise disposed of at wholesale prices. The sales prices of the demonstrator vehicles, when finally sold by the dealer, normally exceed the dealer's acquisition costs. Some dealerships write down demos on a monthly basis to reflect the expectation that the dealership will not realize its "usual" gross profit on those vehicles because a knowledgeable buyer will usually negotiate a lower price due to the miles on the vehicle. As a consequence, when a dealer says he is taking a "loss" on a demo, that generally means he is not receiving the same gross that he would receive if the vehicle had not been subject to demo use.

The IRS pointed out that the dealer does not—in the regular course of business—offer its demonstrators for sale to the public at prices listed in the *NADA Official Used Car Guide*.

Customers purchasing demonstrator vehicles receive the full factory new car warranties - that is why the mileage is usually kept below 6,000 miles. The demonstrators sold carry the Manufacturer's Statement of Origin (MSO). The customer/pur-

chaser acquires a vehicle that has never been previously sold, licensed (except for the dealer's tag), or titled. Also, the dealership—or its sales personnel—earn the same factory-based sales incentives and the same manufacturer's holdbacks when it sells a demonstrator vehicle as it does when it sells other, non-demonstrator, new vehicles. (In this regard, see: "FICA Taxes Apply to Factory Incentive Payments/LTR 9525003..." on the following page.)

The dealer includes the demonstrators in its new vehicle inventory and values them at the lower of cost or market by writing down the value of its demonstrators on hand at year-end to wholesale values determined by reference to the NADA guide.

DEALER'S ARGUMENT

The taxpayer contended that the *NADA Official Used Car Guide* provided a reasonable means to determine the bid price of its demonstrator vehicles. The central issue here was that Regulation Section 1.472-4(a) provides that under ordinary circumstances and for normal goods in an inventory, the term "market" means the current bid price prevailing at the inventory date for the particular merchandise in the volume in which it is usually purchased by the taxpayer, and is applicable with respect to goods purchased and on hand.

Regulation Section 1.471-4(b) provides that where no open market exists or where quotations are nominal...the taxpayer must use such evidence of fair market value at the date or dates nearest the inventory as may be available, such as specific purchases or sales by the taxpayer or others in reasonable volume and made in good faith.

Although the dealership contended that the NADA Guide provided a "reasonable means to determine the bid price of its demonstrator cars," the IRS pointed out that the regulation can only be used "where no open market exists or where quotations are nominal." The IRS pointed out that whenever the dealer wants to replace a demonstrator vehicle, it simply does so by purchasing another one from the manufacturer. The dealer offered no evidence that there was not an open market to purchase new cars or that only nominal quotations would be available.

Since Regulation Section 1.471-4(b) does not apply, then under ...-4(a) it is necessary to determine how much the dealer would have to pay on the open market as of the inventory date to purchase the particular demonstrator vehicles in question.

see **DEMONSTRATOR VEHICLES**, page 15



FICA TAXES APPLY TO FACTORY INCENTIVE PAYMENTS TO DEALERSHIP SALES PERSONNEL

LTR
9525003

There is a 25 year old revenue ruling on the books (Revenue Ruling 70-337) which holds that bonuses paid by a manufacturing company to salespersons employed by dealers engaged in selling the company's products are not wages for purposes of FICA, FUTA and income tax withholding.

In recent Letter Ruling 9525003, the IRS distinguished this revenue ruling—even suggesting that it may be in need of revision—in holding that incentive payments made by an automobile manufacturer to an automobile salesman employed by an auto dealership were subject to FICA tax. The letter ruling was specifically limited to “taxes imposed under Section 3101 of the Code” (i.e., FICA tax) and did not address FUTA and/or income tax withholding.

Another interesting aspect of this letter ruling relates to the “Siamese-twin” relationship that seems to exist: i.e., for every employee subject to FICA tax, must there be an employer subject to an equal amount of FICA tax? If so, then look for the IRS to also start collecting equal amounts of FICA tax from the dealership-employers.

THE FACTS

The taxpayer in this case was a salesman, employed not by the manufacturer, but by an automobile dealership/franchisee of the manufacturer. The salesman is treated as an employee by the dealer and received wages for his services and on these wages the dealer withholds and pays appropriate employment taxes. The manufacturer offers financial incentives to salespeople in the form of cash and discounts on products and services and the manufacturer reports the incentive payments on Forms 1099-MISC.

Apparently, the salesman had several years' income tax returns in question and in the first year received considerably large amounts (multiples of \$10,000X) which amounts decreased substantially in subsequent years. The manufacturer stated that it does not employ the salesman and the awards are compensation for services performed by the salesman for the dealer. The dealer, in turn, represented that it provides the manufacturer with all the information necessary to compute the amount of the awards to be reported on Forms 1099.

Although the compensation plan for employees of the dealership does not specifically refer to manufacturer awards, manufacturers promotions are ongoing at all times throughout the year and are payable

only when a particular type of vehicle is sold through an authorized dealer.

APPLICABLE LAW

For FICA tax purposes, Section 3101 imposes on employees a tax on the wages paid to them by their employer with respect to employment. In a footnote in the Applicable Law discussion, the TAM states that “Section 3111 of the Code imposes a corresponding tax on employers.”

Section 3102 requires employers to withhold and deposit the employee's portion of the FICA tax. The TAM observes that the Code generally places the responsibility for withholding and paying employment taxes on employers. “However, because an employee, not the employer, is the subject of this examination, we can not address the tax liabilities of entities not involved in this particular case.”

Employment Tax Regulation Section 31.3101-3 provides that the employee tax attaches at the time that the wages are received by the employee and ...31.3102-1(c) provides that the employer is liable for the employee tax with respect to all wages paid by him to each of his employees whether or not it is collected from the employee. In addition, until collected from him, the employee is also liable for the employee tax with respect to all wages he receives.

The ultimate responsibility for the employee portion of the FICA tax lies with the employee, and the Internal Revenue Service is not required to first seek payment from the employer in collecting the tax (*Navarro vs. United States* W.D. Texas, 1993). Nevertheless, the IRS more often first seeks to collect employment taxes from the more stable and stationary taxpaying entity (i.e., the dealership) than from peripatetic salespersons roaming from dealership to dealership.

There was no disagreement over the status of the salesperson as an employee of the dealership under common law rules.

Section 3401(d)(1) of the Code provides that, for purposes of income tax withholding, the term “employer” means the person for whom an individual performs or performed any service, of whatever nature, as the employee of that person, except that if the person for whom the individual performs or performed the services does not have control of the payment of the wages for such services, the term “employer” means the person having control of the payment of wages.

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Factory Incentive Payments to Dealers...

(Continued)

The FICA provisions do not contain a definition of employer similar to the definition contained in Section 3401(d)(1) of the Code. However, *Otte v. United States*, 419 U.S. 43 (1974), 1975-1 C.B. 329, holds that a person who is an employer under Section 3401(d)(1) for income tax withholding purposes is also an employer for purposes of FICA withholding under Section 3102.

The TAM cites several revenue rulings indicating that amounts paid to an individual by a party that is not the common law employer for services performed in the employ of the common law employer are compensation for those services and, thus, wages for Federal income tax withholding purposes. The IRS distinguished Revenue Ruling 70-337 in which bonuses paid by manufacturers to salespeople employed by dealers were held not to be wages for Federal employment tax purposes by pointing out that the critical factor was that the payments were for services performed for the manufacturer—rather than for the dealer.

Revenue Ruling 70-337 was held to be not applicable in situations in which the third party payment is compensation for services performed for the common law employer. The IRS National Office stated that Revenue Ruling 70-337 should be distinguished if **any** of the following circumstances are present:

R.R. 70-337 DISTINGUISHED

- The bonuses paid are an integral part of the wage structure of the dealer-employer
- The dealer-employer is liable for payment of commissions to sales personnel even if the manufacturer does not remit the amounts to the dealer, or
- The dealer-employer indicates to the employee that the compensation will be received by the employee as a result of services the employee performs for the employer (in other words, the dealer encourages employees to anticipate or "count on" the receipt of additional bonus monies as a result of their sales of products or services subject to Factory incentives).

The IRS pointed out that in the instant case the bonus payments were not compensation for services performed for the manufacturer. The payments were generated automatically when the dealer verified that the salesman had met the manufacturer's conditions and requirements which were satisfied solely through the salesman's performance of services for the dealer as an employee of the dealer. The TAM states "in fact, Manufacturer states that its awards are com-

pensation for services performed for Dealer and that salespeople performed no services directly for it."

The National Office recognized four factors in concluding that the payments received were an integral part of the wage structure of the dealer:

FOUR FACTORS

- To qualify for an award, salespeople must sell vehicles through an authorized dealer,
- Although the award programs are not specifically referenced in the dealer's compensation plan, the dealer is an active participant in the award process through its role in verifying that the requirements (for payment) have been met,
- Incentive programs in one form or another are in effect at virtually all times throughout the year, and
- The manufacturer repeats many of the programs year after year, thus creating the expectation among dealers and salespeople that additional sources of compensation will be available.

As a consequence, the IRS concluded: "We have no doubt but that (the) Dealer is able to offer its salespeople less base compensation than it would were it not for the Manufacturer's award programs."

IN SUMMARY: the incentive payments were received by the salesperson for services performed as an employee of the dealership, the salesperson was not required to perform additional services for the manufacturer in order to receive the incentive awards and the award payments constitute an integral part of the overall wage structure. As a result, the awards were paid with respect to employment and the salesman was liable for the FICA taxes with respect to the award payments.

Look for something expanding this directly to dealership-employers in the near future. Will Quarterly Payroll Forms 941 will be revised with extra lines for these new FICA taxes?

DEALER DOUBLE DIPPING: This will also directly affect any dealer who—as a salesperson—also receives incentive payments reported on Forms 1099. Many dealers receive Factory incentives which they report in their own personal income tax returns based on the Factory-provided Forms 1099. If the payment recipient has reported them as self-employment income in Schedule C, then the applicable taxes and the overall tax burden will be changed and partially shifted to the corporation... and amended returns may be required.





IRS AUDIT ACTIVITY—1995

The dazzling acronyms and terms on the facing page and discussed in this article all stand for the same thing: AUDITS... time-consuming and expensive audits.

With summer upon us, various representatives of the IRS are closing in around us with a variety of projects, programs and exams to make life interesting. In an extensive interview, a former ranking assistant commissioner (Examinations) commented that massive reorganization and training cutbacks have left the Internal Revenue Service at a critical juncture. He added "they're not able to train people well," and "the skill level is not where it should be." These comments by John Monaco are interesting to compare with comments made by former IRS Commissioner Lawrence Gibbs about two weeks later in which Mr. Gibbs indicated that smaller companies are going to be audited more often and more carefully than they have been in the past. Hmm...what does all this really mean? Whom should you—and I—believe?

I'm willing to bet that many readers have already received a handful of IRS document requests and examination letters for several clients. On top of this, just around the corner in a few months we'll have the TCMP audit season upon us. In preparation...and anticipation...let's examine what's going on:

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ECONOMIC REALITY AUDITS

A hail of controversy was raised at a recent AICPA Tax Division meeting (in Washington June 5-7) in connection with the IRS' "Economic Reality" audit questionnaire which many practitioners complained raised troublesome problems and issues. In this regard, for more information, see *Accounting Today*, Volume 9, No. 11 "Firestorm Erupts as IRS Tells CPAs to Quiz Tax Clients," "Economic Reality' Checks Look Like Fraud Probes, Accountants Say (*Tax Notes*, July 12, 1995) and *The Raby Report on Tax Practice: Tax 20 Forum - IRS Audit Activity*, June, 1995. And the TCMP audits haven't even begun yet!!

The infamous list of 27 questions is on pages 12-13. Judge for yourself how much your heart...and your client's...can stand. "Do I really want to know the answers to all of these questions?"...is what many CPAs have been asking themselves.

Many CPAs are concerned that if the responses to these questions by their client/taxpayers materialize into a tax fraud audit, the CPA may have stayed involved too long and possibly face malpractice issues. See "Eggshell Audit" if the name doesn't suggest enough on its own. *Tax Notes*, June 12, 1995, comments that a CPA cannot afford to know the answer to a question regarding a taxpayer's cash on hand because no privilege is recognized in a CPA-client relationship. Therefore, many felt uncomfortable with the list of questions, as well as with how to handle potential answers their clients might provide.

On the other hand, IRS representatives did not agree with the complaint that these questions create a presumption of non-compliance and it was stated that the cash-on-hand questions will be asked in the Taxpayer Compliance Measurement Program audits that will start in October, as well. Several IRS representatives indicated that these questions are simply audit practice that has served the IRS well over the years and that these "old technologies" are simply being freshened up by '90's terms like "Economic Reality Audits," which in turn is being replaced by "Financial Status" emphasis. As one IRS rep quipped: "You call it what you want...We call whatever sells." In other words...Chill..."Don't answer them if you don't want to - we're not going to subpoena the taxpayer for that information." Query: What are you going to do?

It was reported that the "Economic Reality Approach" was developed because the IRS felt agents lacked the skills to probe for unreported income during audits and, as we all know, there is great emphasis on the huge loss of tax dollars attributable to unreported income and the efforts of the IRS to close that gap.

see **IRS AUDIT ACTIVITY—1995**, page 8



**THE IRS AUDIT ALPHABET
PUT 'EM TOGETHER ANY WAY YOU WANT
THEY STILL SPELL... **AUDIT****



CEP	Coordinated Examination Program. Formerly applied only to 1,500 largest corporations; now reportedly being expanded to nearly 30,000 companies.
DIF	Discriminate Function (System). The IRS' magic formula that allows it to select returns that are more likely to have high dollar adjustments upon audit. Updated periodically to reflect results of TCMP audit data.
DORA	District Office Research & Analysis. A program based on the belief that statistical analysis can be used more effectively on a regional or district basis...than on a National (i.e., TCMP) basis.
ISP	Industry Specialization Program.
MSSP	Market Segment Specialization Program.
MSU	Market Segment Understanding (Programs or Products).
TCMP	Taxpayer Compliance Measurement Program. (Some suggest acronym for: This Could Mean Prison!) Detailed, line-by-line, item-by-item, audit in which <u>everything</u> is looked at, no stone left unturned, and no documentation is left unasked for.
TSM	Tax Systems Modernization Program. IRS' move toward automation and centralization resulting in considerable downsizing, cutbacks, and office/district reorganizations within the Agency.
Compliance Check	?????...Something that can lead to or be expanded into an audit at any time.
Compliance 2000	Audit Smarter, Not Necessarily Harder.
Economic Reality Audit	A term describing 27 audit questions being asked in current audits to determine unreported income. See pages 12-13. Currently being replaced by the term "Financial Status"...in the hope that taxpayers will forget the stink raised over these Economic Reality questions at a recent AICPA meeting.
Eggshell Audit	An audit in which the Examination Division is auditing a return involving a material error or possible fraud. Taxpayer representatives "walk on eggshells" because of malpractice implications, need to withdraw in favor of legal counsel and lack of privilege/confidentiality surrounding their knowledge of client's financial and tax affairs.



COMPLIANCE CHECKS...NOT REALLY "AUDITS"...WHAT ARE THEY?

Before discussing "real flesh and blood" IRS audits, let's talk about the more recent and elusive phenomenon termed "compliance checks" with which some taxpayers have to contend. While the IRS denies they are audits, compliance checks are being forced upon many categories of taxpayers as part of what the IRS describes as something "intended as an educational program."

AUTO DEALER COMPLIANCE CHECKS: In early 1993, auto dealers in certain IRS districts received "compliance check" letters delving into areas covered by four revenue procedures issued in 1992.

These letters began by stating "In the past several months, the Internal Revenue Service has issued four new revenue procedures which affect automobile dealerships:

- *REVENUE PROCEDURE 92-20*...is intended to encourage taxpayers to voluntary change to correct methods of accounting before being contacted by the IRS. For automobile dealerships, this includes correcting the method of accounting for inventory under the Last-In, First-Out (LIFO) method.
- *REVENUE PROCEDURE 92-79* issued September 28, 1992, provides auto dealers with an alternative method of calculating LIFO for new cars and new trucks...to calculate their yearly index by comparing the base cost of the vehicle in ending inventory to the base cost of a comparable vehicle at the beginning of the year. The Revenue Procedure also defines a "new item" which requires an index of 1.00 in their yearly index computations...
- *REVENUE PROCEDURE 92-97* formalizes...TAM 9218004 that auto dealers who sell "dealer obligor" extended service contracts must amortize the cost of all insurance premiums over the terms of the insurance policies...by doing this (i.e., changing methods), dealers will not be required to make adjustments under IRC Section 481 (a).
- *REVENUE PROCEDURE 92-98* provides for an alternative method of reporting income for "dealer obligor" extended service contracts. Under this procedure, taxpayers can elect to defer and report as income over the term of the contract that portion of the income from a service contract that equals the amount to be paid for insurance premiums. The amount deferred and reported over the term of the contract will be on a "gross up" basis. Taxpayers can find examples of this Service Warranty Income Method (SWIM) in Revenue Procedure 92-98.

"The Internal Revenue Service "Compliance 2000" program includes an effort to inform members of specific industries about new rulings or procedures that affect them and their taxes. The program also includes an effort to determine those areas of tax law that may not have received adequate publicity so that educational programs may be undertaken where needed and any compliance problems resolved promptly. As part of this initiative, we are trying to determine the level of compliance with the above Internal Revenue Procedures. To do so, we are requesting that you forward to us the information listed below:

1. Copies of any Forms 3115 you have filed or will be filing to comply with the Internal Revenue Procedures listed above.
2. The name and telephone number of the person who should be contacted if further questions arise.

"Please mail copies of Form 3115 to the Internal Revenue Service, XXXX..... **THIS INQUIRY DOES NOT CONSTITUTE AN EXAMINATION OF YOUR RETURN.**"

Last year, a few IRS districts conducted further compliance checks in connection with auto dealers' LIFO calculations and "new" item and "item category" determinations under the Alternative LIFO Method.

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INDEPENDENT CONTRACTOR STATUS COMPLIANCE CHECKS: Recently, taxpayers involved with independent contractor issues and Section 530 relief have been subject to the same “educational program.” Letters announcing a compliance check state that a compliance check does not constitute an examination or inspection under Internal Revenue Code Section 7605 and is not an audit. In these “compliance check” situations, the Service states that it intends to check documents that have been filed with the IRS, but that the review must be done at the taxpayer’s place of business.

COMPLIANCE CHECK VS. AUDIT EXAM: Apparently, the distinction between a compliance check and an IRS audit examination is that an examination involves the systematic inspection of books and records, whereas a compliance check involves only a “review of forms” that the taxpayer has already filed with the IRS.

IRS representatives have indicated that revenue agents are instructed not to ask any questions about numbers, although if they notice anything specific, they can always recommend an examination. In at least one instance, a U.S. District Court in Atlanta frowned on the notion of a “compliance check” and issued a summary judgment and permanent injunction in favor of the taxpayer.

The IRS has just released a specialized manual related to the on-going controversies over independent contractor status and Section 530 relief. This manual contains interesting commentary in the form of some do’s and don’ts instructions to revenue agents on how to conduct a “compliance check.”

- | | |
|-----------|--|
| DO | <ul style="list-style-type: none"> • Tell the taxpayer upon initiation of a compliance check that this is a mere compliance check and does not qualify as an inspection under IRC 7605(b) or an audit under Section 530 of the Revenue Act of 1978. • Follow-up oral notification to the taxpayer with a written notice that the compliance check does not qualify as an inspection under Section 7605(b) of the Code or an audit under Section 530 of the Act. • Limit the scope of the compliance check only to IRS documents that have already been voluntarily supplied to the Service or that are required to be maintained by the taxpayer. |
|-----------|--|

- | | |
|--------------|--|
| DON'T | <ul style="list-style-type: none"> • Question any tax liability, such as asking how the taxpayer determined the status of its workers. • Inspect any taxpayer records other than IRS forms. • Suggest that compliance checks can be used to provide tax relief in exchange for prospective tax compliance or that future compliance will forestall past filing or an examination. |
|--------------|--|

The Section 530 independent contractor manual makes it clear that the nature of a compliance check can be expanded at any time if—in the agent’s judgment—“it is necessary to go beyond the scope of a compliance check.” In that case, the taxpayer should be notified both in writing and orally that the compliance check has been expanded into an investigation...and an audit should then commence.

CONCLUSION

I'm sorry, but...where do we draw the line?

During every “real” audit, we also have multiple “compliance checks” going on to the extent that the IRS agent asks to “review”/“look at”/or “see” copies of prior or subsequent years’ return, related information filings and/or *related* party tax returns. (See IRS Document Requests and discussion: pages 16-21.)

see IRS AUDIT ACTIVITY—1995, page 10



“REAL” AUDITS

Moving from the not-really-an-audit/compliance check situation to the more obvious, tangible and unpleasant audit situation, consider some comments from *The Raby Report on Tax Practice* (June, 1995):

- “Agents seem to focus more on timing issues that they would not have bothered with in the past, and display a greater concern with how what they do impacts the IRS statistics on things like dollars agreed.
- “We have seen a decrease in the overall skills of revenue agents. Also, group managers do not seem to be technically competent and thus back examiners without really understanding issues or listening or responding to the view of taxpayers and representatives.
- “Some examinations have long delays due to too much nit-picking, pulling agents away for training, or just improper case management.”

Would *you* agree with these generalizations? Thanks to help from several readers, we have included the more thorough IRS audit document requests received by some dealers within the last few weeks. These ask for everything you ever wanted to know about... and more. See page 16 *et. seq.*

The *Dealer Tax Watch* has previously included extensive discussions on comments made by Robert Zwiers, the IRS Motor Vehicle Industry Specialist, on various hot tax topics (see June, 1994 *Dealer Tax Watch*), the IRS Compensation Questionnaire which is almost standard in dealership audits these days, (see also June, 1994 *Dealer Tax Watch*) as well as summaries of NADA tax issues coverage and analyses of the IRS Dealership Audit Manual (June, 1994, page 8), NADA's Dealer Guide to Federal Tax Issues (December, 1994, page 6).

Against these specifics, consider the overall backdrop of the newer Industry Specialization Program (ISP), Market Segment Specialization Program (MSSP) and the most recent Market Segment Understanding (MSU) programs and projects. All of these suggest a better technically equipped and greater resource-laden IRS agent knocking on your door in the future.

MSSP

The Market Segment Specialization Program (MSSP) is a regionally or locally developed study of a market segment and it is conducted by the Examination function.

The MSSP project, in general, began in Los Angeles with an automobile dealership project and expanded into Los Angeles area audits of auto dealerships and gasoline retailers. The project, like an ill wind, spread from the West and is now becoming well entrenched in the IRS. To date, the IRS has published 15 guides, with another two dozen in the draft stage and approximately 80 industries in all targeted to be studied. Many districts are just recently becoming involved with the MSSP project activities and all of this takes time.

The focus of MSSP studies is to:

1. Identify non-compliance areas within a market segment. Usually, this is done by a mini-TCMP type audit conducted on a small number of taxpayers within the market segment,
2. Develop audit techniques to improve compliance in the market segment studied and to document them in comprehensive audit guides covering the practices and peculiarities of a market segment or issues that may be relevant, and
3. To train IRS examiners to address non-compliance matters common in the market segment.

The MSSP process focuses on the practical problems of auditing the market segment and identifies particular facts that the IRS examiner should look for to determine if an issue common in the market segment is present. Usually, a small number of individuals will become IRS experts on the particular market segment involved. They then act as specialists and information sources advisory to other IRS examiners nationwide about various aspects of the market segment. Robert Zwiers is generally regarded as the automobile dealer industry specialist and he is regularly called with specific technical questions and is a frequent speaker at industry gatherings.

→



One result of the MSSP approach has been that information developed from examining a specific market segment can be systematically fed into databases and analyzed to determine levels and trends of compliance for the entire segment, rather than for individual taxpayers. Another result is that the IRS appears to be moving in a more cross-functional fashion with coordination between Examination, Appeals and Counsel, thus resulting in greater uniformity in the treatment of issues within the segment.

ISP

The Industry Specialization Program (ISP) is a multi-functional team approach involving Examination, Appeals and Counsel to ensure uniform and consistent treatment of specific legal issues that affect a particular industry or are particular to an industry and may have an impact broader than that industry. In this regard:

1. The ISP provides better identification, development and resolution of significant industry issues and the primary product is the coordinated issue process.
2. The ISP team initiates the ISP projects which it addresses and there is National Office representation on the ISP team.
3. The ISP team members may, in appropriate circumstances, solicit the view of affected industry groups and taxpayer representatives on issues it is addressing...but discussions to reach mutual understandings on the ISP issues are not engaged in with industry and/or taxpayer representatives.
4. Examination is bound by the technical positions taken in examination ISP position papers. Appeals must follow the Appeals ISP position paper as well.

MSU

The IRS recently released information concerning its Market Segment Understanding (MSU) program which is not to be confused with either the MSSP or the ISP initiatives. The unique feature of a MSU is the establishment of a working group of IRS and private sector segment representatives to develop a MSU product. Through discussions, the working group seeks to achieve a mutual understanding of the facts and, to the extent feasible, a mutual understanding of how a legal principle or principles may be applied to varying facts and circumstances which exist within the market segment.

To begin the MSU process, it is necessary to have market segment representatives who are willing to engage in discussions that are aimed at reducing non-compliance. Interest in a particular area of non-compliance is also needed at the District or National Office level. The primary products of the MSU process are a guideline document that provides clarification of the issue or a proforma accord. When these documents are issued by the IRS, the general agreement of the segment representatives should be obtained before the IRS issues the MSU documents. Thus, the intention of the joint meetings is to create a mutually acceptable written Internal Revenue Service guideline, audit technique or other document available on a general basis to the public and/or to IRS personnel. These MSU guideline and proforma accord documents must not:

- Forgive any proposed and/or known tax, penalties and/or interest liabilities.
- Limit or eliminate past, current or future civil and/or criminal enforcement by promise or implication.
- Settle or compromise any actual tax liability.
- Treat similarly situated taxpayers differently (for example, in the case where a proforma accord has been developed, the proforma accord should be available to all similarly situated taxpayers), or
- Be cited as legal precedent or authority.

An example of a MSU product is the recent "Market Segment Understanding With the Food Service Industry - Tip Reporting Alternative Commitment (TRAC)." The purpose of the tip rate program was to ensure compliance by employees of food and beverage establishments with tip income obligations. After joint meetings, the TRAC proforma agreement embodied four principal commitments: Employee education, employer reporting, employer tip reporting procedures and Section 3121(q) notices. Apparently, the focus of MSU activities will be more in the educational area, than elsewhere.

see IRS AUDIT ACTIVITY—1995, page 14



**LIFESTYLE & ECONOMIC REALITY AUDITS
QUESTIONS TO BE ANSWERED
(BY MR. AND MRS. X) FOR REVENUE AGENT**

**27
QUESTIONS**

1. Home phone number.
2. Work phone number.
3. Date of birth of Mr. X.
4. Confirm 1994 is on extension - please provide copy.
5. Either spouse previously married?
 - Paying or receiving alimony or child support?
 - If so, how much and paid to whom?
6. Educational background of both - highest level achieved - degree received, etc.
7. Mr. X previous occupation, employer and date.
8. Date of birth of children.
9. Purchase documents:
 - Application, closing documents, etc. for home.
 - Who is mortgage holder? Payment?
10. What other real estate is owned?
 - When acquired?
 - Monthly rent?
 - Do you manage or do you have a management company?
11. Did you make any improvements during 1993 to any of your real estate?
 - What was done?
 - How much was it and how was it paid for?
12. How many autos do you own?
 - What are they?
 - What is the payment?
13. Do you own any large assets (over \$10,000) besides auto and real estate?
 - What is it, where is it kept?
 - Is it paid for? If not, what is the payment?
14. Did you sell any assets in 1993?
 - If so, what, to whom and how much?
15. Did you loan anyone any money during 1993?
 - If so, who and how much?



Lifestyle & Economic Reality Audit Questions

(Continued)

16. Did you receive repayments of any loaned money in 1993?
17. What loans do you have besides auto and mortgage?
 - How much?
 - Monthly payment?

CASH QUESTIONS

18. Do you ever take cash advances from credit cards or lines of credit?
 - How much and how often?
19. What cash did you have on hand in 1993 usually, personally or for business, not in a bank - at your home, safe deposit box, **hidden somewhere**, etc.?
20. What is the largest amount of cash you had at any one time in 1993?
21. Did you transfer funds between your accounts? If so, how much and when?
22. Did you ever redeposit funds previously withdrawn from your accounts?
23. Did Mrs. X deposit her paychecks from _____ into the bank? What account?
24. Do you have a safe deposit box?
 - Where?
 - What is kept in it?
25. Were you involved in any cash transactions of \$10,000 or more?

OTHER

26. How long has business been at its current location?
 - Where was it previously?
27. Employee business expenses - what meals are being deducted?
 - Please provide appointment calendar receipts, business purpose, business relationship for **all** expenses.

QUESTIONS NOT ON ECONOMIC REALITY LIST, BUT OFTEN ASKED

28. Health status, infirmities, treatment and recoveries.
29. Hobbies.
30. Education of children and other family members...where, how extensive, how financed?

ADDITIONAL INFORMATION FOR ABOVE ITEMS



TCMP AUDITS

Beginning in October, the Taxpayer Compliance Measurement Program (TCMP) audits will start again after an absence of many years. The last round of TCMP audits was conducted in 1988. The principal use of the TCMP program is to use information from it to periodically update the selection formula - known as the DIF or Discriminate Function - formula for selecting tax returns for audit.

The current TCMP program initiative will commence with the selection of approximately 150,000 tax returns (individual, corporate and partnership) for line-by-line, item-by-item, detailed audits. Selected by a stratified sampling process, these TCMP audit returns will represent various income classes, market segments, geographic areas and other categories. These TCMP audits will not include corporations with assets exceeding \$10 million.

Apparently, agents will have access to the selected taxpayer's two previous returns and other information reports when conducting a TCMP audit. One of the purposes of the 1994 TCMP initiative is to learn more about the so-called "economic reality" of the selected taxpayers by determining whether the information reported on the tax return reflects the true economic circumstances of the taxpayer.

For more information regarding the types of tax returns to be selected for the TCMP audits and where they will be selected from...see pages 22 and 24. The press has recently reported that House Speaker Newt Gingrich and several members of Congress are somewhat opposed to the 1994 TCMP program. Whether their opposition will soften—or impede the TCMP audit process—is anyone's guess.

DIF

As indicated above, according to the IRS, what is learned during TCMP audits will be incorporated into the DIF selection formula which, in turn, is used for selecting returns for regular audits in succeeding years.

DIF is the statistical formula based on the TCMP data that uses a type of regression analysis to classify tax returns for potential audit. The introduction of the DIF formula and method selection in 1970 is reputed to have greatly reduced the number of returns audited that result in no change in tax liability. The higher the DIF score, the more likely it is that the tax return will produce an adjustment that will increase the taxpayer's liability.

Although the DIF selection process may identify tax returns with the greatest potential for audit adjustments, there are always other limitations in the form of available personnel resources and other projects within the Service that may have a higher priority. The DIF is dependent on TCMP data which, in turn, allows the redevelopment of a new DIF formula which can be more effective in identifying tax returns reflecting what are perceived to be patterns of non-compliance.

DORA DATABASES

As part of its Market Segment Specialization Program (MSSP), the IRS has indicated that it eventually intends to replace TCMP audits - which generate information collected on a National basis - with data collected on an on-going basis and on a regional or district basis from examinations of specific market segment taxpayers. This information will be systematically fed into DORA (District Office Research & Analysis) databases.

There are currently 31 DORA sites (30 U.S. plus 1 International). The IRS believes it should be able to more effectively look at individual taxpayers geographically and as representatives of a market segment with the proper collection and coordination of audit and taxpayer information on a district or regional level. These DORA sites will assist in gathering information on a more pinpointed geographic basis and add a greater element of demographic precision to the overall market segment approach. See page 23.

Apparently, DORA was involved in a Mississippi project in 1994 and was highly successful - resulting in adjustments in more than 95% of the cases reviewed - where specific taxpayer groups in specific cities were targeted, returns pulled for designated zip codes and other more focused steps were employed.

DORA may have tremendous impact on the shape of things to come!

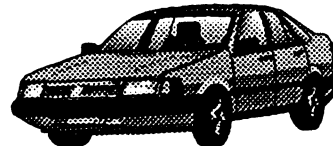
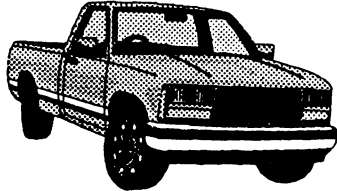
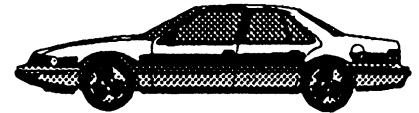


The dealer's argument was that the *NADA Official Used Car Guide* was an appropriate indicator because it reflects market prices for similar cars (e.g., cars with 6,000 miles). Although the IRS conceded that the *NADA Official Used Car Guide* may be representative of the market value of used cars, the IRS distinguished it as being an inappropriate indicator of the replacement cost of the dealer's demonstrator vehicles because the dealer does not buy used vehicles for use as demonstrators.

The Service noted that when the dealership wants to replace its demonstrator vehicles, it replaces them with new vehicles bought from the factory/manufacturer, which vehicles have never been sold, licensed or titled and carry the manufacturer's Statement of Origin and complete factory new car warranties. These characteristics will not be present in the used cars quoted in the *NADA Official Used Car Guide*.

In further support of its position, the IRS cited *Space Controls, Inc. v. Commissioner*, 322 F.2d 144, 148 (5th Cir. 1963) to the effect that the lower of cost or market method of valuing inventory is an instance where the tax law permits the deduction of an unrecognized loss and is a recognized exception to the necessity of reflecting in income tax returns only closed transactions. In the instant case, the dealership presented no evidence that the price at which it purchases its demonstrators (i.e., from the manufacturer) has fallen below its cost. On the contrary, the dealership's market writedowns result solely because the vehicles used as demonstrators have more mileage than other vehicles not used as demonstrators.

Accordingly, the IRS held that the dealership could not write down the value of its demonstrators at year-end by referring to the wholesale values of used cars in the *NADA Official Used Car Guide*. ☺



De Filippis' DEALER TAX WATCH

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Form 4564 Rev. Jan. 1984	Department of the Treasury Internal Revenue Service INFORMATION DOCUMENT REQUEST	Request Number
TO: (Name of Taxpayer and Co. Div. or Branch)		Subject
C Corporation Dealership		Income Tax 1993
		SAIN No. Submitted to:
		Dates of Previous Requests

Description of Documents Requested

- A. Corporate Minute Book
- B. Stock Record Book
- C. General Ledger, Journals, and Schedules
- D. General Journal Vouchers Including the 13th Month (If Made)
- E. Schedule of Accounts Receivable and Accounts Payable at 12/31/92 and 12/31/93
- F. Chart of Accounts, Source Codes, Journal Setup, Manufacturers Accounting Manual.
- G. Detailed Depreciation Schedules (Regular Tax, Alt Min Tax, and Ace)
- H. Physical Inventory Records for parts and accessories
- I. Accountant's Workpapers and/or Taxpayer's Workpapers and Records Regarding:
 - 1. Year-End Worksheet Reconciling Books to Return (Working Trial Balance)
 - 2. Year-End Adjusting Journal Entries and M-1 Detail
 - 3. Year-End Bank Reconciliations
 - 4. Cost of Goods Detail Including 263A Computations
 - 5. Beginning and Ending Inventory Valuations—LIFO Inventory
 - All Workpapers for Computation of LIFO Reserve
 - a. Summary of LIFO Computation
 - b. A Schedule of the Double Extension of Vehicles Used in Computing the LIFO Inventory Value
 - c. Detail for LIFO Summary
 - (1) A Schedule of Actual Vehicles in Ending Inventory and Their Actual Cost by Model Line (i.e. Physical Inventory)
 - (2) A Schedule of Actual Vehicles Valued at Current Year Unit Cost
 - (3) A Schedule of Actual Vehicles Valued at Base Year Cost (i.e. Beginning of the Year Costs)
 - d. Invoices of the Above Vehicles In:
 - (1) Ending Inventory
 - (2) Current Year Cost
 - (3) A Schedule of Actual Vehicles Valued at Base Year Cost (i.e. Beginning of the Year Costs)
 - 6. All Workpapers for Computation of Parts LIFO Reserve

From:	Name and Title of Requester	Date
		4/ /95
	Office Location	



Form 4564 Rev. Jan. 1984	Department of the Treasury Internal Revenue Service INFORMATION DOCUMENT REQUEST	Request Number
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TO: (Name of Taxpayer and Co. Div. or Branch) C Corporation Dealership	Subject Income Tax 1993
	SAIN No. Submitted to:
	Dates of Previous Requests

Description of Documents Requested

- 7. Physical Inventory Records For:
 - a. New Cars and Trucks
 - b. Used Cars and Trucks
- 8. Beginning and Ending Inventory Valuations--Lower-of-Cost or Market (i.e. For Used Cars) if applicable.
 - a. Physical Inventory Records For Used Cars and Trucks
 - b. Copy of the Year-End Inventory Write-Down, If One Was Made
- 9. Car Jackets For Vehicles Affected by the Write-Down To Lower-Of-Cost or Market (List by Stock #, Customer Name, Amount)
- 10. Copies of Financial Statements and Audit Report Prepared For You
- J. Copy of Prior and Subsequent Year Tax Returns
- K. Copy of Shareholders Income Tax Returns - Federal and State
- L. Copy of Related Returns i.e. Related Corporations, Partnerships; Short Period Returns, if Applicable
- M. Bank Statements and Canceled Checks for all Bank Accounts, Checking and Savings (Also Provide Voucher Checks if Applicable)
- N. Employment Tax Returns--Form 940; Form 941 for all Quarters (9303-9503)
- O. Payroll Records For All Employees--Forms W-2; Forms W-4 for the Four Most Recent Quarters
- P. Copies of Form 1099 Filed and Received; Copies of Form 8300 Filed
- Q. Excise Tax Returns if Applicable
- R. Pension-Trust Returns (Forms 5500 if applicable) and a Copy of Your Plan
- S. Information Regarding Any Loans During the Year Including Loans To/From Shareholders. Shareholders Information Should Include Notes and Payment Schedule.
- T. Copies of Financial Statements Submitted to the Manufacturer for the year.
- U. Copies of Floor Plan statements for 12/31/93.
- V. List of Employees Who Were Provided With the Use of A Demonstrator and/or Other Company Vehicle; and Schedule of Demonstrator Vehicles and Company Vehicles; and Schedule of Vehicles Which Were Driven by the Shareholder(s) and Officers, Their Family Members and/or Friends
- W. Form 970 - Election to Use LIFO; Any Elections to Change Accounting Methods - Form 3115; Form 1120-X or Form 1139 filed
- X. Documentation to Support Abandoned Assets Reflected on Form 4797.
- Y. Computations for Service Contracts under Revenue Procedure 92-97 and 92-98 if Applicable.

From:	Name and Title of Requester	Date
		4/ /95
	Office Location	



Form 4564 Rev. Jan. 1984	Department of the Treasury Internal Revenue Service INFORMATION DOCUMENT REQUEST	Request Number
TO: (Name of Taxpayer and Co. Div. or Branch)	Subject	Submitted to:
S Corporation Dealership	1992 Form 1120S	
	Dates of Previous Requests	

Description of Documents Requested

- A. Corporate Minute Book and Stock Record Book
- B. List of Demos and people to whom assigned
- C. General Ledger and subsidiary ledgers, if applicable, i.e., sales, purchases, accounts receivable, accounts payable, etc.
- D. General Journal and subsidiary journals, if applicable, i.e., sales, purchases, accounts receivable, accounts Payable, etc.
- E. Chart of Accounts
- F. Cash Receipts and Disbursements Journals, i.e., Check Register
- G. Listings of Beginning and Ending Accounts Payable and Accounts Receivable
- H. Detailed Depreciation Sheets, book and tax
- I. Accountant's workpapers regarding:
 - 1. Year-end worksheet reconciling books to return
 - 2. Year-end Adjusting Journal Entries and Closing Entries
 - 3. Year-end Bank Reconciliations
 - 4. Cost of Goods Sold
 - 5. Beginning and Ending Inventory Valuations
 - 6. Copies of financial statements prepared for you
 - 7. Any accounts analyzed by them at year-end or for certification
- J. Copies of prior and subsequent tax returns
- K. Copies of all Officers and Shareholders' personal tax returns - Federal and State
- L. Bank Statements and canceled checks
- M. 941's, 940, W-2's, W-3, and 1099's for the year
- N. Pension-Trust Forms and a copy of your plan
- O. Worksheets utilized to reconcile the "books" to your tax return
- P. Copy of your Signed Form 2553

From:	Name and Title of Requester	Date
		4/ /95
	Office Location	



IRS DOCUMENT REQUEST FOR S CORPORATION

ADDITIONAL INFORMATION REQUESTED BY AUDITOR

1. Provide a detailed list of all persons who worked for you during 199x who were not considered employees, who performed services of car jockeys, drivers and/or shuttlers. Include the amounts paid to each of these parties in 199x.
2. If taxpayer pays life insurance premiums on officers/shareholders, indicate how the payments of these premiums are handled for book and tax purposes.
3. If taxpayer is leasing property from a related party under a triple net lease, indicate amount of accrued but unpaid real estate taxes on this property as of December 31, 199x.
4. Contact all parties to whom you sold scrap during the year and have them furnish a statement as to the amount of scrap you sold to them during the year.
5. Identify business relationship of indicated individuals who received holiday gifts.
6. Provide invoices and/or explanations on contributions indicated on the attached sheet.
7. Supply journal entries showing the amounts of gasoline consumed out of company tank by drivers of demo vehicles (whether for their demo vehicles or for personal vehicles).
8. Provide copies to be retained by the Revenue Agent for all shareholder 1040's, Forms 8300 filed for cash transactions in excess of \$10,000, beginning-of-the-year and end-of-the-year inventory count sheets and subsequent year's tax return.
9. Provide a listing of all accounts which make up gross receipts.
10. Where on return are the amounts deducted for which 1099's were issued?
11. Provide detail schedule for other income.
12. Provide a copy of the LIFO election and all LIFO index calculations from the first year LIFO was used to date.
13. Complete demonstrator usage worksheet.

See IRS demo worksheet...page 21.



NOTE **MULTIPLE** "COMPLIANCE CHECK" ASPECTS OF AGENTS REQUESTS.

DOCUMENT REQUEST FOR C CORP DEALERSHIP

- A. Corporate Minute Book: See *Dealer Tax Watch*, June, 1994 (pages 11-14) for Corporate Minute Book Information Worksheet.
- I(4). Note Request for Section 263A Inventory Cost Capitalization Computations. No standard guidance has been issued for auto dealer Section 263A computations. See articles in December, 1994 *Dealer Tax Watch* on section 263(a) 1994 major changes, Rev. Proc. 94-49, historic absorption ratio method, simplified resale methods, and sample section 263(a) computations.
- I(5). Note detail requested in connection with LIFO inventories: This includes LIFO computations, rebasing (if applicable in connection with Alternative LIFO Method) and detailed current year inflation index calculations and invoices. For a sample LIFO Inventory Report, call for further information.
- I(5)(c)(1). Note request for actual cost by model line will highlight taxpayers compliance with the LIFO eligibility requirement that inventory be valued at actual cost.
- I(8)(b). Request for copy of year-end inventory writedown worksheet had better not show any demonstrator writedowns on it.
- I(9). Request for car jackets for vehicles affected by writedowns to LCM probably will allow agent to zero-in on whether or not writedowns are excessive.
- K. Note request for copy of only shareholders' income tax returns...request was not made for officers and shareholders income tax returns. Compare with document request for S Corp dealership.
- P. Note request to review copies of cash transaction Forms 8300.
- P. Note request for Forms 1099 filed—as well as received—independent contractor status issues.
- S. Loans to and from shareholders, as well as other loan transactions, are now regularly and more closely scrutinized by examining agents. Watch arms-length nature, interest rate, collateral, maturity.
- T. Note request for copies of financial statements submitted to manufacturer: will this reflect year-end estimate of change in LIFO reserves? If not, possible conformity violation...also possible conformity violation if LIFO adjustment is not run through Cost of Goods Sold section. Similarly, Item I(10) might also be significant in this regard.
- V. Note detailed information requested in connection with demonstrator vehicles. See facing page for demo worksheet IRS uses.
- W. Note request to review Form 970 - Election To Use LIFO: If this cannot be located or provided, consider applying for relief under Revenue Procedure 92-85 before an IRS audit commences.
- W. If dealer switched to the Alternative LIFO Method in 1992 or a later year, a copy of the Form 3115 making this change also needs to be available.

DOCUMENT REQUEST FOR S CORP DEALERSHIP (NOT USING LIFO)

- I(7) Note request to review any account analyses prepared by accountants at year-end.
- K. Note request to review copies of all officers and shareholders personal income tax returns. Possibly picking up children and or parents who may not be shareholders in the process.
- P. Note request for copy of signed Form 2553 electing S status.
- Several of the additional requests are self-explanatory; note depth of audit perspective.
 - Note request for copies of all LIFO index calculations from first LIFO year forward is not necessarily unusual because if the Alternative LIFO Method were elected, it would be necessary to rebase all pre-Alternative LIFO year inflation indexes to 1.000 as of the beginning of the year of change.

→



OTHER CONSIDERATIONS

- **Reasonable compensation:** For the C corporation dealership, the IRS has a specialized audit questionnaire relating to justifying "reasonable" compensation. This four-page questionnaire is reproduced in the *Dealer Tax Watch*, June, 1994, pages 20-23 along with extensive discussions and articles on dealer reasonable compensation issues in the June, 1994 and the September, 1994 *Dealer Tax Watch*.
- Note dealers and their spouses may be subject to the 27 questions relative to "Economic Reality" and lifestyle matters (see pages 12-13).
- A reader who recently completed several IRS dealership audits adds the following:
- The IRS is looking more and more at balance sheet accounts and wanted to be sure that liabilities were cleared out at the start of the year.
- Agents paid special attention to compensation accrued at the end of the year and the 2½ month rule under Section 267.
- The Parts PIF allowance also was subject to special scrutiny. In a number of instances, the agents wanted to accrue as income at year-end the November/December statement allowance even though it was not necessarily a fixed receivable amount at year-end because the dealer might return parts in the early part of the following year.

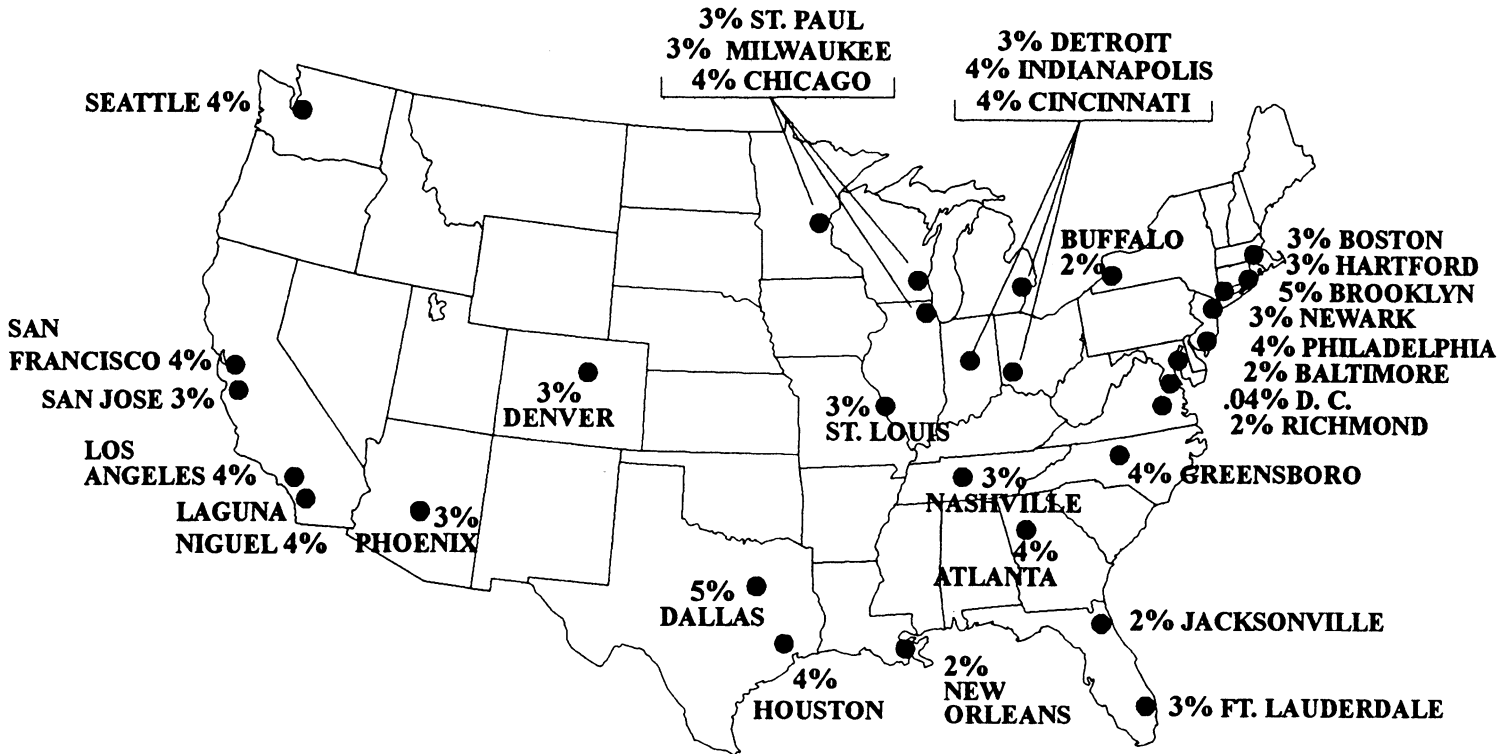
IRS' DEMONSTRATOR USAGE WORKSHEET

Employer/Non-Employee	Position	Average FMV of Auto Driven	Reported Auto Use W-2 Wages	Total W-2 Wages	Total Miles Driven	FMV Gas Provided

Instructions: Fill out this schedule for all individuals who had access to a Company Auto. Include both Employees and Non-Employees. Where no Income was reported by an individual for use of an Auto enter a \$-0- in the appropriate Column.



TCMP SAMPLE SIZE BY DORA SITE



TCMP AUDITS - APPROXIMATE SAMPLE SIZE - 1994-1995

Type of Taxpayer	Tax Form	Approximate Sample Size	Estimated Size of Population	Percentage of Population
Individual - Nonbusiness	1040	33,300	111,889,000	0.0298
Individual - Schedule C Sole Proprietors	1040	58,900	6,182,000	0.9528
C Corporations	1120	35,300	2,514,000	1.4041
S Corporations	1120S	12,500	1,815,000	0.6887
Partnerships	1065	12,500	1,500,000	0.8333
Foreign Controlled Corporations	1120	664	42,300	1.5697
Total		153,164	123,942,300	

Source: IRS



TCMP AUDITS - APPROXIMATE SAMPLE SIZE - 1994-1995

SAMPLE SIZE BY DORA (DISTRICT OFFICE RESEARCH & ANALYSIS) SITE *

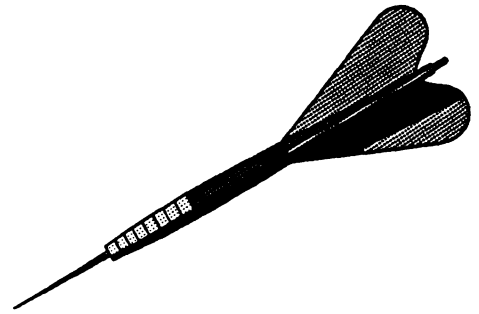
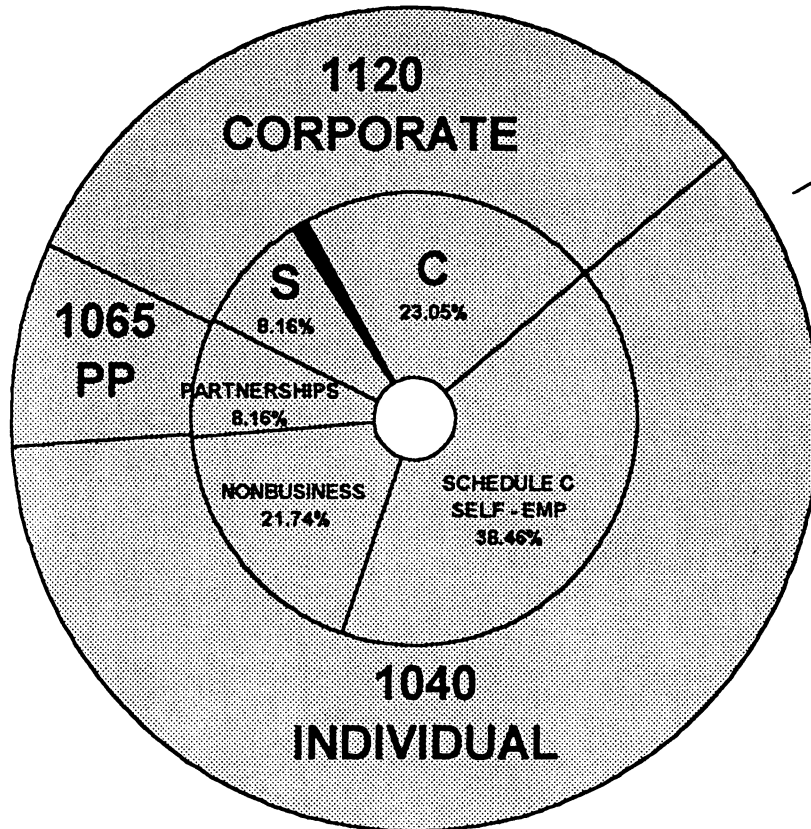
DORA SITE	1992 TOTAL RETURNS	TCMP SAMPLE SIZE	PERCENTAGE **
1. PHILADELPHIA	10,331,400	6,813	.0659
2. BROOKLYN	9,670,800	8,009	.0828
3. CHICAGO	9,508,500	6,685	.0703
4. CINCINNATI	8,687,200	5,734	.0660
5. SEATTLE	8,323,200	6,382	.0767
6. INDIANAPOLIS	8,158,600	5,445	.0667
7. DALLAS	8,158,400	7,429	.0911
8. GREENSBORO	7,779,400	5,781	.0743
9. ATLANTA	7,699,500	5,725	.0744
10. HOUSTON	7,449,100	6,340	.0851
11. LAGUNA NIGUEL	7,127,700	6,028	.0846
12. NEWARK	7,119,500	5,054	.0710
13. DETROIT	7,071,500	4,603	.0651
14. LOS ANGELES	7,056,700	6,515	.0923
15. SAN FRANCISCO	6,983,000	5,440	.0779
16. MILWAUKEE	6,493,000	5,363	.0826
17. BOSTON	6,274,100	4,478	.0714
18. JACKSONVILLE	6,184,300	3,678	.0595
19. FORT LAUDERDALE	6,026,500	4,134	.0686
20. SAN JOSE	5,694,900	4,524	.0794
21. ST. PAUL	5,625,000	4,863	.0865
22. ST. LOUIS	5,550,500	4,386	.0790
23. DENVER	5,525,100	4,701	.0851
24. HARTFORD	5,398,200	4,110	.0761
25. NASHVILLE	5,357,600	3,887	.0726
26. PHOENIX	5,306,400	4,074	.0768
27. BUFFALO	5,282,800	3,337	.0632
28. RICHMOND	5,018,600	3,117	.0621
29. BALTIMORE	4,751,600	2,957	.0622
30. NEW ORLEANS	4,575,300	3,639	.0795
31. D.C. (FOREIGN CONTROLLED CORPORATIONS)	42,300	664	1.5697
TOTAL		153,895	

* TCMP sample size includes market segment returns in the specified DORA.

** According to the IRS, the sample distribution by DORA is similar to the population distribution of returns. Since market segments with less homogeneity require larger sample sizes, and some of these market segments are not equally distributed geographically, the sample size by DORA is not exactly proportionate to the population distribution..... Source: IRS.



FEELING LUCKY ANYONE...? DARTS ANYONE...?



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