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. IRS AUDITS ARE EVIDENT EVERYWHERE. The IRS continues to be very active and we've selected a number of hot topics to discuss in this issue. The *Automotive News* and other dealer publications echo stories of the IRS assessing large deficiencies in dealerships where demo use has not been properly documented...or where it is being abused.

Dealers involved with dealer-controlled (buy-here, pay-here) financing for used cars sold to credit-challenged customers are receiving considerable IRS attention, as are their transactions with related finance companies and entities. Letter Ruling 9534023 shows a good example of how dealers are setting up related finance companies or entities in connection with their overall income tax and/or estate planning. See page 19.

In another case involving dealership accounting for tax deductions, the Tax Court supported the IRS in disallowing a deduction "up front" for an accrued liability...and said that "all events" had not occurred to fix the liability. The *Spitzer Columbus, Inc.* case discussed on page 8 proves that **timing still is everything!**

In *Heritage Auto Center, Inc.*, see page 3, the IRS recently released its Reviewed Brief involving its contest over the allocation of the purchase price in a buy-sell agreement between goodwill/blue sky/franchise value, agreements not to compete and consulting agreements. Its review concluded that the allocation was an afterthought...a sham...and was unacceptable. It appears that the taxpayer, *Wright*, did it all wrong. You can learn much from what was done and how it was (or should have been) documented.

Both *Spitzer Columbus, Inc.* and *Heritage Auto Center, Inc.* involved "unusual facts" resulting from actions by the Attorney General's office in their respective states. Unfortunately, with all the regulation and "consumer's rights" dealers have to contend with, these situations may not be so unusual after all. Both cases are instructive in showing how the IRS believes certain transactions should be treated for tax purposes.

Other areas where the IRS is probing: dealership off-shore captive insurance companies, reasonableness of dealer compensation, loan accounts, travel and entertainment and accounting for extended warranty service contracts. See also Update item #2-3-4-6 and 7.

WATCHING OUT FOR

see **DEALER TAX WATCH OUT**, page 2

#2. IRS AUDITS...TCMP AUDITS. In our last issue, we devoted quite a bit of space to IRS audit activity and the controversial 150,000 TCMP audits that were scheduled to start later this year. In the meantime, there has been tremendous pressure against the TCMP program.

Reports of opposition in the Congress, as well as budget considerations, suggest that the IRS' TCMP program is under attack. The IRS just announced that the TCMP audit program will not be initiated this year. Hallelujah!!

#3. IRS CONTINUES TO HIT DEMO USE. You can't miss all the attention in the press given to huge assessments resulting from IRS attacks on the use of demonstrators. *Automotive News* (August 7, 1995 and October 2, 1995) contain major articles recounting the cases of dealers in Massachusetts, Wisconsin, New Hampshire and elsewhere. The state-wide audits in Wisconsin have reached almost every dealership, raising questions especially in connection with the use of demonstrators by managers, rather than by salesmen. Interestingly enough, several CPAs from Wisconsin have indicated that even within the state, different agents have accepted different settlements. See NADA's *Federal Tax Treatment of Demos* (1990) for specific rules.

Rather than repeat all these unexciting "rules" (which the IRS bends on some audits anyway!) we have included a sample Demonstrator Agreement on pages 17-18 as a Practice Guide that you might want to compare against your own.

#4. IRS USED CAR DEALER AUDIT GUIDE. The IRS Audit Technique Guide for Independent Used Car Dealers contains interesting information specific to used car dealers. More than that, it also contains much useful information in the broader context of how the IRS approaches the audits of all automobile dealerships. See pages 11-16.

Practice tip: Any CPA looking to provide another or a higher level of service to dealer clients need look no further. All you have to do is make a checklist for yourself out of what IRS agents are being told in this IRS guide to go in and look for. Then go in and look for it yourself. These engagements will end up helping you and the dealer avoid shocks, suprises and rude awakenings later on. Our list on page 16 of Income Recognition and Reporting Issues can be used for starters as another Practice Guide or as part of your own Industry Background files.

#5. DEALERSHIP "EXIT STRATEGIES." Dealership succession and business continuity planning is sometimes lumped under the chic term "exit strategies." As you know, many manufacturers are planning intensive campaigns to throw dealers out of their own dealerships... "cannonball exit" strategies.

Industry observers say there are far too many dealers in this country than necessary ...and this results in excessive distribution costs for the manufacturers supporting too many dealers. Consequently, factories are now finding it necessary to down-size their dealer bodies... just as we have in some instances advised our dealers to down-size their own businesses. As the manufacturers implement these programs, dealers' CPAs will be hard-pressed and challenged to fit activities planned over a longer term into a more immediate and stressful timetable.

What we (CPAs) need to develop here is a whole new approach for helping dealers who need **involuntary** exit strategy planning assistance.

#6. FINANCIAL STATEMENT CONFORMITY REQUIREMENT FOR DEALERS USING LIFO. As we have said previously, this is still the hottest IRS audit issue for auto dealers using LIFO. The IRS released adverse technical advice throwing out dealer elections for conformity violations in their statements sent to the manufacturers and to factory-affiliated credit corporations.

IRS Letter Rulings 9535009 and 9535010 denied these LIFO elections. Furthermore, there was no "audit protection" preventing this result just because the dealers had elected to use the Alternative LIFO Method in 1992. You should expect the worst from these rulings.

These dealer LIFO matters have been discussed extensively in the September, 1995 ***LIFO Lookout*** which included detailed analyses of these Letter Rulings and other adverse ramifications. For readers of the ***Dealer Tax Watch*** who may not be subscribers to the ***Lookout***, we have reprinted two "Fatal Flaws Flowcharts" which help analyze the IRS letter rulings on conformity and a series of reasons why Congress should intervene. (See pages 21-23.)

CPAs and dealers have been asked to write their Congressmen to bring pressure upon the IRS in its unreasonable interpretations of these conformity regulations. We should all take note of the result obtained where Congress gets involved in "touchy" matters...as evidenced by its stopping TCMP audits for 1995-6 dead in their tracks.

#7. MORE IRS ACTIVITY...IN OTHER AREAS. Many of our dealer clients are in the highest (effective) tax brackets. Some directly as a result of their employment by dealerships operating as C Corporations, others as a result of their status as partners in a partnership or as shareholders in an S Corporation operating a dealership.

see **DEALER TAX WATCH**, page 24

BUY - SELL PRICE ALLOCATIONS

In June 1994, the ***Dealer Tax Watch*** analyzed the Tax Court's decision in *East Ford, Inc.* which involved the problem of a seller and a purchaser's conflicting valuations for tangible and intangible assets transferred in the sale of a business. In that case, the Tax Court had to assign values to the assets transferred and decide whether any portion of the purchase price was applicable to good will, long-term rental leases or any other assets.

Another case involving purchase price allocations for car dealerships has surfaced: *Heritage Auto Center, Inc. v. Commissioner.* This case is Tax Court Docket No. 26362-92 and only recently was an IRS Reviewed Brief made available under the Freedom of Information Act. The Brief, filed for the respondent-IRS by then Acting Chief Counsel, David Jordan, was filed August 11, 1994.

This IRS Reviewed Brief sets forth the positions of the IRS in connection with whether a covenant not to compete had economic significance, independent of the dealership's going concern value or good will. A number of additional issues are involved, including several related to the taxpayer's consulting agreement. This IRS Brief shows how tenaciously the IRS attacks purchase price allocations, looking much further than it ever seems to have looked in the past. The arguments it presents are a lawyer's delight and a dealer's dread.

BACKGROUND / FACTS

This case involves the years 1988 and 1989 and a Tax Court trial was held in May of 1994 although an opinion apparently has not yet been rendered. In March of 1988, Heritage Auto Center, Inc. was in the process of purchasing two dealerships from a corporation 100% owned by William T. Wright. The purchasers and the sellers met on March 4, 1988 to review the terms of the proposed purchase agreement. These terms included $1,350,000 to be paid above the amount to be paid for tangible assets. These amounts had been negotiated by the buyer and the seller prior to the March 4, 1988 meeting.

In the proposed purchase agreement, the purchaser had simply agreed to pay the excess amount of $1,350,000 as a lump sum without any allocation between goodwill or a covenant not to compete. Apparently, the term "blue sky"—meaning intangible value—had been used in the discussions but no allocation had been made between goodwill and a covenant not to compete. The first draft of the purchase agreement did not allocate a significant portion of the purchase price to either goodwill or a non-compete covenant.

The first draft of the purchase agreement provided that both the seller, individually, and his two corporations would execute a covenant not to compete; however, it provided that the <u>entire</u> amount of the purchase price would be paid to the corporations. That first draft also provided that the seller "will preserve for Buyer the goodwill of the dealerships, including the goodwill of its suppliers, customers and others having business relations with the dealerships."

The purchase agreement dated March 4, 1988 provided that the buyer was purchasing all of the seller's goodwill as a going concern for $200,000.

The selling dealer (Wright) had engaged in sales promotions and advertising for the dealerships, including television commercials, which apparently resulted in adverse publicity and a suit was filed by the Attorney General of the State of Washington alleging consumer fraud. By refraining from engaging in certain specified acts and practices, the seller individually and his corporations would be able to avoid sizable civil penalties prescribed under a Consent Degree.

At the time the purchase agreement was entered into, there were civil suits pending against the seller based on consumer fraud and the purchasers did not want to acquire the stock of the selling corporations because of potential liabilities against them. Before the adverse publicity due to the Attorney General's suit, the dealerships had been very profitable and the Seattle, Washington metropolitan area was a good market for automobile sales. The $1,350,000 which the purchasers agreed to pay for the intangible value of the dealerships was based upon what the buyers thought they could make from the business over a reasonable period of time. The buyers also knew that the seller was trying to sell his other auto dealerships in the Seattle, Washington area. They further knew that the individual seller (Wright) was not in good standing with Ford Motor Company. As a matter of policy, the buyers would not have purchased any automobile dealership without securing a covenant not to compete as part of the contract.

see **BUY-SELL PRICE ALLOCATIONS**, page 4

 (Continued from page 3)

BUY-SELL PRICE ALLOCATIONS
HERITAGE AUTO CENTER, INC. - TAX COURT DOCKET NO. 26362-92

	Draft Agreement	Original Agreement	Per Taxpayer Amended Agreement	Per IRS Brief
Goodwill/Blue Sky/ Franchise Value		200,000	--	1,350,000
Agreement Not to Compete (Non-Compete Agreement)		1,150,000	675,000	--
Consulting Agreement			675,000	--
TOTALS	$1,350,000	1,350,000	1,350,000	1,350,000

On the tax returns, the non-compete agreement payment of $675,000 and consulting agreement payment of $675,000 was amortized over a 3-year period. For financial statement purposes, the total amount of $1,350,000 was treated as goodwill subject to amortization based on a 40-year life. The $1,350,000 represents the amount paid over and above the amount paid for tangible assets ($1,964,300). Thus, the total purchase price was $3,314,300.

Taxpayer's Form 8594, Asset Acquisition Statement Under Section 1060, for the taxable year 1988 claimed the above amounts as the fair market value of intangible amortizable assets with useful lives of three years purchased by it from the seller.

Taxpayer claimed an amortization deduction of $225,000 per year (pro-rated on a monthly basis for 1988). Position of the IRS is that the entire amount ($1,350,000) was paid for non-amortizable assets and no deduction for amortization should be allowed.

As a matter of form, Mr. Wright could not directly assign his franchises to the purchasers, but had to resign them contingent upon each manufacturer's approval of the purchaser's application for a new franchise.

Neither the first draft of the purchase agreement nor the actual purchase agreement allocated any part of the purchase price to the individual selling dealer's agreement to resign his franchises (Ford, Toyota and Suzuki) in favor of the individual shareholders of the purchasing corporation.

The first draft of the Non-Competition Agreement and the final Non-Competition Agreement (which was attached to the actual purchase agreement) provided that $1,150,000 would be paid to the individual selling dealer at closing for his agreement not to compete with the buyers for a period of three years and that this amount paid was non-refundable.

At the trial, none of the purchaser's witnesses knew how the allocation of the $1,350,000 between the goodwill and the covenant not to compete had been made. Shortly after the execution of the purchase agreement, the parties agreed that the allocation would be readjusted if it were determined that the manner of the allocation was not in the best interests of the individual seller. At that time, the shareholders of the purchasing corporation (i.e., the buyers) intended to have at least $100,000 applied to goodwill, "but not a great deal more." The buyers were aware of the tax advantages to them of allocating part of the purchase price to the covenant not to compete or to a consulting agreement, instead of to goodwill. No mention had been made in either the first draft of the purchase agreement or the final purchase agreement of any provisions for Mr. Wright, the individual selling dealer, to render consulting services to the buyer.

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Sometime between March 7, 1988 and April 7, 1988, the parties agreed to re-allocate $675,000 to the covenant not to compete and $675,000 to a consulting agreement and nothing to goodwill. None of the witnesses for the purchasing corporation at the trial knew why the change to the allocation had been made.

With respect to the consulting agreement, the initial discussions were that the individual selling dealer also was to be paid a per diem fee of $1,000 for each and every day, or part thereof, whether such consultation was by telephone or in person. This $1,000 per day fee was not acceptable to the purchasers "because they were concerned that it made the $675,000 consulting fee look like a sham and endangered its deductibility for tax purposes."

An Addendum to the Purchase Agreement provided that no portion of the purchase price would relate to goodwill and that "all goodwill of the business of Seller is not to be assigned any value."

The finalized Non-Competition and Consulting Agreement called for $675,000 payable at closing to William T. Wright for his covenant not to compete for a period of three years. The amount paid was not reimbursable in the event of death or disability. The agreement stated that the covenant not to compete was "...necessary and reasonable to protect the interest of Buyer, including Buyer's business and goodwill." In addition, the Agreement provided that the seller would be paid $675,000, in three equal installments of $225,000, to secure his services as a consultant for three years. The seller's obligation to consult was limited to a maximum of 5 days a month, not to exceed 15 days per calendar quarter. The buyers also "could pre-pay the consulting fee at any time without penalty and without terminating the agreement." The $675,000 allocated to the covenant not to compete was paid at closing and the $675,000 allocated to the consulting agreement was prepaid at closing.

Interestingly, during the years 1988-89-90, the full-time operating manager of the dealerships earned no more than $180,000 per year. On the dealership's combined financial statements, the $1,350,000 excess cost over fair value of the assets acquired was shown as goodwill and was amortized on a straight-line basis over 40 years. **This was inconsistent with the Form 8594**, Asset Acquisition Statement Under Section 1060, that was filed for the taxable year 1988 which reflected $675,000 as paid for the consulting agreement and $675,000 as paid for the covenant not to compete.

ISSUES

There are three issues involved in this case. The first issue is whether the covenant not to compete in the purchase agreement had economic significance independent of the going concern value or goodwill of the dealerships being sold and the intangible value of the franchises which the dealer agreed to resign in favor of the purchasers. Notice how intricately the IRS has worded this issue.

The second issue is whether the Addendum to the Purchase Agreement, made approximately one month later, should be disregarded as "an afterthought which does not reflect the true economic substance" of the buyer's purchase of the dealerships.

The third issue is whether the amounts paid by the purchaser for the going concern value or goodwill of the dealerships and their related franchises are amortizable under Section 167(a).

Cases cited in the IRS/Respondent's brief:

1. *Dixie Finance Co., Inc. v. United States*, 474 F.2d 501 (5th Cir. 1973)
2. *Epstein v. Commissioner*, T.C. Memo. 1964-192
3. *Forward Communications Corp. v. United States*, 608 F.2d 485 (Ct. Cl. 1979)
4. *Lemery v. Commissioner*, 52 T.C. 367 (1969), aff'd. 451 F.2d 173 (9th Cir. 1971)
5. *Payne v. Commissioner*, 22 T.C. 526 (1954)
6. *Shwartz v. Commissioner*, T.C. Memo. 1960-228

see **BUY-SELL PRICE ALLOCATIONS**, page 6

 (Continued from page 5)

IRS CHALLENGES TO PURCHASE PRICE ALLOCATIONS

1. The buyers had **no reasonable expectation** that the individual selling dealer would compete with them as a Ford, Toyota or Suzuki automobile dealer in the Seattle, Washington metropolitan area within 3 years of their purchase of the assets of the dealerships.
2. The risk that the individual seller would compete...(in that area...for that period of time)... was not significant.
3. At the time of the purchase of the assets, the franchises were valuable assets. Furthermore, they were intangible assets without an ascertainable useful life.
4. The buyers had a reasonable expectation that under new management and with new names, the dealerships that were purchased would be profitable again.
5. The buyers believed that the dealerships had going concern value or goodwill despite (or notwithstanding) the adverse publicity of the individual selling dealer and his dealerships.
6. The interests of the parties were not adverse with respect to the characterization of the $1,350,000 agreed to be paid in excess of the value of the tangible ("hard") assets.
7. The $1,150,000 allocated in the original purchase agreement to the covenant not to compete **did not comport with economic reality**.
8. The covenant not to compete had **no economic significance independent of** the going concern value or goodwill of the dealerships and the intangible value of the franchises.
9. The Addendum was entered into in order to pass more of the purchase price directly to the individual selling dealer and shareholder, rather than to his corporations.
10. At the time that the Purchase Agreement was executed, the **parties had no intention** that the individual seller would perform consulting services. Furthermore, the need for the buyer to consult with the seller was not significant. Additionally, there was **no reasonable expectation** that the buyers would need to consult with the seller for as much as 60 days per year, nor that they would need to consult with the seller for a period of three years.
11. The $675,000 amount allocated to the consulting agreement "**did not comport with economic reality**." It was an attempt to justify the amortization for tax purposes of the $1,350,000 agreed to be paid in excess of the amount paid for the tangible assets of the dealerships.
12. The $675,000 amount allocated to the consulting agreement in the Addendum **was not paid for anticipated consulting services**, but was paid as part of the purchase price of the assets for the dealerships.
13. Finally, the purchaser is **not entitled to amortize any part** of the $1,350,000 under Section 167.

IRS ARGUMENTS

In its summary of the overall record, the IRS Brief states that at the time of the purchase of the dealerships, the buyers were aware of the difficulties the seller was having with the State of Washington. The buyers were also aware of the prior profitable history of the dealerships and they knew that they would be profitable again once they disassociated from the seller. "They knew that Wright had become ineffective as an automotive dealer in the area and that he was trying to sell his other dealerships in the area as well."

The IRS pointed out that no part of the purchase price was allocated to Wright's agreement to resign from the franchises notwithstanding the fact that the Purchase Agreement provided that the "Seller will preserve for the Buyer the goodwill of the dealerships, including the goodwill of its suppliers, customers, and others having business relations with the dealerships."

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Another point that did not escape the IRS was that in the Addendum to the Purchase Agreement, the parties modified the agreement to provide that no portion of the purchase price would relate to goodwill and in that modification the parties stated that all goodwill of the business of the seller is not to be assigned any value. In other words, the parties mutually acknowledged and agreed that there was goodwill value, but that it would not be assigned any dollar or monetary amount in the contract.

The IRS observed that by restructuring and recharacterizing the payments so that they would be made to William T. Wright directly, the amounts paid directly to him would avoid first being subject to his corporations' liabilities. "Any amount paid for goodwill would be payable to Wright's corporations as the seller, rather than to Wright individually, where it would be subject to their pending and potential liabilities and would not be amortizable by the buyers."

Another argument raised by the IRS was that as a result of the Tax Reform Act of 1986, the parties interests were not adverse with respect to the characterization of the $1,350,000 and it made no difference, tax wise, to William Wright as the seller whether the amounts he received were received as capital gains or as ordinary income. Consequently, the parties were not negotiating at arms-length when they agreed to allocate part of the purchase price to the covenant not to compete.

The IRS further contended that the covenant not to compete was a provision that the buyer would have included in any purchase agreement with anyone under the circumstances as a matter of good practice. The IRS emphasized that it became a question of whether, "under the circumstances of this case, that provision had any economic significance independent of the going concern or goodwill" of the dealerships and the intangible value of their related franchises. In support of this, the IRS cited several cases for the proposition that where there was no real expectation that the seller would or could compete with the buyer, the Court has disregarded the parties' allocation of the amount to a covenant not to compete in a purchase agreement and has held that the covenant was without value.

The IRS also pointed out that although the purchase agreement allocated a large amount of the total purchase price to the covenant not to compete, none of the buyers' shareholders who appeared as witnesses at the trial could explain how the allocation was made. Furthermore, shortly after they executed the purchase agreement, the parties agreed to change the allocation and, again, none of the buyers' shareholders who appeared at the trial could explain why that change had been made. The IRS argued that "obviously, the amount allocated to the covenant not to compete was something artificial which had not been genuinely bargained for and which did not have economic significance to the parties independent of the purchase of the dealerships' intangible value."

With respect to the consulting agreement, the IRS contended that it "was no more than an afterthought devised to justify the large amount allocated to the covenant not to compete in the Purchase Agreement and to safeguard its deductibility for income tax purposes. A contract modification which does not represent the true economic substance of the transaction will be disregarded."

The IRS pointed out that there never had been any mention of William T. Wright performing any consulting services for the buyer prior to the time when the contract was readjusted. On the other hand, an allocation to going concern value or goodwill was (apparently) contemplated from the beginning. The literal wording in the Addendum that "all goodwill of the business of seller is not to be assigned any value" suggested the existence of goodwill, to which no monetary value was assigned for transaction purposes.

The IRS added to its argument by pointing out that William T. Wright wanted to be paid an additional $1,000 per day for every day that he consulted, whether by telephone or otherwise, and inferred from this fact that Mr. Wright did not consider the $675,000 to be compensation for any consulting services he might perform. The fact that the obligation to pay for consulting services was absolute, unconditional and non-terminable for any cause and the fact that the entire amount was "prepaid" in full at closing—even though it could have been paid in installments—suggests that this was not the type of arrangement that would be entered into in an arms-length transaction if the parties actually intended that amount to be compensation for services to be rendered over several years. (This may remind some readers of the oft-repeated adage about pigs getting fat and hogs getting slaughtered!)

see **Conclusion to BUY-SELL PRICE ALLOCATIONS** on page 10

ACCRUAL DEDUCTION DENIED UPON ISSUANCE OF REBATE COUPONS ...DEALERSHIP MUST WAIT UNTIL COUPONS ARE HONORED

In our first issue of the ***Dealer Tax Watch*** (June, 1994), we summarized a **petition** that had been filed in the Tax Court on April 8, 1994 by *Spitzer Columbus, Inc.*, an Ohio dealership, contesting the IRS' disallowance of a deduction claimed in its 1989 tax return for $362,603. This amount represented an accrual for a settlement in a lawsuit which disputed the dealership's practice of charging car buyers a handling fee as part of the sale of new and used vehicles. The settlement decree had required the dealership to repay the fees that had been included as part of the purchase price of about 3,700 vehicles sold.

Since the dealership had included all of the handling charges in income prior to its 1989 tax year, it claimed a deduction in its 1989 tax return for the amount it calculated as its entire liability resulting from the consent decree.

Both the IRS...and the Tax Court in TC Memo 1995-397 (August 17, 1995) disallowed the accrual of the deduction.

BACKGROUND

Spitzer Columbus, Inc. became involved in 1987 with the Ohio Attorney General's Consumer Protection Division when it started a non-public investigation of the dealership group of which *Spitzer Columbus* was a part. The dealerships were charged with violating various provisions of the Ohio Consumer Sales Practices Act and a consent judgment was entered on November 22, 1989 requiring the taxpayer to make restitution of every $97.50 delivery and handling fee that had been included in the purchase price of vehicles sold from May 1, 1987 through November 22, 1989.

The dealership provided a list of all customers who purchased new or used vehicles in transactions involving a delivery fee during that 2½ year period. Along with the list, the taxpayer provided a coupon in the name of each purchaser which was mailed to that purchaser accompanied by a notice.

The coupons were valid—or could be redeemed - at <u>any</u> dealership that was part of the *Spitzer* group, including *Spitzer Columbus, Inc.* The coupons could be redeemed for any one of the following:

- $100 towards the purchase of any part or service,
- $150 towards the purchase of any new or used vehicle, **<u>OR</u>**
- $97.50 <u>in cash</u> - in the event the customer submitted a signed statement rejecting the other offers.

Part of the "fine print" was that the Attorney General's office had to be satisfied that the customer had, <u>in fact</u>, paid the $97.50 delivery and handling fee and that the customer had not negotiated that fee away at the time of the purchase. Under certain circumstances involving discounts and trade-ins, there was a <u>rebuttable presumption that the delivery and handling fee was negotiated away</u>. The taxpayer had the burden of proving that the customer negotiated away the delivery and handling fee, but the Attorney General made all decisions regarding whether the conditions had been met.

Most of the coupons were issued in March of 1990, followed a little later by those issued to customers whose current addresses were hard to locate. In all, 3,719 coupons were issued. The accompanying table shows that during 1990, 1,116 coupons were honored and in 1991 413 coupons were honored. Overall, 2,190 coupons were never redeemed.

The dealership claimed a deduction in its 1989 corporate tax return for all of the 3,719 coupons at their full cash redemption price of $97.50 each. During 1990 and 1991, when coupons were redeemed towards the purchase of new vehicles or parts or service, the dealership included the sales price or service less the coupon amount in income. Deficiencies in income tax were determined by the IRS for the years 1989 - 1990 - 1991 in the amount of approximately $350,000.

<u>The taxpayer never included in taxable income the amounts attributable to the unredeemed coupon amounts which it had deducted in 1989.</u>

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SPITZER COLUMBUS, INC.
REBATE COUPONS ISSUED AND HONORED

	Coupons Issued	1990 Activity	1991 Activity	Total Honored	Never Redeemed
$100 Off Purchase of Parts or Service		514	344	(858)	--
$150 Toward Purchase of New or Used Vehicle	--	30	7	(37)	--
Cash Refund of $97.50	--	572	62	(634)	--
Never Redeemed	--	--	--	--	2,190
TOTALS	3,719	1,116	413	(1,529)	2,190

Out of 3,719 rebate coupons issued, 2,190 were never turned in ...or they were turned in for cash, but not paid by the dealership because the coupon holder could not establish that the fee had not been negotiated away at the time of the purchase.

Out of 1,057 customers who made application for a cash rebate, only 634 actually received payment.

Spitzer Columbus, Inc. claimed a deduction in its 1989 income tax return for the face amount of all rebate coupons issued, $362,602.50 (3,719 x $97.50).

The Tax Court held that the dealership's liability attached only when the rebate coupons were presented...and honored.

SECTION 461(h)

The Tax Court looked first at Section 162(a) which allows a deduction for all ordinary and necessary expenses paid or incurred during the taxable year. The language of 162(a) is augmented by cases which require that "all events" must have occurred which established the fact of the liability. Furthermore, the amount involved must be capable of being determined "with reasonable accuracy."

All of this was incorporated into the Internal Revenue Code by the addition of Section 461(h) in 1984. Various sub-sections now provide that the "all events" test is met with respect to an item if all events have occurred which determine the fact of the liability **and** the amount of such liability can be determined with reasonable accuracy. Furthermore, another part of Section 461 limits the applicability of the test by providing that it is not met until "economic performance" occurs.

The Tax Court's analysis did not involve the applicability of the "economic performance" requirement because the Court found that the taxpayer failed to satisfy either of the two elements that comprise the "all events" test. In this regard, the "all events" test cannot be treated as met any earlier than when economic performance with respect to the item in question occurs.

ALL EVENTS

As indicated by the **and** above, a taxpayer's failure to satisfy **either** requirement in the "all events" test is fatal to the taxpayer's position. *Spitzer Columbus, Inc.* was unable to prove either (1) that the liability was fixed or (2) that the amount of the liability was determinable with reasonable accuracy.

The Tax Court held that the liability attached when the rebate coupons were presented by the customer...and not when they were issued. The Tax Court held that the Attorney General's consent judgment only required the taxpayer to issue coupons to certain customers and the consent judgment itself did not create the requisite liability. The Court distinguished the case cited by the taxpayer (*Hughes Properties, Inc.*) and relied upon *U.S. v. General Dynamics Corp.* as being more analogous.

see **ACCRUAL DEDUCTION DENIED...**, page 10

Accrual Deduction Denied...

(Continued from page 9)

The Court noted that although a coupon redeemed for money off a car purchase or a parts or service purchase would be taken at face value, a coupon returned by a customer for cash "merely began the process of determining whether the customer was entitled, under the terms of the consent judgment, to a cash rebate." The Court observed that only 634 out of 1,057 customers who made application for a cash rebate actually received payment. Since almost one out of every three who requested a cash rebate did not receive it, the Court observed that "the review of the coupons presented for a cash rebate was more than a meaningless step."

The Court held that *Spitzer Columbus, Inc.'s* liability was not fixed until a prior customer presented a coupon, or if the coupon was presented for cash, until the payment was approved.

DETERMINATION WITH REASONABLE ACCURACY

With regard to the need to be able to determine the amount "with reasonable accuracy," the Court observed that the coupon was valid at **any** Spitzer dealership, and not ***only*** at Spitzer Columbus, Inc.

Spitzer Columbus, Inc. offered no evidence as to how a coupon which it issued would be treated if it were redeemed at another Spitzer dealership. Although it bore the burden of proof, it presented no evidence of how an arrangement for reimbursing other related dealerships might operate.

SUBSEQUENT YEARS

Having concluded that a deduction was not allowable for the face amount of the coupons in 1989, the Court looked at the tax treatment for the years 1990 and 1991 when coupons were redeemed and honored. In those years, when the coupon was honored by reducing the purchase price of parts, services or a new or used vehicle, the dealership included in income the sales price less the coupon amount. In effect, this resulted in the expensing of the coupons redeemed in 1990 and 1991.

The Court observed that this treatment by Spitzer Columbus, Inc. in its tax returns, as filed, "is inexplicable in light of its prior expensing of all of the coupons." However, said the Court, the treatment given these coupons in the 1990 and 1991 tax returns "is proper following the denial of the deduction in 1989" and Spitzer Columbus, Inc. was entitled to a deduction for cash actually paid for the redemption of coupons in 1990 and 1991. Obviously, the taxpayer's returns were inconsistent with each other over a period of years. The Court merely noted this and the IRS raised no issues in this regard.

LESSONS FROM *SPITZER COLUMBUS, INC.*

This case shows how the IRS and the Tax Court are currently interpreting Code Section 461(h). The Court's language is particularly instructive insofar as dealerships may have other situations which appear to involve the need for accruals or "reserves" to cover anticipated expenditures. The specific complaints and judgments involved in this case are simply evidence of the litigation-prone and consumer-protected environments in which dealerships operate.

Language used by the Court is often paraphrased by IRS agents in disallowing deductions for additions to "reserve-type" accounts in dealerships. The Court's comment regarding the "all events" test says it all:

> "Where further events must occur before liability is fixed, an accrual amounts to nothing more than a reserve,...and it is well established that (in the absence of specific statutory provisions providing otherwise), reserves are not deductible."

Buy-Sell Price Allocations

(Continued from page 7)

CONCLUSION

CPAs who are advising auto dealers in buy-sell negotiations should be aware of the IRS' arguments and should take care to try to justify and document all of the facts and circumstances as they are reduced to amounts for goodwill/blue sky/franchise value, agreements not to compete (by the selling corporation(s) and by the selling shareholders), and to consulting agreements, all of which may be part of the transaction. They should also be sure that witnesses put on the stand in a Tax Court proceeding know at least certain basics before they try to help their own cause.

How would you like to have your dealer's credibility, capacity, documents and transactions scrutinized the way Mr. Wright's were? Regardless of which side of a buy-sell transaction you are on, the insights from this IRS Reviewed Brief provide a textbook analysis for dealing with future problems. Review the thirteen challenges raised by the IRS and compare them with any situation you have been involved with recently. If you see any areas or issues where documentation or clarification are needed, then do it the right way—not the Wright way!

IRS' USED CAR DEALERS AUDIT MANUAL

IRS MANUAL

The IRS' Independent Used Car Dealer Audit Technique Guide contains a wealth of information for you, whether you're the CPA for a franchised new car dealer or for a used car dealer.

This 140-page Manual or Audit Technique Guide was released in April, 1995 as part of the Market Segment Specialization Program. It was compiled by the IRS Milwaukee District with the assistance of the National Independent Automobile Dealers Association and the Jacksonville, Richmond, Denver and Milwaukee Districts and the IRS National Office.

MANUAL SECTIONS

- Industry Background
- Accounting Methods
- Gross Receipts
- Cost of Goods Sold / Inventory
- Balance Sheet
- Expense Issues
- Package Audit Requirements
- Related Finance Companies

The last one-third of the Audit Technique Guide consists of extensive commentary and workpapers for examining agents in the special areas of (1) employee/independent contractor worker classification situations and (2) dealer-controlled financing arrangements resulting from the sale of lower-priced used vehicles with related/controlled entities (collectively described in the Manual as "Related Finance Companies" or RFCs).

This overview summarizes each section of the Audit Technique Guide/Manual.

INDUSTRY BACKGROUND

The Industry Background section of the Manual contains a detailed "Industry Jargon" guide designed to familiarize inexperienced auditors with a variety of hitherto unfamiliar terms, among them: ACV, Bird Dog Fees, LOC, Package Deals, Skips, Sleds, Spiffs and Yo-Yos. This section also contains an Industry Overview which discusses state regulation and law, problems associated with "curbstoners" (i.e., unlicensed operators), records, consignments, auctions and titling issues and processes.

The most interesting part of this section is the detailed "Initial Interview" guide. Considerable emphasis is placed upon the initial interview process. Questions to be asked as part of the initial interview include (1) Have you ever taken items other than vehicles in trade, (2) What other non-trade-in sources of vehicles do you utilize and (3) Do you and your family members own a car? These, and others, all prompt the examining agents to look for unusual items and to attempt to tie them in with (unreported) income in the taxpayer's return.

The comment is made "the examiner may want to ask the owner if he keeps a personal record or list of his profits on each vehicle or deal. The examiner may also want to ask what other records, listings or summaries on business transactions other than those already provided the business or owner maintained."

ACCOUNTING METHODS

In many places throughout the Manual, the comment recurs that used car dealers usually will have poor internal controls...and the absence of proper internal controls means that the agent will have to do more audit work.

There also seems to be a presumption that used car dealers "employ" a single entry record keeping system, rather than a more conventional double entry (i.e. debits=credits) set of books.

The chapter on accounting methods points out that used car dealers normally will maintain an inventory and, therefore, they are required to use the accrual method of accounting. It points out that many used car dealers use improper methods that defer the reporting of income to subsequent years for installment plan sales that overlap tax years. It also mentions the use of **hybrid** accounting methods, the most common of which is the use of the **accrual** method for gross receipts and cost of goods sold and the **cash** method for other expense items. The Manual states (at page 23), however, that such (hybrid) methods are acceptable as long as they clearly reflect the dealer's income and conform to the regulations.

This section of the Manual also discusses changes in accounting methods (CAMs), Section 481(a) adjustments and the terms and conditions for method changes prescribed by Revenue Procedure 92-20.

GROSS RECEIPTS

The chapter on gross receipts indicates that many used car dealers receiving cash or cash equivalents may not be filing all of the Forms 8300 that should be filed and examining agents are instructed that their work with "gross receipts" needs to be coordinated with the Package Audit Section materials.

see **IRS' USED CAR DEALERS AUDIT MANUAL**, page 12

The Manual says that "...Throughout the country, a number of dealers have been found to be reporting sales at net rather than gross and showing the amount of the trade-in as a return or allowance on the sales contract. They then take the sale of the vehicle they received in trade and include it as Cost of Goods Sold when it is sold. This treatment results in a double deduction of the cost of an auto taken as a trade-in." Agents are instructed not to allow dealers to use the practice of reporting sales at net.

Agents are also warned to be on the lookout for auctions giving prizes with the purchase of certain cars or in connection with drawings that are held to be sure that if a dealer or a dealer employee attending the auction "wins" any consumer durables such as television sets or stereos, those "prizes" are reported in their tax returns as personal income.

In discussing fee income, auction fees and transactions between the dealer and the auction, the Manual states that "one examination uncovered $32,000 in broker fees for sales between dealers, none of which was reported as income." Examining agents are advised to obtain a printout of vehicles purchased from auctions that the dealer does business with and to spot-check the listings for inclusion in income and to check for cars that stand out. "For instance, if a dealer primarily sells domestic 'sleds,' a $20,000 Mercedes SL sports car purchased at auction would be out of character."

In the material on Income Reporting, eight (8) issues are listed that agents should consider during an audit. These are summarized on page 16.

PRE-AUDIT STEPS

1. "Look into the owner's/shareholder's **standard of living** prior to starting the audit. This may indicate he/she is living beyond the means shown on the return.
2. Analyze prior and subsequent return information as percentages of Gross Profit. Large changes in percentage of Gross Profit may indicate need for examination of a particular issue.
3. Run a cash transaction record (Form 8300) check to determine if large amounts of cash are being received and/or deposited. This should be done before starting the examination.
4. Perform quick Cash-T on shareholder/owner based on return information.
5. Check with your state's corporate charter division for a listing of all corporations the owners are involved in as officers or directors."

(Continued from page 11)

COST OF GOODS SOLD / INVENTORY

This section begins with the observation that "the **purchase** figure reported on the return may frequently be a 'plug' in order to balance the cost of goods sold computation. This makes it very difficult, if not impossible, to reconcile the account. Instead of accepting the 'plug' figure, it may be necessary to reconstruct the purchases and inventory from dealer data. This means taking the dealer's invoices, vouchers, and other source data, and creating your own set of books for purchases. If there is a purchase journal or similar documentation available, scan for unusual items. The unusual items may include personal items and capital expenditures, which will result in exam adjustments."

A dealer may have substantial reconditioning costs that are incurred to get a vehicle that was traded in ready for sale. The Manual explains that the total dollars spent on reconditioning cars may be one of a dealer's largest expenses, and that the cost of reconditioning each car should be added to the inventory cost of the car.

Considerable attention is given to the complex inventory issues that arise in the valuation of trade-ins. These complexities arise because the amount the Dealer allows as the "trade-in" value does not usually equal the Actual Cash Value (ACV), which is the initial inventory cost to the Dealer. Portions of this chapter of the Manual are devoted to discussing "Cost Basis of a Trade-in," "Trade-in Valuations" (citing *Brooks-Massey Dodge, Inc.* and Revenue Ruling 67-107), and "Repossessions." These discussions are followed by five pages of General Audit Techniques for costs of goods sold/inventory accounts and transactions, two pages of Regulations and case law citations and extensive Exhibits.

"**The valuation of a trade-in is an art, not a science.**" I did not say this: the Audit Technique Guide says it on page 46. It comments that many dealers rely more on experience and personal judgment, than on an (accepted industry) Valuation Guide. Other dealers may rely solely on their professional judgment of the value of the car in that area at that time. Regardless of which approach is used, according to the Manual, ... "Every dealer values that car for the sole purpose of making a profit on both the car in inventory and the trade-in, when it is ultimately sold."

Some dealers may undervalue their year-end inventory to overstate the cost of goods sold by using unacceptable methods of valuation. For example, one dealer was reported to have used personal knowledge and year-end auction prices for similar cars as the means of valuing inventory. His reason for using auction value was that this was the price he →

could get for his cars if he were forced to "dump" his inventory at auction and close the business. But, according to the IRS, this was not the dealer's primary market. Another dealer was found to be using loan values to determine inventory value. This dealer stated he could get better loans from the bank by using the loan value of the cars as his inventory value (even though he was apparently overpaying his taxes in the process!)

While the industry may recognize the use of experience and personal judgment to value inventory, the Internal Revenue Service and the courts do not. The courts have ruled that only officially recognized valuation guides may be used for tax purposes.

To me, the Manual contains a tremendous distraction—obviously reflecting one of my own (petty) idiosyncrasies—every time it refers to its favorite, highly-prized reference source as the *Kelly (sic) Blue Book*. Everyone knows that "Kelly" is spelled "Kelley" ... or do they?

A more specific observation, relative to the matter of valuation, is that agents are told explicitly that it is the dealer's responsibility to reconstruct the inventory valuation. This **burden of proof** includes providing a written listing of the vehicles in inventory at the end of the year, as well as the valuation assigned to each vehicle. Agents are advised to refer to information that may be available from the State Department of Motor Vehicles where the dealer has not maintained accurate inventory records and it becomes necessary to reconstruct the ending inventory.

ADMONITIONS TO AGENTS

1. Require taxpayers to record all sales at gross and not at net,
2. Look for excessive rebates and allowances where purchases are made from related taxpayers,
3. Look for voided inventory transactions which might evidence "a wholesale trade off the books,"
4. Look for personal vehicles included as purchases—but not in ending inventory (jet skis, boats, snowmobiles), and
5. "Drive by the owner(s) residence to make a preliminary determination of the standard of living and whether cars from the inventory are kept at home."

The sample exhibits show one method of developing workpapers for adjustments to inventory. In the case illustration, the taxpayer was unable to produce any verification of the year-end "values" through records or auction reports for the year under audit. In connection with the sample Information Document Request (Form 4564) the Manual says: "Some states require used car dealers to maintain a log of all used car transactions. If your state requires these logs, include them as part of your initial document request."

In connection with inventories, the Manual points out that "LIFO is very seldom used by used car dealers, but you may come across it. If you find a LIFO inventory case, request assistance from a resource person."

With respect to Section 263A—Inventory Cost Capitalization Rules—the Manual states that "in most cases, Section 263A will not apply to an independent used car dealer because Gross Receipts fall under the $10 million dollar exemption.

BALANCE SHEET

This part of the Manual contains insights into IRS audit inquiries into accounts other than the traditional current assets (i.e., cash, accounts receivable and inventories).

In a particularly well developed discussion on **Loans to Shareholders**, in addition to addressing the usual "*bona fides*" requirements, agents are told to develop constructive dividend issues as well as to check out the non-interest and/or below-market interest rate provisions of Section 7872 for imputed interest ramifications ...and adjustments to shareholder/officer income tax returns.

One audit technique mentioned in connection with fixed assets is .... "(3)(c) ... An inspection of the assets on a surprise basis could indicate that some assets are located at the owner's residence."

Loans From Shareholders comments that capital stock may be disguised in this account and that "thin capitalization" situations should be considered. References are made to Code Section 385, which deals with thin capitalization readjustments, and to Section 7872, which deals with the treatment of loans with below-market interest rates.

Deferred Income Accounts receive special attention beyond the observation that they are often netted against Accounts Receivable in balance sheet presentations. Special attention is directed to **deferred contract charges**. These are usually separate charges for procurement fees, processing fees, charges for (credit status) investigation, appraisal and identification. These charges are generally financed as part of the principal amount of the finance contract and the customer/purchaser is liable for them in total with no discounting or reduction

see **IRS' USED CAR DEALERS AUDIT MANUAL**, page 14

(Continued from page 13)

applicable for early payoff on the note. Interest on the contract is computed on both the contract charges and the unpaid selling price of the vehicle.

The Manual observes that the financing notes, with interest rates of 29% or more, are subsequently assigned to a cash basis (related) finance company which pays the dealer the unpaid balance on the selling price and obtains rights to all unpaid interest and contract fees. It goes on to state that the related finance company reports the contract fees as income at the time of payment, as if the contract fees are analogous to interest income.

The current position of the IRS is that the "claim to right" doctrine requires the auto dealer to report the contract fees in income at the time of sale. According to the IRS, if the auto dealer or the finance company argue that these fees are actually interest, then they will be breaking the truth in lending laws by charging interest far in excess of the rates disclosed in the contracts. In situations where taxpayers raise these arguments, examining are advised to refer to the Milwaukee District MSSP Coordinator or the Auto Industry ISP for guidance on how to proceed.

The IRS' conclusion is that the deferred contract charges are not unstated contract interest. Therefore, they are not amortizable over the contract lives. In addition, the position of the Service is that if the taxpayer contends that these deferred contract charges and fees are interest, the taxpayer will be in violation of the truth in lending laws "by charging better than 100% interest when the contract disclosure shows a much lower rate of interest." According to the IRS, the proper result should be to include the full amount of the charges in the amount realized under IRC Section 1001 per Revenue Ruling 79-292 for transactions before April 4, 1994 and in accordance with Reg. Sec. 1.1001-1(q) for transactions after that date.

With respect to the **retained earnings account**, without any elaboration or qualifying comments, the Manual mentions the issue: "Are accumulated earnings taxes applicable?" and includes as an "audit technique" that consideration be given to the imposition of the Accumulated Earnings Tax imposed by Section 531.

EXPENSE ISSUES

This chapter contains a rundown of expense classifications with suggested audit techniques and alerts. Agents are told to scan accounts looking for large or usual items, "such as payments to the taxpayer's church, political parties, candidates, school tuition and other personal expenses." Ads in local church bulletins are mentioned as a common form of advertising expense that need to be carefully reviewed.

Amortization deductions receive special attention and the discussion reflects the alertness of the IRS to goodwill and going concern valuation issues. Agents are instructed to analyze any such acquisitions that the business makes because Section 197 makes it advantageous for taxpayers to allocate more of the acquisition costs to intangible assets - as opposed to land and buildings. Prior to the Omnibus Reconciliation Act of 1993, goodwill and going concern value were not amortizable for tax purposes.

With the enactment of IRC Section 197, goodwill, going-concern value, and other intangibles have a legislated amortizable life of 15 years. The effective date of Section 197 is August 10, 1993. There are exceptions to the effective date for binding contracts in existence on August 10, 1993, and for property acquired after July 25, 1991.

The Manual also mentions the availability and desirability of requesting engineering assistance where agents believe the taxpayer may be undervaluing land and buildings.

MORE ADMONITIONS

1. Costs associated with the delivery of cars should be included in inventory,
2. Forms 1099 Miscellaneous should be issued for amounts paid out in excess of $600,
3. Transportation charges for "hiking" or shuttling" should be inventoried (and not expensed as commissions or fees). These costs warrant special scrutiny in connection with employee - independent contractor classification issues,
4. "Legal fees always deserve a look during the examination. Any corporate payment for the preparation for shareholder's return will be disallowed as a deduction to the corporation and included in gross income as a dividend to the shareholder," and
5. If demonstrator vehicles are being provided to employees, all the usual record keeping, personal use income reporting and other formalities need to be respected and checked out.

→

PACKAGE AUDIT REQUIREMENTS

This chapter of the Manual lists the forms that should be inspected and the audit procedures that should be followed as part of the standard examination for all types of business activities.

W-4's...Check for unusually large number of dependents or exemptions from withholding. Follow up with inspection of W-2's as necessary.

W-2's...Scrutinize all W-2's for any withholding which appears to be small in relationship to the wages reported. If an employment tax audit is warranted, the W-2 information will be needed to determine if the FUTA and FICA limitations have been met. In many cases, the FUTA limit will have been met, but the FICA limit will not have been met.

1099's...Consider the issue of employee vs. independent contractor (worker classification), particularly if outside individuals are used for shuttling and portering activities.

940's and **941**'s...Issues may include employer/independent contractor status of hikers (shuttlers) and other outside workers...as well as personal use of business autos by employees.

1040's...Constructive dividends, flow through items from partnership and S corporation filing separately.

8300's...Currency transactions over $10,000.00. The review of these forms should be conducted in conjunction with the audit of the cash accounts.

5500's & **5500**-C's...Review pension expenses and distributions.

Other items considered as package audit procedures

Bartering...Consider along with the audit of income accounts. Some used car dealers in some parts of the country have been found to belong to bartering clubs.

Political Contributions...Consider these in conjunction with auditing contributions and dues and subscriptions.

Inventory Checks...See Inventory Section for details of issues and techniques.

Excise Tax Returns...Examiners are required to determine if the taxpayer has met the filing requirements for federal excise tax.

The Package Audit section of the Manual also contains specific guidance relative to Form 8300 matters. As everyone is aware, the IRS is always looking at and for Forms 8300 reporting compliance.

In addition, this part of the Manual includes a major section on worker classification and employee vs. independent contractor status. This special area has received special attention in the March, 1995 issue of the ***Dealer Tax Watch*** with extensive materials and discussion.

RELATED FINANCE COMPANIES

With respect to Related Finance Companies (RFCs), the Audit Technique Guide contains a wealth of material which is by no means limited in its application to "used car dealers." This material is applicable to franchise automobile dealerships who have related finance companies or entities set up in connection with their used car departments and activities. (For example, all of the RFC material discussed in the Manual provides background for the discussion of Letter Ruling 9534023 on page 19 in this issue.)

Exhibits which are part of the chapter on Related Finance Companies include:

- RFC Document Request
- RFC Issue Development Summary
- RFC Adjustment Computations
- Form 886A Explanation of Items
- Accuracy Related Penalties

Beyond the economics of the dealer controlled financing arrangements and the intricacies of the more obvious Internal Code Revenue provisions involved lie the ever-sensitive areas involving the imposition of **accuracy related penalties**.

In this regard, the Manual states... "In cases where the facts indicate the discounting has no economic substance, strong consideration should be given to the applicability of the accuracy related penalty of Section 6662. **In addition**, if the facts and circumstances of your case indicate that the return preparer knew that the RFC discounting lacked economic substance, consideration should be given to the return preparer penalties of Section 6694.

The sample Information Document Request asks for ... "...(17) A copy for our records of all promotional literature, brochures, or other information furnished to the owner, manager and/or key employees in conjunction with the decision to form a RFC."

Query: Do we have something akin to abusive "tax shelter" considerations involved here?

see **INCOME RECOGNITION AND REPORTING ISSUES**, page 16

INCOME RECOGNITION & REPORTING ISSUES FOR USED CAR DEALERS

1. **Not recording a trade-in on a sale, then selling the trade-in for cash**. One way to avoid reporting all sales is by cash sales in which a trade-in is sold directly to a third party. The dealer takes a car in as a trade from customer A. Customer A signs the title, but the dealer does not put the car in inventory or show it on the dealsheet as a trade-in. The dealer then sells the car to customer B for cash and signs the title over to the customer. The dealer keeps the cash and the title shows a direct sale from customer A to customer B. There is no indication that the dealer was ever involved in the trade. Indications that this may be occurring include unidentified cash deposits, reconditioning costs incurred about the same time, but not allocated to vehicles, substantial sales discounts or sales contracts that show a trade-in allowance with no corresponding stock number assignment. However, substantial discounts are frequently given by dealers to get rid of overage vehicles, where a cash (no financing) sale occurs or in similar situations.

2. **Reporting net sales based on financing obtained, omitting cash received.** Comparing the sales contracts with the financing files should disclose this problem. Also, the state sales tax can be used to determine the sales price, which would include any cash paid.

3. **Not reporting the sale of all cars purchased.** Comparing the purchase of vehicles acquired by trade and at auctions to a subsequent sale of that vehicle can provide information on accuracy of sales figures. Also, a review of claimed travel expenses can lead to information about auctions attended where possible purchases occurred or sales were made. However, dealers often attend auctions where they make no purchases or sales.

4. **Purchasing packaged cars, allocating the full cost of the package to only some of the units; then selling one or more units off the books.** A review of the purchase documents may provide evidence of the number of cars purchased. Furthermore, an analysis of the cost assigned to the inventoried cars acquired in the package should be made for reasonableness. However, it is common for the buyer to assign a different value to each car in the package than the seller assigned. The buyer is not privy to the seller's allocations, and generally bases his allocation on the relative value of each vehicle in the package to him. <u>Purchases from other dealers are generally similar to purchases from auctions</u>. However, there may be no written record of the transaction, and the transfer of title probably will be by a reassignment of title to the purchasing dealer. Frequently, the dealer may make a package purchase. This is a purchase of several cars for a lump sum. The purchasing dealer should record the cost of the cars based on the ACV of each car to the total purchase price. The ACV of cars sold in a package can vary greatly since it is common to put one or two cars that are difficult to sell in a package, with the expectation that the purchaser will want the other cars in the package enough to accept the entire package. As with cars purchased at auctions, the cost of the car will be increased by any reconditioning costs incurred in preparing the car for sale.

As mentioned above, dealers purchase a car as part of a package deal that are "clunkers." The dealer may know this at the time of purchase, in which case a low market value will be placed on the inventory value of the vehicle. At other times, a dealer will not realize it bought a "clunker" until reconditioning has begun.

5. **Buy 4, book 3.** Another method dealers may use to avoid reporting all income is to purchase 4 cars at auction. The purchase document will show 4 cars purchased. The dealer then books 3 cars into inventory and sells the fourth car without reporting the sale on his books.

6. **The ...dealer may take almost anything as a trade-in.** Boats, trailers, snowmobiles, campers, etc. may be accepted as a trade-in. These traded items may or may not end up on the lot for sale. The dealer may be getting personal use of these items and sell them on the side as personal property instead of inventory.

Vehicles taken in as trades may not be issued a separate stock number. It is a common industry practice for the new trade-in to be assigned a new stock number that is a subset of the original stock number.

7. **Bartering clubs.** Some dealers are members of bartering clubs. In Wisconsin, the dealer would receive "points" from the bartering club based on the value of the car, which could be spent on services or goods such as mechanical or body work on cars purchased for resale. Such activities are frequently not included as income.

8. **Multiple repossessions.** Many dealers engaged in "Buy-Here, Pay-Here" operations may repossess the same vehicle several times before it is ultimately sold. The dealer reports the gain on the first repossession, but not on the subsequent repossessions. The sections on "Repossessions" and on "Buy-Here, Pay-Here" operations should be consulted.

DEALERSHIP LETTERHEAD

SAMPLE AGREEMENT FOR DEMONSTRATOR VEHICLES

DEALERSHIP ____

USER'S NAME ____

1. The demonstrator vehicle is provided to the User primarily for the purpose of facilitating the User's performance of services, where and if appropriate, for the Dealership. The use of the vehicle is also intended to provide and enhance high visibility and exposure for the Dealership and its products. Use of the demonstrator vehicle for personal purposes and personal use mileage is to be kept to a minimum and the User agrees to do so.
2. The demonstrator vehicle is required to be available at all times to be shown to potential customers.
3. The demonstrator must be available at all times to be loaned to Dealership customers upon approval of Dealership management.
4. User is not allowed to store personal possessions in the vehicle and is responsible for all parking tickets. In addition, User agrees to use seat belts and to engage other safety restraints at all times and to refrain from smoking and to prevent others from smoking while in the vehicle.
5. If the demonstrator is used for any unauthorized use, including vacation use, then the User agrees to pay the Dealership 30 cents ($.30) per mile for any and all non-business usage. This mileage (if any) must be reported to the Dealership and paid for no less frequently than annually. The User agrees that he/she will be using a personally owned or a different vehicle for all material personal mileage driven.
6. The demonstrator vehicle is not to be loaned to, nor used by, friends, relatives or the User's spouse.
7. The User agrees to pay for all gasoline costs allocable to non-business use and to see that regular maintenance is performed on the vehicle.
8. The Dealership will__will not__provide insurance on the vehicle and the User is responsible for the insurance deductible in the amount of $_____ and is responsible for any unreimbursed costs.
9. Upon termination of the use of the demonstrator, the User agrees to immediately return the demonstrator. The User agrees that the Dealership may report the demonstrator as stolen if it is not returned to the Dealership within one day after being notified by the Dealership that this agreement has been terminated.
10. Dealership elects Not to Withhold income taxes and/or Social Security/FICA taxes until and unless written notice to the contrary is given to the User.

(continued)

see **DEMONSTRATOR AGREEMENT**, page 18

Demonstrator Agreement (Continued from page 17)

11. Parts, service, business and other managers may be supplied demonstrator vehicles. These demonstrators are supplied for the benefit of the Dealership and are required to be used as a condition of employment by the employees to whom they are provided subject to all the terms and conditions of this agreement. User agrees and understands that these vehicles are to be available to be loaned to customers, and/or parts pickup, dealer trades, emergency service calls, bank deposits, post office, customer pickup, after hour calls for the Dealership, security and fire protection, sales presentations and other purposes.
12. The demonstrator vehicle is subject to sale by the Dealership at any time and without regard to any inconvenience such sale may present to the User.
13. The User must accept the make and model of demonstrator vehicle selected by the management of the Dealership. The User is responsible for all costs to return the vehicle to the Dealership and to restore the demonstrator to "new" condition when it is returned.
14. The User assumes responsibility for paying all income taxes and any other taxes that may be imposed as a result of User's personal use of the demonstrator vehicle.
15. The User agrees to pay the Dealership $____ per month for the personal use of the vehicle. The User agrees that the annual taxable value is $____. The average value of the vehicle to be used is $_____.
16. The vehicle must remain within the Dealership's marketing area.
17. User acknowledges having a current valid drivers license and that his/her driving record has no recorded use of alcohol or illegal drugs. User agrees to give two day's notice if his/her drivers license is suspended.
18. Method of Valuation (check one):

    ___ No charge needed since demonstrator vehicle will be used by full-time salesman or equivalent.

    ___ Fair market value of lease (based on local third party lease) $________.

    ___ Annual Lease Value Table (from IRS table) $________.

    ___ Fleet Average Valuation $________.

    ___ Vehicle Cents-Per-Mile Valuation ______ Personal Miles ________.

    ___ Commuting Valuation Rule ($3.00 per day round trip commute) ________.

    ___ Personal miles driven in 199_ were _____Total miles driven were_____Value $_____.

Date _________ Date _________

______________________________ ______________________________

Authorized Signature for Dealership *User's Signature*

______________________________ ______________________________

Title *Print User's Name*

(This agreement should be completed when the vehicle is first supplied and every January thereafter.)

DEDUCTION ALLOWED FOR LOSS ON SALE OF NOTES TO RELATED FINANCE ENTITY

LTR 9534023

Recently, many dealers have become more involved in selling used vehicles to purchasers with less favorable credit histories and credit ratings. Trade publications abound with information and advertisements urging dealers to become more involved with the financing aspects of used car sales by setting up dealer-controlled financing arrangements. These are sometimes referred to as "buy-here, pay-here," "tote-a-note" or "note lot" operations.

These expanded used car (financing) activities may be carried on in the context of a more highly structured franchise relationship or they may be carried on less formally as an outgrowth of current used car lot operations. For some, dealer-controlled financing has become a new and major profit center because of the very high interest rates that may be charged to poor credit risk purchasers. These interest rates are limited by state law, but in some instances, they may be averaging 30% or more. Business policy decisions often come into play as dealers decide whether they want to "settle for" lower effective interest yields with possibly greater repeat customer business, or "hit a home run" by going for the highest interest rates possible. Obviously, these decisions will be reflected in the bottom line—over the long run, as well as the short run—through reposession experience and losses and customer satisfaction as evidenced by repeat and/or referral business.

The "benefits" of dealer-controlled financing are usually only available after the dealer has first mastered and survived the start-up stages of the operation and the initial adverse cash flow results.

Transactions between dealers and related finance entities receive special IRS attention and scrutiny. Quite often the so-called buy-here, pay-here activity is simply one phase of a franchised automobile dealer's overall operating activities...i.e., it is simply how the dealer runs the used car department. In other instances, a used car dealer (who is not a franchised new car dealer) may have a related finance entity to which he directs customer paper which banks and other financial institutions will not accept. The IRS Used Car Audit Technique Guide—discussed elsewhere in this issue—contains extensive material on the operations and IRS audit attitude toward Related Finance Companies (RFCs).

STRUCTURE AND PLANNING FLEXIBILITY

IRS Letter Ruling 9534023, dated May 31, 1995, addressed two questions in the context of transactions between the franchised auto dealer and the related finance entity. Note the word entity here: It signifies that the related finance activity may be conducted by a corporation/company, or by a partnership (general or limited) or by some other entity (LLP or LLC)...etc. In other words, the structuring of the related finance entity (for this type of used car activity) becomes a matter of planning ingenuity, which is in part shaped by state law requirements or limitations and in part by intra-family tax planning considerations.

The facts in the Letter Ruling amply illustrate the variability of the strategy that may be employed. In this case, the dealership was a franchised full line automobile dealership (operating all the usual departments) which had made an S election for tax purposes. This dealership was 100% owned by one individual. The dealer had (several?) daughters, two of whom were the 100% shareholders in an S corporation, which S corporation—in turn —was a 50% partner with "PRS"—the other 50% partner. Now, the S corporation (owned by the two daughters) and PRS were the equal 50% partners in the Related Finance Entity described in the Letter Ruling simply as "Credit."

Note all of the opportunities for legitimately flowing income to different shareholders or partners (with different income needs) in different amounts evidenced in this overall arrangement.

ACTUAL OPERATIONS

The dealership began its used car financing program in 1994 as an outgrowth of the sale and the finance of low value and low cost vehicles to purchasers who had high credit risk ratings. In the typical situation or transaction, the customer paid for the used vehicle it was buying with a combination of (1) cash, (2) a trade-in vehicle and (3) an installment note for the balance of the purchase price.

see **DEDUCTION ALLOWED FOR LOSS...**, page 20

Deduction Allowed for Loss... (Continued from page 19)

As part of the financing program, the Credit (Partnership) would purchase the customer's installment note from the dealership for an amount equal to the fair market value of the installment note - and this fair market value in the words of the Ruling "is considerably less than the face amount of the note." In other words, the notes were sold at a discount by the dealership to the related finance credit partnership.

The Ruling indicates that the credit partnership was formed to handle the financing of the program. Although the dealership/taxpayer was the payee on the installment note, the credit partnership approves the financing application form. The facts indicate that the credit partnership "would have to acquire a state license to be the initial creditor and is not a party to the transaction until it purchases the installment note from Taxpayer" (i.e., the auto dealership at a later date).

If the customer did not pay the full amount due under the terms of the installment note, the credit partnership did not have any recourse against the related selling dealership. Once the dealership sold the installment note to the credit partnership, the dealership did not have the right to any additional proceeds from the installment note. Any repossessions necessitated by customer default were handled by the dealership on behalf of the credit partnership. (No further specifics are provided in this regard.)

IRS HOLDINGS

- The **amount realized** by the dealership upon a sale under the financing program **is the entire amount** received as payment for a used automobile sold to a customer...which includes (a) the face amount of any installment note received, (b) the amount of money received and (c) the fair market value of any other property received.
- The dealership may accrue a deduction under Section 165 for any loss incurred on the sale of the installment note to the credit partnership. Thus, the **dealership may deduct the loss on the sale** as reflected by the discount factored into arriving at the "fair market value of the installment note...which is considerably less than the face amount of the note."

IRS CAVEAT

The ruling specifically indicates that it expresses no opinion as to the Federal tax treatment of the transaction under provisions of the Internal Revenue Code other than Sections 1001(a) and (b) and 165(a). The ruling also states that "no opinion is expressed as to the tax treatment of any conditions existing at the time of or effects resulting from the transaction that are not specifically covered by the above ruling." As an overall limitation, letter rulings are directed only to the taxpayer who made the request and IRC Section 6110(j)(3) provides that they may not be used or cited as precedent.

Apparently, other code sections—such as Section 482—or case law doctrines might be involved under other circumstances.

WHY CONGRESS OR THE COMMISSIONER SHOULD INTERVENE

The current Letter Rulings (9535009 and 9535010) on dealer conformity completely ignore broader issues and concerns which are important to the fair and consistent administration of the Internal Revenue Code and to the equitable treatment of all auto dealers. These issues are likely to be raised if a dealer has to go to court. If litigated, hopefully they would be favorably resolved for the taxpayer—as they were in *Powell* and *Insilco* .

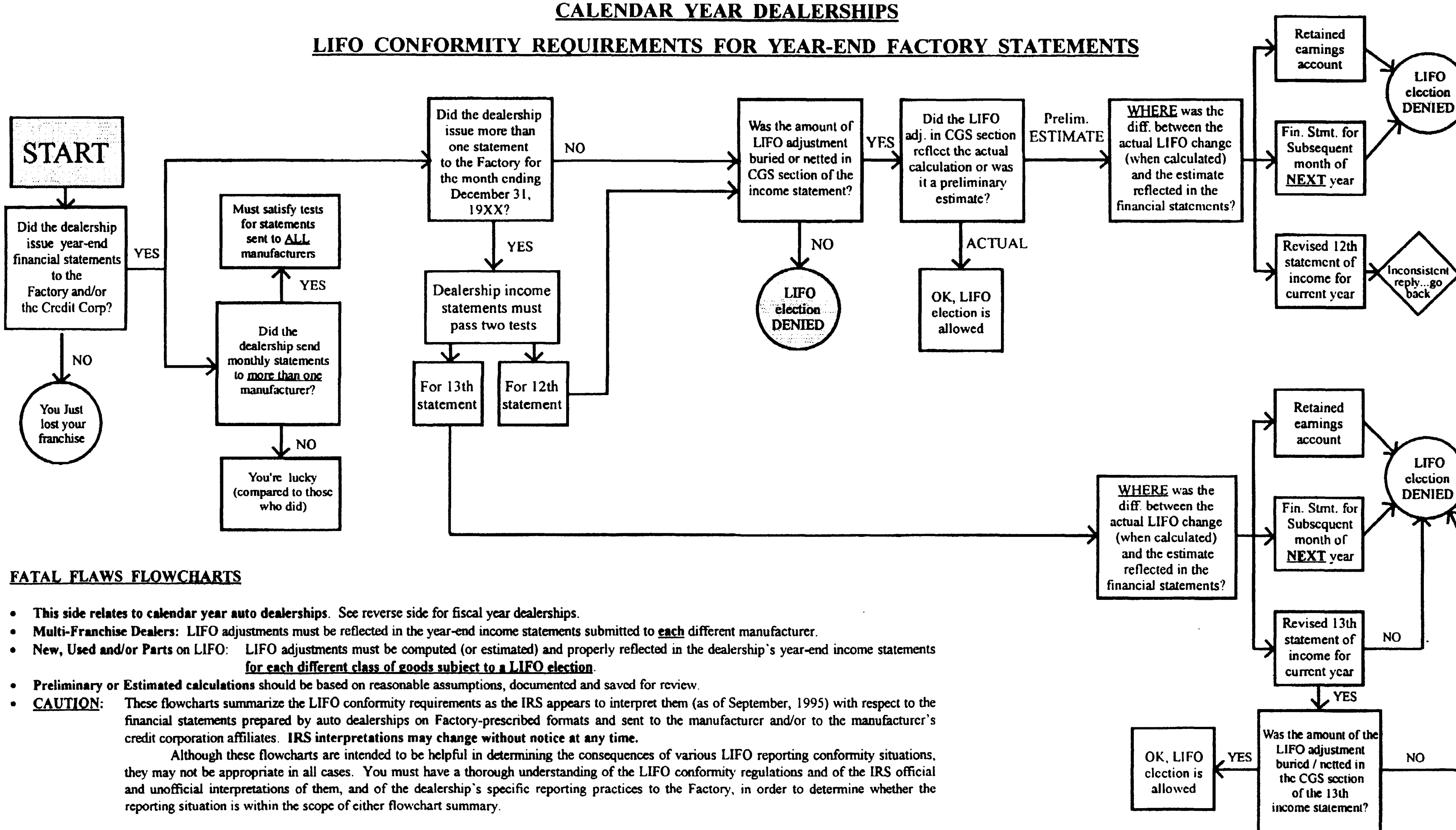
In *Powell,* the (District) Court stated "We believe in a case such as this, where the IRS asserts that there is no room for interpretation, where there is no long-standing administrative interpretation and where there is little case law or legislative history to guide the Commissioner, we have an affirmative duty to determine the **rightness** of the interpretation, not just its reasonableness."

As the result of *Insilco*, Congress' ultimate response to the conformity controversy was to change the Internal Revenue Code (adding Section 472(g)) to eliminate on a prospective basis the conformity problems that were troubling the IRS and the interpretation it was stretching the law to make.

1. In almost all instances, violations of the conformity requirements are unintentional. If a dealership has violated a conformity requirement, does that unintentional and inadvertent violation warrant termination of the taxpayer's LIFO election? Many manufacturers statements did not ever allow for reporting LIFO results anywhere. Also, many auto dealers have relied exclusively on paid professional advisors, including their CPAs. Are those not reasonable causes to permit a more lenient sanction than termination of the election?
2. Revenue Procedure 79-23 specifically provides that the Commissioner may exercise discretion in remedying a LIFO conformity violation. If termination of a taxpayer's LIFO election is warranted, is the Commissioner justified in exercising authority/discretion to waive the dealer's (inadvertent) violation of the conformity requirement?
3. If exercised in the form of an **AMNESTY**, the discretion available to the Commissioner to waive termination of the LIFO election as the punishment for technical violation, (especially in light of the action taken by Congress resulting from *Insilco* to remedy the conformity 'problem' on a prospective basis) would evidence a reasonable and humane act consistent with the spirit of the *Compliance 2000* initiative, about which we hear so much... but see so little.
4. The regulations, as interpreted by the IRS, unreasonably expand the intention of Congress in these dealership situations. There should be a distinction between the intention of Congress relative to (a) reports to stockholders and to the public and (b) to the reports provided in franchisor-specified formats by automobile dealerships to their manufacturer/supplier/franchisors and, indirectly, to their affiliated credit corporations.
5. The lack of consistent interpretation of these regulations by IRS examining agents and the lack of consistent enforcement of these restrictive interpretations in various IRS districts currently and in prior years undermines the integrity of the system and the belief everyone would like to have that all taxpayers should be treated equally—even if that means *harshly.*
6. The IRS' interpretation and application of these regulations appears to be inconsistent with the policies expressed by various Treasury officials in explaining the intent underlying the liberalization of the LIFO Conformity regulations in 1981.
7. If termination of a LIFO election is the only penalty for a technical conformity violation, a penalty that harsh raises an issue involving the dealer's right to due process under the Fifth Amendment.
8. Finally, if the LIFO elections of countless dealers must be terminated, what is the proper year for the termination? How are prior years audited and closed by the IRS to be treated? What are the proper procedures, computations and terms and conditions—including the number of years over which the LIFO reserve is to be repaid—so that all dealers will receive the same treatment?

CALENDAR YEAR DEALERSHIPS

LIFO CONFORMITY REQUIREMENTS FOR YEAR-END FACTORY STATEMENTS

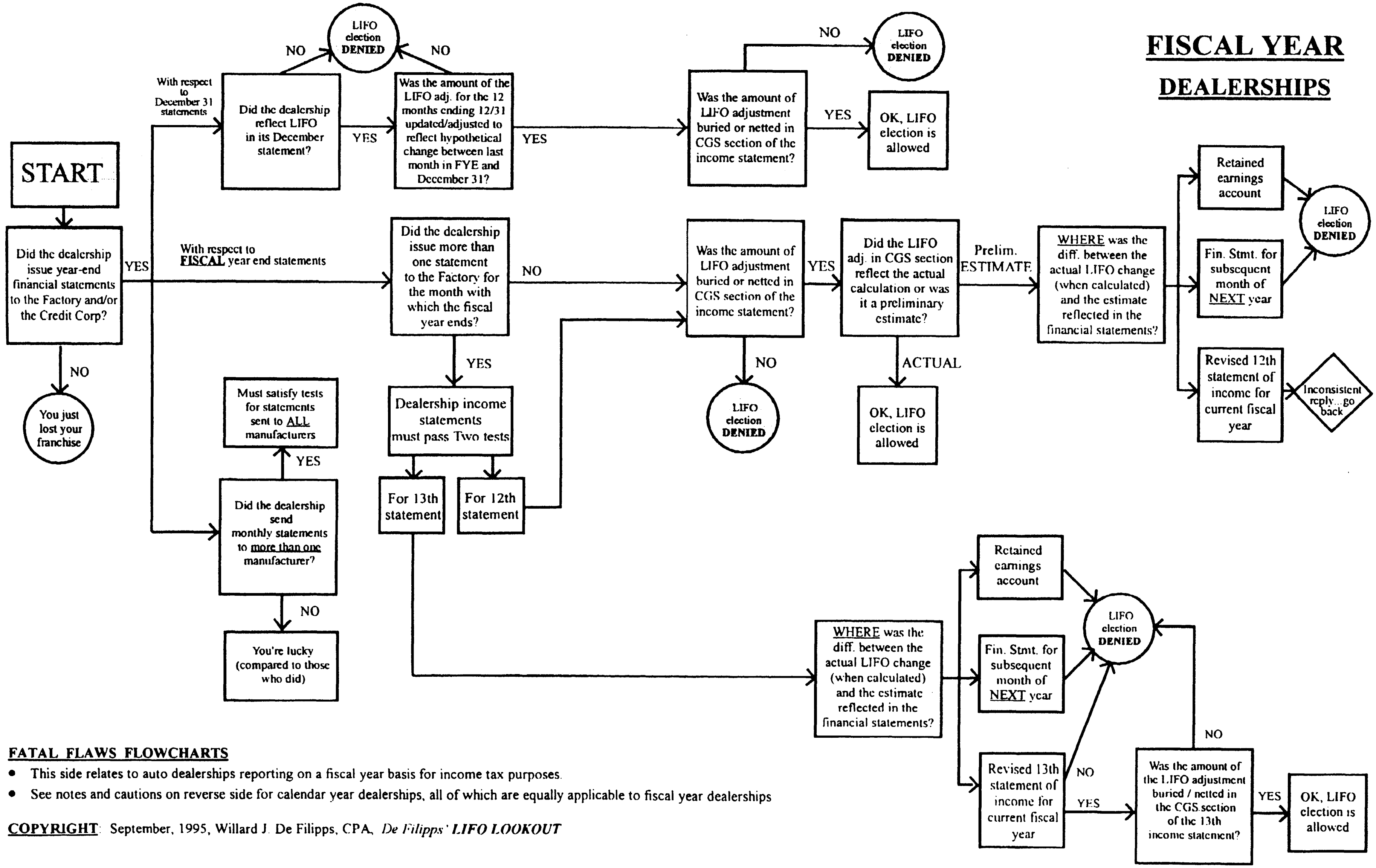


FATAL FLAWS FLOWCHARTS

- **This side relates to calendar year auto dealerships**. See reverse side for fiscal year dealerships.
- **Multi-Franchise Dealers:** LIFO adjustments must be reflected in the year-end income statements submitted to **each** different manufacturer.
- **New, Used and/or Parts** on LIFO: LIFO adjustments must be computed (or estimated) and properly reflected in the dealership's year-end income statements **for each different class of goods subject to a LIFO election**.
- **Preliminary or Estimated calculations** should be based on reasonable assumptions, documented and saved for review.
- **CAUTION**: These flowcharts summarize the LIFO conformity requirements as the IRS appears to interpret them (as of September, 1995) with respect to the financial statements prepared by auto dealerships on Factory-prescribed formats and sent to the manufacturer and/or to the manufacturer's credit corporation affiliates. **IRS interpretations may change without notice at any time.**

  Although these flowcharts are intended to be helpful in determining the consequences of various LIFO reporting conformity situations, they may not be appropriate in all cases. You must have a thorough understanding of the LIFO conformity regulations and of the IRS official and unofficial interpretations of them, and of the dealership's specific reporting practices to the Factory, in order to determine whether the reporting situation is within the scope of either flowchart summary.

FISCAL YEAR DEALERSHIPS



FATAL FLAWS FLOWCHARTS

- This side relates to auto dealerships reporting on a fiscal year basis for income tax purposes.
- See notes and cautions on reverse side for calendar year dealerships, all of which are equally applicable to fiscal year dealerships

 (Continued from page 2)

Because of their high taxable income, many dealers might have opted to pay the additional tax on their 1993 tax returns resulting from an increase in the rates over a 3-year period. All of this was part of the Omnibus Budget Reconciliation Act of 1993 which added a new higher marginal rate of 36%.

Without going into all the details, in recent months the IRS simply could not get all of its own paperwork straight. It sent erroneous notices about balances due to many dealer clients... some of them receiving several notices evidencing the compounded confusion that the IRS had in this matter and its inability to control its own "computers."

When the IRS makes obvious mistakes like this, and eventually wakes up, it tries to do the best it can to minimize the public relations damage. Perhaps a little more IRS introspection on this matter would produce a certain amount of moderation or tolerance in other areas by the IRS. Quite often when CPAs make mistakes, the IRS is quick to assume that there was an intention to do something wrong. But somehow, when the IRS makes mistakes... there's always a logical reason.

On another front, the AICPA has been hammering away at the IRS over its Economic Reality Audits (see the June, 1995 ***Dealer Tax Watch***, page 6, for more on this). The IRS has now repackaged the whole idea and changed its name from "Economic Reality Auditing" to "Financial Status Auditing." The AICPA's August/September, 1995 ***CPA Letter*** raises further concerns and reports on the progress of AICPA-IRS discussions on this touchy subject.

Make no mistake about it...agents are still instructed to sniff out every possible conflict between what they see on the tax return and what they are told in audit interviews. They're still hung up on the **lifestyle** of the dealer. You'll see plenty of examples of this in the IRS Audit Technique Guide for Used Car Dealers (critiqued in this issue). IRS agents are told to drive by the dealers' houses to see where... and how... they live! And more!

LIFO SEMINARS—DEC., 1995

Seminars have been scheduled at various locations around the country in December.

The Day 1 - LIFO FOR AUTO DEALERS course covers all aspects of making LIFO elections, eligibility requirements (Cost, Conformity and Consent/Form 970) and computation mechanics.

Day 2 - ADVANCED APPLICATIONS involves subjects which cannot be covered in the first day including understanding and reconciling LIFO reserves, changes in LIFO methods, rebasing indexes and other developments.

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

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