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 STILL EVIDENT: DEMOS STILL HIT HARD. One very busy dealer practitioner here in the Midwest reports that an examining agent recently told him that all auto dealerships in the Chicago area were going to be audited within the next year. Target issues: the usual: LIFO, travel & entertainment, demonstrators, service contracts and officers' life insurance.

In one recent audit aimed only at demos, the IRS agent left demos alone for sales people... For everyone else in the dealership, including spouses, using demos, the IRS applied the lease vehicle tables allowing only 20% business and treating 80% as personal use. In other words, for a vehicle with a lease table value of $18,500, the annual lease value would be $5,100, of which 80% or $4,080 was determined to be the amount reportable as taxable income attributable to the personal/non-business use of the vehicle. After subtracting any payment that the individual user might have made or reimbursed to the dealership (typically none), that would leave $4,080 as additional taxable income to the individual.

The IRS assessed the dealership 43.3% tax (a flat 28% Federal income tax withholding plus 15.3% FICA, Medicare, etc.) for an assessment of approximately $1,770 on one vehicle for one year. This amount, multiplied by three years, and then multiplied by all employees except salespersons having demo vehicles, adds up to a mighty big wallop.

No further adjustment was made in pursuit of gasoline or other vehicle operating expenses. The examining agent indicated that if the dealer could show that the users of the demos have filed amended tax returns or otherwise included demo use amounts in their income tax returns, the dealer may claim a refund for some of the taxes paid.

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#2. PANDORA'S BOX: THE OUT-OF-CONTROL DEALER RECEIVABLE. It's fun watching out for tax cases. Usually one or two interesting cases come along each quarter. The really interesting case this quarter involves a dealership's receivable from its key shareholder-officer. The IRS turned this receivable into a huge constructive dividend along with significant additional penalties for fraudulent return filings... both by the dealer and by the corporation. Not since our major coverage on reasonable compensation last year has there been a case as significant as this one in terms of potentially nasty consequence to dealers... as well as to their tax return preparers.

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Accordingly, our feature coverage in this issue addresses *Yarbrough Oldsmobile Cadillac, Inc. et. al. v. Commissioner* (Tax Court Memo 1995-538) and its constructive dividend and related fraud implications.

#3. OTHER IRS ACTIVITY: ECONOMIC REALITY OF A NON-COMPETE AGREEMENT. *Beaver Bolt, Inc.* is another recent case out of the Tax Court which picks up on the *Heritage Auto Center, Inc.* case discussed in our last issue of the *Dealer Tax Watch* involving buy-sell price allocations. *Beaver Bolt* sheds further light on the elements that the IRS is hitting so strongly on in reviewing the economic reality of non-compete agreements.

In connection with Form 8300 cash reporting and money laundering, a recent case involved a Minnesota car dealer who unsuccesfully alleged entrapment by the IRS. The appeal of *D. L. Jensen* (on page 18) affords a down-to-earth look at how dealership personnel—including dealers—may be approached in a sting operation.

#4. LIFO FINANCIAL STATEMENT CONFORMITY REQUIREMENTS. As *Dealer Tax Watch* readers were reminded in Update Comment #6 last quarter, there is still much confusion...and still no official "final" guidance from the IRS on how LIFO should be reported in dealership year-end financial statements going to the Factory.

Be sure your 12th and 13th month statements reflect LIFO adjustments in the Cost of Goods Sold section. For extensive additional coverage on the LIFO conformity situation, see the December, 1995 *LIFO Lookout*. Enough said here on that subject.

#5. AICPA SECOND NATIONAL AUTO DEALERSHIP CONVENTION. The AICPA's Second Annual Conference was held in Chicago, IL at the Fairmont Hotel on October 19-20.

Reaction from CPAs attending the Conference this year was mixed—if not somewhat or a little negative. Generally, this year's Conference did not seem to provide as much for practicing CPAs and was viewed by some as catering more to dealer and dealership controller attendees. Well, it's hard to please everyone these days. The industry overview by Maryann Keller and presentations by several other speakers were well worth hearing. Unfortunately, a few other presentations seemed flat and far too basic to be of much use or interest at all. Carmax, really drew a crowd, as it continues to receive significant attention in the industry. For more on the AICPA Conference, see page 15.

#6. DEALER/CPA 21 RESOURCE GROUPS. Our Dealer/CPA 21 Resource Groups completed a very successful initial year, providing opportunities for CPAs who are interested in networking capabilities and resource expansion.

At the request of group members, we have expanded our twice a year meeting format to 2½ days each time. There's tremendous (and that is not an understatement!) synergy and chemistry among newly acquainted group members.

New groups are forming if you are interested and our next series of meetings is planned for June.

#7. CAR DEALER INSIDER SPONSORS CONFERENCE ON DEALERSHIP VALUATION AND BUY-SELLS. *Car Dealer Insider* presented a conference on October 19-20 entitled "Discover the Gold: How to Buy, Sell and Value a Dealership." Unfortunately, this conference was held on the same days as the AICPA Auto Dealership Conference in Chicago.

The Conference Manual may be purchased for $140 from *Car Dealer Insider* (800-929-4824). The Manual is entitled "How to Come Out a Winner in Buy-Sell Agreements." It consists of fourteen pages of reprints from CDI on General Motors Dealer Network Strategy and other reprints concerning buy-sell negotiation strategies and the infamous memo to all GM dealers from R. L. Zarrella dated October 5, 1995 on Dealer Network Planning.

The Conference Manual also includes (1) a model buy-sell agreement based on California law, (2) an outline on "Strategies to (for?) Structuring the Deal" which includes a case study and (3) the outline of a dealership succession planning presentation made by The de Vries - Roberts Group. Bucky de Vries had been a presenter on this topic at NADA and his presentation was critiqued on pages 4-8 of our March, 1995 *Dealer Tax Watch*. Bucky was also one of several presenters at our Dealer/CPA 21 Resource Group meetings in Baltimore last July.

You might consider adding this CDI Conference Manual to your reference library. Just be forewarned that you may find it difficult to "connect" with this material without benefit of a conference tape you can listen to and follow along.

#8. AICPA AUTO DEALERSHIP ENGAGEMENT MANUAL—1995 REVISION. The October, 1995 revision of the AICPA's Dealership Engagement Manual includes several additions that may be useful.

For the price, you can't beat it and continuous improvement in the material is evident.

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YARBROUGH: THE OUT-OF-CONTROL DEALER RECEIVABLE

As we continually watch for new IRS activity and dealership tax cases to report, we're never sure what may come along. It's been a while since a "really big" case has come down the pike, but we've got one for you this issue. *Yarbrough Oldsmobile Cadillac, Inc. et. al. vs. Commissioner* is a Tax Court Memo Decision (1995-538) filed November 13, 1995. It reflects the successful IRS attack against a continuously growing dealership receivable from the dealer which the IRS recharacterized into a significant constructive dividend to the dealer. On top of that, the IRS assessed fraud penalties against both the dealer individually and the dealership corporation.

For the dealer, the tax deficiencies for the years 1983 through 1986 were approximately $575,000 with $400,000 more in penalties and over $100,000 of additional interest due on the portion of the underpayment attributable to fraud and other penalty computations. For the dealership, the deficiency was also significant for 1983 through 1985.

The dealership corporation was formed in Florida in 1974 by Elvin Yarbrough as a 51% shareholder and a passive investor who owned the other 49%. Yarbrough Oldsmobile Cadillac, Inc. ("YOC") operated under the day-to-day direction and supervision of Mr. Elvin Yarbrough.

ELVIN = EVERYMAN?

What makes this case excite our curiosity and keep our attention is that many dealers and CPAs can probably relate to some parts of it to some degree.

The activity reflected in the "running account" on the dealership's books for the receivable from the dealer may bring on a sense of *deja vu*, especially if one ignores (1) the unusual medical circumstances, (2) the controversy over the dealer's capacity or incapacity to commit fraud and (3) the fact that in November of 1985 the dealer was advised that he was under criminal investigation for filing false Federal income tax returns.

MAJOR QUESTIONS

Whether the dealer, Elvin Yarbrough, received constructive dividends from YOC, and if he did, what were the amounts for the years in question,

Whether prizes and awards that the dealer received were to be treated as taxable income to him in his personal returns,

Whether the dealership, YOC, was entitled to certain business expense deductions which the IRS disallowed, and

Whether **both** the dealer, individually in his personal return, and the dealership, in its corporate return, were liable for fraud and other additions to tax, and if so, which of the IRS adjustments were attributable to fraud and were subject to additional penalty and interest computations.

In mid-1987, the dealer was diagnosed as having a tumor in the frontal lobe of his brain. This tumor was eventually removed and the dealer was able to return to managing the dealership's affairs on a day-to-day basis. The issue of whether or not the dealer had the requisite intent or ability to commit fraud was debated by several expert witnesses. Don't let the unusual medical complications that Mr. Yarbrough endured come between you and a real understanding of the case: Despite Mr. Yarbrough's significant medical problems, he was still convicted of fraud.

THE OMINOUS OCTET

- The YOC-Elvin (or dealership-dealer) account receivable.
- The yacht Capriole.
- The Sea Ray boat.
- The motor home.
- The Sylva residence...in North Carolina where son, Buddy, lived while he attended school.
- Travel and entertainment expenses, for which taxpayers produced no records.
- Additional personal expenses of the dealer paid by the dealership and claimed by the dealership in its corporate tax return as deductible business expenses.
- Travel awards on trips to Germany, France and Switzerland provided by GM.

FRAUD, TOO

The Court concluded that collectively the dealer's actions evidenced an overall intent to file fraudulent returns. The IRS adjustments with respect to the yacht Capriole, the Sea Ray boat and the payment of the dealer's personal expenses by the dealership were found to be attributable to fraud. The Court held that the same conduct that formed the basis for the dealer's liability for fraud in his own individual income tax returns also relates to the dealership's liability for fraud in its corporate tax returns for the corresponding years. According to the Court, the dealer "was fully aware of the falsity of and of the underreporting of income that were reflected on YOC's income tax returns."

see ***YARBROUGH:* THE OUT-OF-CONTROL RECEIVABLE**, page 4

Yarbrough: The Out-Of-Control Dealer Receivable

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CONSTRUCTIVE DIVIDENDS

The IRS determined that for 1983, 1984, 1985 and 1986, the dealer received constructive dividends from the dealership (YOC) totalling $235,664, $326,156, $291,331, and $274,075 (the taxable portion of which for 1986 was limited to $196,042 as a result of the dealership's 1986 earnings and profits), respectively.

The Tax Court stated that these figures reflected very substantial underreporting of income and underpayments of Federal income taxes as to both the dealer and the dealership for each year of the audit.

The overall message from this case is clear: Unreasonable dealer receivables may lead to constructive dividend recharacterization by the IRS. That, in turn, may lead to underreporting penalties and possibly even to fraud assertions against the dealer, the dealership and even against the return preparer.

CONSTRUCTIVE DIVIDENDS DETERMINED BY IRS

	1983	1984	1985	1986
The YOC-Elvin Account	$137,673	$ 17,510	$ 64,825	$258,939
Capriole	-	170,635	133,179	-
Sea Ray Boat	1,155	-	-	-
Motor Home	10,697	16,802	-	-
Sylva Residence	-	65,000	-	-
Travel/Entertainment	22,014	14,012	22,080	-
Employee Benefits	25,676	1,768	-	-
Utilities	2,461	3,281	-	-
Company Vehicle Expense	1,663	2,179	4,084	-
Miscellaneous Expense	1,945	2,869	1,228	-
Repair Expense	9,693	312	2,227	-
Outside Services	132	968	6,242	-
Depreciation	-	-	2,400	-
Salary Expense	8,203	10,600	21,411	-
Interest Expense	-	2,053	10,947	-
Demonstrator Vehicles	14,352	18,167	22,708	-
Elvin's Residence	-	-	-	15,136
Total	$235,664	$ 326,156	$291,331	$274,075

WHEN EVERYTHING WAS PUT TOGETHER: SUBSTANTIAL UNDERREPORTING OF INCOME

Dealer's Taxable Income

Year	As Reported by Dealer	As Sustained by the Tax Court	Underreported Taxable Income
1983	$ 103,285	$ 434,279	$ 330,994
1984	283,714	612,362	$ 328,648
1985	219,427	520,845	$ 301,418
1986	209,743	399,785	$ 190,042

Dealership's Taxable Income

Year	As Reported by Dealership	As Sustained by the Tax Court	Underreported Taxable Income
1983	$132 ,021	$ 205,171	$ 73,150
1984	410,227	449,567	39,340
1985	308,762	382,932	74,170

THE OMINOUS 8 ISSUES

#1 THE YOC-ELVIN ACCOUNT
THE DEALERSHIP'S RECEIVABLE FROM THE DEALER

FINDING OF FACTS: The dealer directed that a sub-account be established under the Accounts Receivable - Customers (Account 220) account and certain payments made to the dealer by the dealership and certain salary and other adjustments were recorded as debits or credits in the YOC-Elvin account. The outstanding debit balances at December 31 for the years 1982 through 1986 in this account were: $87,465 - $223,138 - $240,648 - $305,473 and $564,412, respectively. During the years in question, the dealer's liability to repay these balances to the dealership was never reflected by any promissory notes or by any other loan documents. The dealer never provided the dealership with any collateral or security for the amounts advanced and the dealer was not required to make periodic payments to the dealership.

The dealer did not list this purported liability to the dealership for this debit balance as a liability on his own personal financial statements that were submitted to banks in connection with personal loan applications. At one time or another, various controllers of the dealership had advised the dealer that loan documents should be executed, that interest payments should be made and that the balance of the receivable should be reduced over the years. These controllers also had advised the dealer that the dealership should not be paying his personal expenses. It was not until after the dealer was informed that he was under criminal tax investigation that any interest was charged on the debit balances in the receivable account.

The Tax Court proceedings contain a detailed analysis of dealership's expenditures offset by entries to the dealer receivable account:

1. Purchase of real property for the dealer's wife's interior decorating business.
2. Purchase for dealer of "floating restaurant" (followed shortly thereafter by "transfer ownership of floating restaurant into dealership's used car inventory").
3. Purchase of dealer's Coastal Highway real property.
4. Installation of fence at the dealer's residence.
5. Purchase of dealer's liquor license.
6. Reduction in other debt that the dealer owed to the dealership (coincidentally equal to an offsetting amount representing the dealership's year-end bonus amounts to dealer).
7. Payment to tear down a structure on dealer's Coastal Highway property.
8. Payment of dealer's utility bills.
9. Rental of condominium.
10. Payment for paving work.
11. Purchase for dealer of Chrysler-Plymouth dealership.
12. Purchase of real property for the dealer.

In one of the transactions above, the dealer, as controlling shareholder of the dealership, effectively withdrew $325,000 from the dealership, and as a 50% shareholder of another corporation which opened a new Chrysler-Plymouth dealership, made a capital contribution of that amount to the new dealership to enable it, along with another shareholder's matching contribution, to purchase real property on which a new dealership was operated.

IRS AUDIT POSITION: The IRS determined that for each year, the year-end net increase over the prior year in the dealership's debit balance of the receivable from the dealer represented a constructive dividend by the dealership to the dealer.

TAX COURT HOLDING: The Court concluded that for each year in issue, the YOC-Elvin Account did not constitute a valid loan account. The Court held that the net increase each year in the outstanding debit balance represented a constructive dividend by the dealership to the dealer. The Court considered the IRS' arguments: The dealer did not execute loan agreements or promissory notes, the dealer was not subject to limits on the amount that he could withdraw from the dealership, that there were no fixed payment dates nor was there a

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requirement that the dealer make payments to the dealership. Interest on the growing receivable balance was not charged until after the taxpayer was notified of the criminal tax investigation. No formal dividends had been declared or paid despite the annual increases in the dealership's retained earnings. The dealer completely controlled the business affairs and day-to-day operations of the dealership.

The dealership and the dealer had argued that there had been an intent to repay and some repayments were made. Furthermore, the minority interest of the passive shareholder acted as a restraint or limit on the amounts the dealer could withdraw from the dealership. Arguments were also offered that the lack of loan documents and promissory notes was not significant.

The Tax Court rejected all of the dealer and dealership's arguments. The Court said that the dealer's self-serving testimony is entitled to little weight and that the payment of the dealer's utility bills for his residence, the transfers of cash to him, the rental of a vacation condominium for the dealer and his family and improvements to the dealer's personal residence were examples of the personal nature of the dealer's expenses that were paid by the dealership. The fact that certain salary adjustments or bonuses were credited against the receivable account was "not entitled to significant weight in our consideration of how to treat the annual net increase in the YOC-Elvin Account."

#2. THE YACHT CAPRIOLE

FINDINGS OF FACT: In August of 1984, a used 60-ft. motor yacht named the Capriole was purchased for $80,000 in cash. The dealer created a false invoice reflecting that the seller had traded in the yacht to the dealership in exchange for a vehicle valued at $5,500. The dealer, using dealership funds, made a cash downpayment to the seller of $5,000 and then applied to a bank for an $80,000 loan, nominally on behalf of the dealership, to provide the remaining funds for purchase of the yacht.

The dealer signed a promissory note with the bank reflecting his capacity as the president of the dealership and as a personal guarantor of the note. The loan proceeds from the bank were used to pay the balance due to the seller and the yacht was used as collateral for the $80,000 loan.

The seller understood that the dealer, and not the dealership, was purchasing the yacht. Registration and title documents showed that the yacht was owned by the dealership but that it was to be used for "pleasure." On the yacht's log and guest register, the dealer—not the dealership—was indicated as owner. The yacht was carried on the dealership's books in the used car inventory(!) and for two years dealership employees—at the dealer's direction—did not attempt to sell the yacht. The log and guest register did not reflect any business use of the yacht, although it was used by the dealer on numerous occasions to entertain personal friends and guests.

During 1984 and 1985, the dealership also paid significant amounts for repairs, restoration, maintenance and operation and the dealership deducted these expenses as business expenses. The dealership did not claim depreciation deductions relating to the yacht. Several years later, the yacht was traded to an unrelated party for real estate located in North Carolina in a transaction showing a stated sale price for the yacht of $186,500. The real property received in the exchange was treated by the dealership as an asset of the dealership and it is unclear whether a gain or a loss was reported in the dealership's income tax return for the year of the trade. The fair rental value for the use of the yacht was $1,200 per day.

IRS AUDIT POSITION: The IRS determined that the dealership held only nominal legal title to the yacht and that the dealer, Elvin Yarbrough, was the real owner of the yacht. The Service determined that for 1984, the $80,000 purchase price provided by the dealership for the acquisition of the Capriole represented a constructive dividend to the dealer. The IRS also determined that the yacht was used by the dealer solely for his personal benefit and disallowed the expenses for repairs, restoration and maintenance. The Service took the position that the dealership's payment of all these expenses were constructive dividends to the dealer.

TAX COURT HOLDING: The Tax Court supported the IRS on all points. The Court noted that "it is significant that Elvin created false documentation to reflect incorrectly that the Capriole was received by YOC as a trade-in on a new automobile. On the log book and on the guest register, Elvin, not YOC, was indicated as owner of the Capriole." The Court noted that even if it were to conclude that the dealership should be treated as the owner of the yacht, the fair rental value of the yacht for the two years that it was available for the dealer's use would be approximately $438,000 per year, which is more than the constructive dividend relating to the yacht determined by the IRS for 1984 and 1985.

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#3. THE SEA RAY BOAT

FINDINGS OF FACT: In 1981, the dealership had transferred $9,575 to the dealer so that he could purchase a used 22-ft. Sea Ray boat from one of the dealership's employees. The Sea Ray was purchased by the dealer for his own personal use. More used car inventory: The boat was carried on the dealership's books in the used car inventory. The dealer, his son and their friends used the boat for personal recreation and did not maintain a log relative to the business use of it.

The dealership paid expenses for maintenance, repairs and operation. In one year, the expenses paid were not deducted for income tax purposes; in other years, other expenses were paid and deducted. Depreciation was not claimed on the boat.

IRS AUDIT POSITION: The IRS disallowed all expenses claimed by the dealership and determined that these amounts constituted constructive dividends to the dealer. In addition, the amounts paid but not deducted by the dealership in connection with the Sea Ray boat were also treated by the IRS as constructive dividends to the dealer.

TAX COURT HOLDING: The Tax Court held that the dealer was to be treated as the owner of the boat and it upheld the IRS that the business expense deductions claimed by the dealership should be disallowed and treated as constructive dividends to the dealer. The Court also held that expenses paid <u>but not deducted</u> by the dealership in connection with the boat should also be treated as constructive dividends to the dealer.

#4. THE MOTOR HOME

FINDINGS OF FACT: In 1983, one of the dealership's customers traded in a motor home on the purchase of a new automobile. This motor home was included in the dealership's new car inventory at a cost of $10,000. The dealer used the motor home for his personal use and instructed the dealership's sales staff not to sell the motor home. Over two years, repairs and improvements approximating $27,500 were made to the motor home. These repairs and improvements were paid for by the dealership and a portion of this amount was paid to the dealer's wife for improvements to the motor home made by her interior decorating business.

The majority of the use of the motor home represented the dealer's personal use. This included travels to North Carolina to visit a son in school, and travel to the 1984 summer Olympics in Los Angeles. No log or other record was maintained in connection with the use of the motor home.

IRS AUDIT POSITION: The IRS disallowed all expenses claimed by the dealership and treated them as constructive dividends to the dealer.

TAX COURT HOLDING: The dealership argued that because it received the motor home in trade on the sale of a new automobile and because the dealer used the motor home primarily for business, the motor home should be treated as a dealership asset and expenses associated with it should be treated as deductible business expenses.

The Tax Court held that the dealership was the owner of the motor home. It also held that the approximately $27,500 paid by the dealership for maintenance, improvement and operation of the motor home was not deductible by the dealership and the dealer was treated as receiving those payments as constructive dividends.

#5. THE SYLVA RESIDENCE

FINDINGS OF FACT: In 1984, the dealer purchased a $67,500 home in Sylva, North Carolina for use by his son while he was attending college there. Title to the residence was placed in the name of Yarbrough Leasing, Inc., a family corporation owned 2% by the dealer, 49% by the dealer's wife and 49% by the dealer's son.

The dealership had transferred a $65,000 check to the leasing company to provide most of the funds necessary to purchase the residence. This $65,000 advance to cover the purchase of the residence was reflected on the dealership as an account receivable due from the Yarbrough Leasing entity.

There subsequently occurred a partial repayment, followed by a loan application, followed by a transfer of funds from the leasing company to the dealer. For two years, the dealer's son lived in the North Carolina residence while attending college. The son paid no rent to the Yarbrough Leasing entity for use of the residence. A college friend of the dealer's son who also resided there paid rent of approximately $200 per month directly to the dealer (not to the Yarbrough Leasing entity).

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The dealer personally was the named insured on the related homeowners insurance policy. The residence was sold in 1991 and a small loss resulted from the sale.

IRS AUDIT POSITION: The IRS determined that the full $65,000 transferred from the dealership to Yarbrough Leasing for purchase of the residence represented a constructive dividend from the dealership to the dealer, followed by a capital contribution of $65,000 from the dealer to Yarbrough Leasing. Note the doubly disadvantageous consequences to the dealer as a result of this two-step approach.

TAX COURT HOLDING: The dealership took the position that the $65,000 used by the dealer to purchase the North Carolina residence represented a loan by the dealership to the leasing company and not a constructive dividend to the dealer. The Tax Court held that the dealer, "in substance and in effect, withdrew the $65,000 from YOC and transferred that amount as a capital contribution to Yarbrough Leasing in order to provide Yarbrough Leasing the funds necessary to purchase the Sylva Residence." The Tax Court concluded that only $15,000 of the $65,000 should be treated as a constructive dividend to the dealer. The Court indicated that the IRS did not give the dealer credit for the $50,000 repayment that was made by the dealer or by the leasing company shortly after the $65,000 was transferred to Yarbrough Leasing.

#6. CLAIMED TRAVEL AND ENTERTAINMENT EXPENSE

FINDINGS OF FACT: During the years in question, miscellaneous personal expenses of the dealer and his wife were paid by the dealership and these expenses were claimed on the dealership's corporate tax returns as deductible business travel and entertainment expenses.

IRS AUDIT POSITION: On audit, a portion of these claimed travel and entertainment expenses were disallowed and treated as constructive dividends to the dealer. Out of almost $80,000 paid from 1983 through 1985, the IRS disallowed $58,000 which it treated as constructive dividend payments.

The dealer did not introduce any records or other credible evidence to show that either the expenses were deductible business expenses of the dealership or that they did not represent constructive dividends.

TAX COURT HOLDING: The dealer, on behalf of the dealership, argued that he had entertained potential customers, some of whom purchased new automobiles almost every year and that General Motors encouraged the dealer to entertain potential customers. He also argued that entertainment was a necessary expense to attract purchasers of high-priced Cadillac automobiles. The Tax Court completely upheld the IRS and treated the disallowed T & E amounts as constructive dividends to the dealer.

#7. TRAVEL AWARDS

FINDINGS OF FACT: In 1983 and 1985, the dealer received travel awards from General Motors. These awards were in the form of trips to Germany, France and Switzerland. The dealer did not provide his income tax return preparer with any information regarding these travel awards and no amount was included in the dealer's personal income tax returns in connection with these trips.

IRS AUDIT POSITION: The full amounts reported by General Motors for these trips were taxable income to the dealer under Section 74.

TAX COURT HOLDING: The Court agreed with the IRS that the cost of these travel awards from GM represented taxable income.

#8. ADDITIONAL PERSONAL EXPENSES OF THE DEALER PAID BY THE DEALERSHIP AND CLAIMED BY THE DEALERSHIP AS DEDUCTIBLE EXPENSES

FINDINGS OF FACT: The reported decision contains an extensive listing of the personal expenses of the dealer that were paid from 1983 through 1986 by the dealership and treated in the dealership's income tax returns as deductible business expenses. The dealer had instructed the dealership employees to pay these expenses and to reflect them as deductible business expenses in the tax returns.

Among the additional personal expenses of the dealer that the dealership paid and claimed as deductible:

1. 3-Months rent on California ocean-front property.
2. Purchase of spa and sauna and installation thereof at the dealer's residence.
3. Plastering and painting of dealer's residence.
4. Dealer's son's college rent.
5. (see page 20 for more)

see **THE OMINOUS 8 ISSUES,** page 20

CONSTRUCTIVE DIVIDENDS & SHAREHOLDER LOANS
WHAT THE TAX COURT SAID IN *YARBROUGH*

"Numerous Court opinions establish that if shareholders of a corporation receive corporate funds or corporate property for personal use, they will be charged with distributions from the corporation, taxable to them as constructive dividend income, if the corporation has sufficient earnings and profits. (***)

"In addition, the corporation will not be allowed to deduct costs of owning and maintaining property and other expenses that are attributable to personal use of the property by the shareholders. (***)

"In determining whether constructive dividends have been received by a shareholder, the key factors to consider are:

- Whether the shareholder received economic benefit from the corporation without expectation of repayment therefor, and
- Whether corporate benefits made available to the shareholder represented benefits primarily of a personal nature and did not relate to the business of the corporation. (***)

"A mere declaration by a shareholder that a withdrawal was intended as a loan is insufficient if the transaction fails to meet more reliable indicia of debt. (***)

CONSTRUCTIVE DIVIDEND CRITERIA

"Whether a shareholder withdrawal constitutes a bona fide loan or a dividend involves a question of fact that turns on a consideration of all of the surrounding facts and circumstances. Some of the relevant facts are:

1. The extent to which the shareholder controls the corporation,
2. The earnings and dividend history of the corporation,
3. The magnitude of the withdrawal and whether a ceiling existed to limit the amount to be withdrawn from the corporation,
4. How the withdrawal was recorded on the books and records,
5. Whether promissory notes were executed,
6. Whether interest was paid or accrued,
7. Whether security was given for the withdrawal,
8. Whether there was a set maturity date,
9. Whether the shareholder was in a position to repay the withdrawal,
10. Whether the corporation ever undertook to enforce repayment, and
11. Whether there was any indication the shareholder attempted to repay the amount withdrawn. (***)

"Unfettered control of a corporation by a shareholder weighs in favor of a constructive dividend characterization, as does a corporate history of not declaring and paying dividends in spite of substantial earnings and profits. (***)

"Shareholder repayments are evidence that a withdrawal from a corporation constituted a loan. The repayment, however, must be bona fide. ...Little weight need be given to repayments that appear to be motivated by a tax audit. ...Additionally, the fact that a taxpayer made some repayments may be overshadowed where total withdrawals each year, after repayments, steadily increase from year to year.

"Further, repayments that occur through bookkeeping entries such as salary credits and credits for bonuses are given less weight because such repayments are funded by the corporation.

"In *Estate of Taschler*, the Court...noted...with regard to repayments in the form of salary credits:

'...Within limits, taxpayer had complete control over the amount of his salary payments. He could have increased or decreased them as he saw fit, and determined the time when they should be paid. So whether amounts were or were not deducted from his salary payments is immaterial, for the net effect on ...(the corporation's) financial status would have been the same. They came from the assets of the corporation.'

"Interest charges and interest payments indicate an intent to repay, but the probative value of interest charges may be significantly reduced if the interest charges did not begin until after a tax audit was initiated.

"In appropriate circumstances, the fair rental value of property includes all of the days on which the property is available for personal use, not just the days on which the property is so used."

(***)...Indicates omission of cases cited.

CHECKLIST FOR IDENTIFYING POSSIBLE LOAN—CONSTRUCTIVE DIVIDEND PROBLEM AREAS

PRACTICE GUIDE

COMMENTS

DOCUMENTATION, BONA FIDES, GROWTH AND ACTIVITY

1. Do loan documents exist?
2. Does the loan documentation appear to be adequate?
3. Is the receivable balance collateralized or otherwise secured?
4. Does the security or collateral appear to be adequate?
5. Has interest been regularly charged and paid? If not, why not?
6. Is there a fixed repayment schedule? If not, why not?
7. Realistically, what limits exist in connection with what goes in and out of this account?
8. Has the total loan balance each year, net of repayments, been steadily increasing?
9. What is the average loan balance amount for the

	Mid-year	Year-end
• Past 3 years	$________	$ ________
• Past 5 years	$________	$ ________
• Past 10 years	$________	$ ________

10. Are repayments substantially through bookkeeping entries and salary adjustments? If so, to what extent?

CONSISTENCY WITH OTHER DATA AND EVENTS

1. Is the receivable from the dealer, as shown on the dealership's books and records and in the financial statements, treated as a liability in the dealer's personal financial statements submitted to banks and other prospective lenders or business associates?
2. How has the receivable from the dealer been treated in any dealership valuation computations? Has the balance been *adjusted, modified or reclassified* in any way?
3. How has the receivable from the dealer been treated in dealership working capital computations? Has the receivable from the dealer been included as a current asset?
4. Has the corporation ever paid any dividends? If so, to what extent?
5. Does the dealer have any unusual or special interests and hobbies? Have these interests been reflected to any extent in the dealership's investments or in advances to the dealer?
6. Does the corporation own any "toys," unique or "nondepreciable" assets which the dealer uses almost exclusively or considers his own?
7. If yes, under what circumstances were these assets acquired? How are they titled? Are they insured? Are there any co-owners?
8. Can any of the documentation relative to quasi-personal use assets be interpreted as potentially misleading or inconsistent with other facts or documentation or classification in the accounts and tax returns?
9. Is the documentation (including insurance policy coverage) consistent starting with the acquisition of the asset, continuing with the maintenance of the asset and concluding with the ultimate disposition of the asset?
10. Have you analyzed detail supporting schedules listing all of the items or assets in the following accounts? Are there any questionable items included in these accounts?

- Used vehicle inventory
- Non-franchise assets
- Any other unusual account(s): ____________________ →

BENEATH THE SURFACE AND BEYOND THE OBVIOUS

COMMENTS

1. Is the dealership a member of a controlled group of corporations? List below all related or controlled entities with which the dealer or the dealership does business.
2. Have any other loans or advances (or guarantees) been made to other related entities that might be characterized by the IRS as having been made *"for the benefit of"* the dealer?
3. Are you aware of any other direct transactions between the dealership and the dealer which might be subject to recharacterization (fully or partially) as constructive dividends?
4. Has the dealership paid any professional fees for the personal benefit of the dealer?
5. Have any payments been made by the dealership in connection with divorce proceedings or settlements involving the dealer or any other members of the dealer's family?
6. Are you aware of any other similar direct or indirect transactions?
7. How has the dealer secured financing for any additional franchise purchases or expansion activities?
8. In connection with these events, does all of the documentation appear to be in order and to reflect arms-length negotiations?
9. Have there been any "diversions" of assets which the dealer may have "quarterbacked" that might be characterized as constructive dividends?
10. Has the risk of recharacterization of activities or transactions by the IRS been considered and discussed with the dealer? If yes, explain below.
11. If potential exposure exists, have accuracy-related penalties and preparer penalties been considered and discussed?
12. Have you considered including a representation from the dealer in connection with these matters in the engagement letter or elsewhere? If not, explain below.

ADDITIONAL COMMENTS & EXPLANATIONS

Preparer's signature and date

Reviewer's signature and date

CONSTRUCTIVE DIVIDENDS COME IN ALL SIZES, SHAPES & FROM ALL ANGLES

PRACTICE GUIDE

"TYPICAL" PROBLEM AREAS

1. "Loans" by the corporation to the shareholder for which the shareholder cannot demonstrate intent to repay and/or the bona fides of the loan.
2. Excessive or unreasonable compensation paid by the corporation to a shareholder-officer.
3. Improper travel and entertainment or other business expenditures incurred by the shareholder and charged to the corporation.
4. Sale of property by the corporation to the shareholder at less than fair market value (i.e., a bargain purchase of corporate property by a shareholder).
5. Purchase of property by the corporation from the shareholder at a price in excess of fair market value (i.e., a sale of property by the shareholder to the corporation at an excessive price).
6. Excessive rentals and other payments (royalties, license fees, etc.) for use of property owned by the shareholder.
7. Shareholder use of corporate-owned property or facilities for non-business/personal purposes (where adequate rent payments are not made for such use).
8. Forgiveness by the corporation of shareholder indebtedness to the corporation.
9. Assumption by the corporation of shareholder indebtedness to other (related) corporations.
10. Payments made by the corporation for the benefit of the shareholder, either directly or to discharge any obligation of the shareholder. This could include the payment of legal fees, alimony or other support obligations arising out of divorce proceedings or settlements.
11. Excessive compensation, rental or other payments by the corporation <u>to other members</u> of the shareholder's family.
12. Advances or other transfers of funds between related corporations may be treated as constructive dividends to the common shareholders.
13. Where a shareholder loans money to the corporation, if the loans by the shareholder are treated as contributions of capital, any *"interest"* the corporation pays to the shareholder on the alleged "loan" will be characterized as (constructive) dividends.
14. Payment by the corporation of premiums on life insurance policies which the corporation's shareholders own directly.
15. The supplying of corporate employees for labor, or materials or other assets to maintain or construct assets or other activities for the benefit of the shareholder.

POSSIBLE LIMITING OR MITIGATING FACTORS

- The amount of any constructive dividend taxable to a shareholder is limited to corporate earnings and profits, as computed under Section 312.
- It may be possible to demonstrate that the shareholder has not received any economic benefit from the corporation's expenditure. If this can be demonstrated, there should be no constructive dividend equivalent taxable to the shareholder.

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ELEMENTS

- There must be a distribution of money, property or an economic benefit from the corporation to the shareholder.
- The distribution to the shareholder must be from the corporation's earnings and profits.
- The distribution (of money, property or economic benefit) is not recorded or treated in the corporate records as a formally declared dividend.
- The amount or fair market value of the distribution is taxable to the shareholder at regular income tax rates to the extent of the corporation's earnings and profits. Beyond that amount, the distribution in excess of earnings and profits is treated as a return of capital to the extent of basis in the stock. Once basis has been reduced to zero, any additional amount is treated as capital gain.

Note: The term "distribution" includes more sinister activities (diversions) which are intended to reduce corporate taxable income by by-passing the corporation or by not involving the corporation directly. A diversion may also be accomplished through the use of intermediaries acting for or on behalf of the shareholder.

IRS MANUAL INSTRUCTIONS TO AGENTS IN AUDITING SHAREHOLDER ACCOUNTS AND LOANS

LOANS TO SHAREHOLDER

The IRS/MSSP Auto Dealerships Manual identifies the following discretionary audit procedures for the loans to shareholders account:

1. Analyze the composition of the account balance.
2. Trace the source of repayments.
3. Determine whether or not a bona fide debtor-creditor relationship exists.
4. Ascertain whether the current year's increase represents dividend distribution, compensation or possible diversion of income.
5. Determine that interest income has been properly recorded.
6. Follow SAIN (Standard Audit Index Numbers) program for loan to shareholders/ liability, where applicable.

LOANS FROM SHAREHOLDER

With respect to Loans From Shareholders, the IRS audit techniques include:

1. Analyze the composition of the account balance.
2. Determine if the corporation is "thinly capitalized."
3. Consider factors bearing on the debt to equity ratio.
4. Review the recording of interest expense and verify the interest accrued at year-end is paid within the statutory period.

OTHER COMMENTS

Note that one of the items on Form 4564, Information Document Request (as reflected in the June, 1995 *Dealer Tax Watch* on page 17) relates to a request for: "Information regarding any loans during the year, including loans to/from shareholders. Shareholders information should include notes and payment schedule."

As discussed in the September, 1995 *Dealer Tax Watch*, the IRS' Used Car Dealers Audit Manual contains a fairly comprehensive discussion of constructive dividend issues, including much of what the Tax Court said in *Yarbrough*. Also, in connection with its discussion regarding fixed assets, this Manual states that "an inspection of the assets on a surprise basis could indicate that some assets are located at the owner's residence." Indeed, some of them may actually be the owner's residence.

THE DARKER SIDE: FRAUD ADDITIONS TO TAX

In *Yarbrough Oldsmobile Cadillac, Inc. et. al.*, the Tax Court held that the IRS had shown that very substantial underreporting of income and underpayments of Federal income taxes had occurred on the dealer's **AND** on the dealership's Federal income tax returns for the years at issue. For those years, old Code Sections 6653(b)(1), 6653(b)(2) and 6653(b)(1)(A) and (B) were involved.

> "A pattern of consistent underreporting of income may indicate fraud, as does the failure to maintain adequate records of income and expenses.
>
> "The use of a corporation to disguise the personal nature of expenses constitutes an indicium of fraud.
>
> "The corporation can act only through its officers and does not escape responsibility for acts of its officers performed in that capacity.
>
> "It follows that corporation fraud is established through the fraudulent acts and intent of corporate officers.
>
> "Generally, courts have recognized that in limited situations, because of mental incapacity or disease, a taxpayer may not have the requisite fraudulent intent."

The burden of proof on the fraud issue is on the IRS insofar as it must prove by clear and convincing evidence: (1) that the taxpayer underpaid taxes owed for each year, and (2) that some part of the underpayment for each year is due to fraud.

After considering the testimony of three expert witnesses (a neurosurgeon, a physician specializing in general psychiatry and a psychiatrist), the Court held that the expert witnesses for the dealership did not adequately take into account the dealer's behavior during the years in issue. In trying to overcome the fraud allegations, Yarbrough had attempted to argue that the dealer's brain tumor, which had been growing for at least 7 years and which had been successfully removed by surgery in 1987, had rendered the dealer incapable of having the intent to file fraudulent tax returns. The Tax Court concluded that during the years in issue the dealer was capable of forming the intent to commit fraud and that he did not suffer from a mental or physical disease or defect that would negate that intent.

The Tax Court stated that the dealer had instructed dealership employees to pay his personal expenses and to record those payments on the dealership's books and records as the payment of business expenses. The dealer did not report these payments as income in his individual Federal income tax returns. The dealer disguised his personal expenses as if they were dealership business expenses. The dealer also used dealership funds to purchase personal assets (i.e., the Capriole and the Sea Ray boat) and to pay expenses associated with those assets. The dealer had been advised by the accountants for the dealership that it was inappropriate and risky to pay personal expenses with corporate funds. The dealer did not take this advice and he continued to use the dealership's funds for his personal benefit.

The Tax Court concluded that the dealer filed fraudulent individual income tax returns for 1984, 1985 and 1986 and that the same conduct that forms the basis for the dealer's liability for fraud relates to the dealership's liability for fraud for 1983, 1984 and 1985. The Court held that the dealer "was fully aware of the falsity of and of the underreporting of income that was reflected on YOC's (the dealership's) income tax returns."

IRS ADJUSTMENTS ATTRIBUTABLE TO FRAUD	IRS ADJUSTMENTS NOT ATTRIBUTABLE TO FRAUD
• Yacht Cabriole. • Sea Ray boat. • Payment of other personal expenses.	• The YOC-Elvin (i.e., dealership-dealer) receivable. • Motor home. • Sylva, North Carolina residence. • Claimed travel and entertainment expenses. • Omission of travel awards from taxable income.

AICPA SECOND NATIONAL AUTO DEALERSHIP CONFERENCE - 1995

The Second Annual AICPA National Auto Dealership Conference was held at the Fairmont Hotel in Chicago, Illinois on October 19-20. This year, the conference was held in only one location (last year it was split between Las Vegas and New Orleans) and both days literally flew by.

CONFERENCE TOPICS

1. Keynote Address: Overview of the Automotive Industry—Maryann N. Keller
2. Megadealer Issues—Joseph O'Brien
3. Benchmarking—Where Should Your Auto Dealership Be?
4. A Computerized Approach to Safeguarding Dealership Assets
5. Tax Strategy and Tax Ideas
6. Everything You Always Wanted to Know About Dealerships Operations But Were Afraid to Ask
7. Parts, Customer Service Index and Profits
8. LIFO—The Latest Developments
9. Dealership Financial Outlook
10. Overview of Valuation Related Issues
11. Panel Discussion: What Does the Future Hold for Auto Dealers?
12. How the Internet Will Change Your Business
13. How to Avoid the Plaintiff Lawyer's Shakedown
14. Effective Business Plans for Automotive Dealership
15. Franchise Agreements and Franchise Law
16. Exit Strategies for the Dealer
17. The Road to Profit Improvement
18. Carmax Superstore Presentation

This year the conference seemed to place more emphasis on subjects more likely to appeal to dealers and dealership controllers...and this seemed to disappoint several of the CPA attendees who shared their reactions with me.

There were only four tax related presentations (Tax Strategies and Tax Ideas, LIFO, Valuation Related Issues and Exit Strategies for the Dealer). Unfortunately, the presentation outline for Tax Strategies and Tax Ideas is extremely sparse (you might say inadequate) and that session seemed far too general for a conference of this stature.

The Conference Manual contains all speaker outlines, including several excellent outlines: Benchmarking, LIFO—The Latest Developments, Valuation Related Issues, Parts, Customer Service Index and Profits, and How to Avoid the Plaintiff Lawyer's Shakedown. Some presentation "outlines" are simply copies of the presenters' slides or overheads with no further explanation.

Tapes of all of the Conference presentations are available and are a useful supplement to the Manual if you want to pick and choose additional reference materials on selected topics.

The AICPA Conference again provided a good opportunity to hear knowledgeable speakers and to get together and share ideas with other CPAs working in the specialized automotive market niche.

Plan now to attend the 1996 AICPA Conference in Phoenix on October 21-22, 1996.

"ECONOMIC REALITY" & NON-COMPETE AGREEMENTS
BEAVER BOLT, INC.

In most dealership buy-sell situations, sooner or later the buy-sell discussions come down to allocating amounts for (1) goodwill—blue sky—franchise value versus (2) agreements not to compete and/or consulting agreements. Typically, the buyer wants to pay more for the latter and less for the former in the hope of writing off or amortizing payments for non-compete and consulting agreements over as short a period of time as possible.

In our last *Dealer Tax Watch*, we extensively discussed the IRS' Reviewed Brief in *Heritage Auto Center, Inc.* Part of that analysis included (at page 6) a list of thirteen "IRS Challenges Purchase Price Allocations." Items 6 and 7 on that list related to assertions by the IRS that covenants not to compete "did not comport with economic reality" or that they had "no economic significance independent of the going concern value or goodwill of the dealerships."

A recent Tax Court Memo Decision 1995-549, *Beaver Bolt, Inc.*, filed November 20, 1995, sheds light on how the Tax Court currently analyzes (and attacks) the "economic reality" of a covenant not to compete when the taxpayer and the IRS cannot agree during the audit or at Appeals.

In this case, the Tax Court found that Beaver Bolt, Inc. reasonably valued the covenant not to compete that it entered into as part of a settlement agreement with a terminating employee who threatened to compete with the business. The terminating employee had been one of the three original founders of the company and was competent and very active in the business. According to the Tax Court, she was healthy and fully able—both physically and mentally—to compete. She had a considerable amount of experience in the nuts, bolts and fasteners distribution business. She had sufficient financial resources to form a competing company, either alone or with other co-owners. She had relationships with customers and suppliers and she knew how to surround herself with the necessary personnel, including salespeople, to establish a successful business.

THE VALUE OF THE NON-COMPETE AGREEMENT

The Tax Court concluded that the covenant not to compete which the departing employee negotiated and received from the company had a value of $324,100. This amount was equal to the difference between the total amount the company paid her ($513,400) and the value of her stock in the company ($189,300). The company had amortized $383,400 as the amount attributable to her covenant not to compete.

EVALUATING THE "ECONOMIC REALITY" OF THE COVENANT

The Tax Court considered nine factors and it generally concluded that each factor favored the taxpayer.

FACTORS

- The seller's <u>ability</u> to compete,
- The seller's <u>intent</u> to compete,
- The seller's economic resources,
- The potential damage to the buyer posed by the seller's competition,
- The seller's business expertise in the industry,
- The seller's contacts and relationships with customers, suppliers and other business contacts,
- The buyer's interest in eliminating competition,
- The duration and geographic scope of the covenant not to compete, and
- The seller's intent to reside in the same geographic area.

As to the duration and geographic scope of the covenant, it applied (i.e., it was limited) only to competition in the states of Oregon and Washington and only for a period of three years. The Tax Court felt that these limits were reasonably drawn to prevent the employee from competing with her former employer. At the time of trial, the former employee still resided in the Portland area.

EXPERT WITNESSES

The Tax Court did not agree with the opinions of either side's *expert* witnesses. The expert witness for the IRS concluded that the value of the covenant not to compete was slightly under $53,000. The expert witness for the taxpayer valued the covenant not to compete at $666,000. The Court, looking to "the objective facts relating to Grecco's ability to compete (which) give a more persuasive basis for deciding the value of her covenant

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WERE THEY TALKING ABOUT THE SAME THING?

Source	000's Rounded	As a % of Tax Court Valuation	Multiple of IRS Expert Witness	Scale
IRS Expert Witness	$ 53	16%	—	$$
Tax Court Decision	324	—	6x	$$$$$$$$$$$$
Amount per Agreement between Company & Employee	383	118%	7x	$$$$$$$$$$$$$$
Taxpayer's Expert Witness	666	205%	12x	$$$$$$$$$$$$$$$$$$$$$$$$$$

not to compete" found the value to be $324,000 (approximately one-half of the Beaver Bolt expert's valuation and approximately six times greater than the IRS expert's).

PENALTIES WERE NOT ASSESSED

In considering various additions to tax asserted by the IRS for negligence, valuation understatement, substantial understatement, and underpayments attributable to a substantial valuation misstatement, the Tax Court noted that the science of valuation was "inexact." (A look at the chart testifies to that.) Based on various mathematical computations, relationships and finding as to "reasonableness," the Tax Court fully dismissed all penalties assessed by the IRS against the taxpayer.

EAGLE EYE AWARD

Remember the admonition: "Always read the footnotes... you might find something valuable in them"?

Note 3 in the Tax Court's decision contains a gem! You may want to try to slip it into an agreement sometime... it could come in handy and provide some real leverage at the right time.

> "Under paragraph 14 of the redemption agreement, until all payments under the agreement have been made, petitioner (i.e. the payor company, Beaver Bolt, Inc.) must have Grecco's written consent before taking various actions, including reorganizing its corporate structure, except in the regular course of business."

This provision allowed the employee (Grecco) to object some 2½ years later to a redemption transaction that the company wished to go through with another shareholder's stock.

This recent Tax Court analysis should be considered in advising dealers and other clients in covenant not to compete allocation matters.

CORRECTION... SAMPLE DEMONSTRATOR AGREEMENT

Item #10 in the sample demonstrator agreement on page 17 of the September, 1995 *Dealer Tax Watch* requires correction.

Item #10 incorrectly states: "Dealership elects Not to Withhold income taxes and/or Social Security/FICA taxes unless and until written notice to the contrary is given to the User."

Clarification: A dealership may only elect not to withhold income taxes. In other words, Social Security/FICA/Medicare taxes must be withheld. An election not to withhold Social Security, FICA and/or Medicare taxes cannot be made. However, applicable Social Security/FICA/Medicare taxes may be remitted either quarterly or annually at the (further) election of the dealership... See applicable IRS withholding publications for particulars.

FORM 8300 AND MONEY LAUNDERING: A VIVID REMINDER

Compliance with Form 8300 filing requirements under Section 6050I is something the IRS is always looking for during its audits. Willful failure to file these forms to report cash payments over $10,000 in business transactions carries severe penalties. In a recent case, the U.S. Court of Appeals for the 8th Circuit confirmed the conviction of an auto dealer on money laundering charges and willfully failing to report cash payments.

Donald Jensen was a co-owner and car salesman at Wells-Ford Mercury in Wells, Minnesota. He had been approached by a drug dealer turned informant in 1987 about buying cars "for cash." Over the next few years, the informant bought four cars from Jensen using substantial amounts of cash. "Early on, Jensen asked Thompson (the informant) if he was using drug money to buy the cars, and Thompson said he was not." Thompson testified that in September, 1992, however, he had told Jensen that he had made a lot of money selling marijuana and explained that he had a few friends who also were "making a large amount of money" and wanted to buy cars with cash.

In October of 1992, the informant bought a 1993 Ford Explorer from the dealer for $26,790. When the informant asked the dealer how much he could pay in cash, he was told that he could pay for the car by financing $5,590, paying $12,200 in money orders from different banks, and paying the rest in cash.

The informant subsequently introduced the dealer to some friends from California who had traveled to the dealership in Minnesota and who purchased cars from Jensen using cash and cashiers checks. One purchaser bought a truck for $21,000, paying $4,000 in cashiers checks and $17,000 in cash. Jensen—the dealer—did not file a Form 8300, as required by law.

Subsequent to all of this, the car dealer asked the informant if he could borrow some money from him, and subsequently cash loans from the informant enabled the dealer to build a home in a nearby town. "Jensen asked, and Thompson denied, that the cash was drug money."

In September of 1993, when the informant was arrested, he agreed to cooperate with the IRS and began taping his conversations with the car dealer. Wearing a recorder, an undercover IRS agent who had been introduced to the dealer by the informant negotiated the purchase of a 1993 Ford Explorer. The undercover IRS agent, using an alias, initially told the car dealer that he was a commodities broker, but later revealed that he had to go to Chicago to pick up marijuana. "(The undercover IRS agent) also portrayed himself as a tax protester, telling Jensen that he did not pay taxes." In discussing how the undercover IRS agent would pay for the car, the dealer told him that if he paid more than "ten grand" in cash, he had to "fill out one of those forms...and I don't want to do that." Jensen then advised the undercover agent how to structure the purchase with cash and money orders. Subsequently, the undercover agent purchased the Explorer for $24,950 paying $6,950 in cash, and the rest in cashiers checks ($3,000 and $9,500) and money orders ($5,500).

The dealer was subsequently convicted on all counts of money laundering and failing to file Forms 8300. He was sentenced to 46 months on each count, with the sentences to run concurrently. The

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FORM 8300 CUSTOMER NOTIFICATION... DUE JANUARY 31, 1996

Don't overlook the Form 8300 requirement that by January 31, 1996, dealerships must notify, in writing, all customers identified during 1995 on a cash reporting Form 8300. The notification must include the name and address of the dealership and the amount of cash reported. It is permissible to provide the written notice immediately after the transaction is complete and not wait until after year-end. Many commentators believe that it is not advisable to merely send the customer a copy of Form 8300. (Some have also suggested it might be prudent to wait until after the customer has completed his/her CSI questionnaire for obvious reasons.)

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

SAMPLE WORDING

Dear (Customer):

We are required by Section 6050I of the Internal Revenue Code to report all transactions involving more than $10,000 in cash. Accordingly, we filed a Form 8300 with the IRS on (date, 1995), indicating that you gave us $(amount) in connection with your purchase of (make, model, year, VIN).

Sincerely,

(Dealership)

Form 8300 and Money Laundering: a Vivid Reminder

(Continued)

Court also ordered forfeiture of cash and real estate and imposed a $25,000 fine.

The dealer appealed his convictions citing numerous reasons including that Section 6050I and 7203 are unconstitutional because they "are vague and allow for selective prosecution."

The Court of Appeals rejected all of the dealer's challenges concerning the constitutionality of the Tax Code and indicated that "an ordinary person is able to understand the conduct prohibited by the statutes... (T)he statutes require proof that the defendant (Jensen, the dealer) knew of the reporting requirement and acted with the specific intent to circumvent the requirement."

The dealer had also argued that there was excessive Government involvement in the undercover investigation, to the point of constituting "outrageous conduct" and that under due process, he (was) entitled to an acquittal or a finding of entrapment as a matter of law.

Although the Court did question the wisdom of the continued investigation of Jensen...after the Government already had ample evidence to support money laundering and failure to report charges, the Court held that the Government's conduct did not amount to a due process violation. "The level of outrageousness needed to prove a due process violation is quite high, and the Government's conduct much shock the conscience of the Court." The Court indicated that to rule on entrapment as a matter of law, it must focus on the defendant's predisposition to commit the crime, not on the investigative tactics employed. Jensen's sales to other drug dealers and his advice to the IRS undercover agent on structuring the purchase undermined his argument that the IRS agent had created the criminal design. The Court also pointed out that "the Government agent is not required to specifically inform the defendant that the money in question is drug money."

The proceedings also involve some other interesting controversy over the recording device that had been used, its inadvertent activation some 3½ hours prematurely so that conversations of other agents involving other matters were recorded as the undercover agent working on Jensen's case drove from St. Paul to Wells and chatted with other agents during the ride. The controversy involved what could or could not be produced on the tape which the Government felt contained "objectionable and sensitive matters unrelated to the case."

Like watching a *film noir* movie, reading this decision affords an opportunity to observe at close range (but without getting hurt personally) how the "nitty gritty" of IRS entrapment procedures or fishing expeditions for non-compliant dealers may go on. The case of *United States vs. Donald Leroy Jensen*, No. 94-3863 (8th Circuit, November 9, 1995) serves as one more vivid reminder that Form 8300 filing requirements, with all of their related ramifications, cannot be taken too seriously.

The Ominous 8 Issues

(Continued from page 8)

5. Rental of wind surfers, barbecue grill, microwave oven and boat.
6. Utility bills for dealer's residence.
7. YOC automobiles (i.e. demonstrators) for personal use of dealer, dealer's wife and their son.
8. Interest on loan to purchase the yacht Capriole.
9. Expenses related to the dealer's housekeeper and to the captain of the Capriole.

IRS AUDIT POSITION: The IRS disallowed the claimed business expense deductions and treated them as constructive dividends to the dealer. In instances where the personal expenses of the dealer were paid, but not deducted in the dealership's income tax return, the IRS determined that those payments also represented constructive dividends to the dealer. "Expenses" which the dealership conceded should be treated as non-deductible personal expenses amounted to $65,487, $43,495, $74,798 and $15,136 for the years 1983 through 1986, respectively.

TAX COURT HOLDING: The Tax Court sustained **in full** all of the IRS' disallowance to the dealership of these claimed business expenses. The Court also held that **all of these payments** should be treated as constructive dividends to the dealer.

Dealer Tax Watch

(Continued from page 2)

Chapter 9 on Taxation includes a records retention guide as well as several expanded discussions on limited liability partnerships and the LIFO reporting conformity requirements. Unfortunately, the Manual is still out of date insofar as it does not reflect the finalization of the Uniform Cost Capitalization Rules well over a year ago. Also, the error in the example showing how LIFO pools having different base years should be combined has been carried forward into this year's revision. Notwithstanding these, there is much useful information in the chapter on taxation.

Chapter 12 includes updated operating and productivity benchmarks for major makes (Chevrolet, Ford, Imports, Buick, Luxury Imports, Pontiac and Chrysler/Dodge). These, too, may be helpful... especially to CPAs who may not have an extensive dealer practice.

#9. NADA CONVENTION. If you want to know more about dealers and dealership operations, make your reservations now for the 1996 NADA Convention. It will be held in Las Vegas on February 10-13.

The most effective way you can get a dealer's attention and expand your dealership practice niche is to be able to tell your dealer clients that you've just come back from the NADA convention where you picked up some great ideas that you'd like to discuss with them.

De Filipps' DEALER TAX WATCH
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First-class