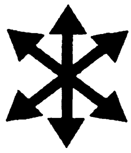
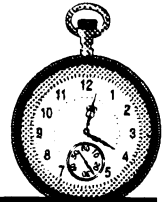


De Filipps' **DEALER TAX WATCH**



A Quarterly Update of Essential Tax Information

Volume 3, Number 1 | Publisher: Willard J. De Filipps, C.P.A. | June 1996

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 AUDIT UPDATE. As far as the IRS' **financial status audits** are involved, there seems to be a letup in these more intrusive audits, although that is not to say that fewer audits are being conducted. The word seems to have come down that agents should not be as zealous as some previously were...perhaps because heated taxpayer resistance was making its way to Washington, DC where the IRS is fighting its own battles to maintain its own funding. In any event, the use and degree of these financial status audits varies from one district to another and they are not altogether a thing of the past.

The major issue that keeps coming up more than any other involves **demonstrator use.** NADA is still trying to work with the IRS to come up with reasonable across-the-board resolution. In late April, NADA released a bulletin updating members on key IRS positions and offering suggestions in light of what's going on. See page 9.

#2. OTHER IRS MATTERS AFFECTING DEALERS. LIFO Financial Statement Conformity Requirement. Still nothing specific on this to report, although the IRS is getting closer to releasing something "definitive." When the IRS "goes public," we'll pass along the highlights for you in the *Dealer Tax Watch* and cover all the details in the *LIFO Lookout.*

Form 3115 Revised. Every change in a method of accounting requires advance approval from the Internal Revenue Service. Permission can only be obtained by first filing Form 3115, Application for Change in Accounting Method, before changing the method. The June, 1996 *LIFO Lookout* analyzed the current revision of Form 3115.

If a dealership is contemplating making any change in accounting methods—whether related to inventory, chargebacks, incentives, accrued expenses, extended service contracts, or just about anything else—the revised version of Form 3115 calls for more information to support change requests.

#3. DEDUCTIBILITY OF AIRPLANE/JET EXPENSES. In our last issue we said we were following a case docketed in the Tax Court, *E. W. Richardson v. Commissioner.* This case involves challenges to a dealership's LIFO computations (which the *Dealer Tax Watch* will not get into, but see the June, 1996 *LIFO Lookout* if you are interested), and challenges to deductions claimed in connection with owning and operating a Lear jet.

WATCHING OUT FOR

Dealer Tax Watch Out 1
How Much Are You Investing In Your Niche? ... 3
Planes & Jets: Is That Airplane Really Deductible?
E. W. Richardson—
Tax Court Docket No. 27308-92 4
Management Fees and Airplane Rentals 5
Costs, Usage & Reimbursement 6
Aircraft Planning & Documentation Checklist 7
Dealership Demos...Still A Hot Audit Issue 9
NADA Recommendations 10
Sample Policy Statement 11
Project 2000 and Dealer Downsizing 12
Survival Suggestions & Practice Opportunities .. 13
What the Factories Say 14
What Dealer Consultants Say 16
What CPAs Say About Dealership Valuations ... 21
What the Lawyers Say 22

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

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

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

If you are involved with a dealership or a dealer who owns and uses a plane in the business...the Lear jet aspects of this case will be of interest to you. For a look at how closely the IRS scrutinizes these arrangements, see page 4.

PROJECT 2000

"THE ACCOUNTANTS, ATTORNEYS, BROKERS & CONSULTANTS RELIEF ACT"

#4. PROJECT 2000: "THE ABC RELIEF ACT". I am not sure whether to quote George Bernard Shaw who said "The greatest problem on communication is the illusion that it has been accomplished" ...or Jerry Lee Lewis who sang ..."there's a whole lot of shakin' going on." In any event, Project 2000—GM's as well as similar activities by all the other manufacturers—has resulted in a whole lot of shakin' going on. And the value of almost every dealership is impacted by what GM and the other Factories are doing—or trying to do.

Car Dealer Insider held a Conference in Washington on April 29-30 on how to "Survive & Thrive Beyond 2000." One full day plus a little time on the second day was devoted to Project 2000 and its impact on auto dealers. This Conference on Project 2000 was well worth attending...although only a handful of CPAs were in attendance. Speakers included representatives from Chrysler and General Motors, well-credentialed dealer consultants, attorneys and CPAs. The consensus was that major changes in the dealership network are inevitable, some occurring sooner than others... and some showing very surprising results.

In our Dealer/CPA 21 Resource Groups, and elsewhere, CPAs are exchanging interesting war stories—and in some cases, horror stories—involving what the Factory has been doing.

Our coverage beginning on page 12 summarizes some of the presentations ...and tapes are available from *Car Dealer Insider* for almost—not all—of the Conference presentations.

#5. MORE OPPORTUNITIES FOR PRACTICE DEVELOPMENT. As if tax planning, operations and internal control assistance are not enough, Project 2000—with all its warts and blemishes—provides a real bonanza for CPAs and other auto dealer advisors.

If you haven't already seen it, the *Practical Accountant* (July, 1996) contains an excellent article by Tony L. Argiz: "Keeping Auto Dealerships in Overdrive." You can't help but see all kinds of practice development opportunities in this niche ...without even factoring in more Project 2000 ramifications!

There seems to be a definite polarity in opinion when an auto dealer's financial statement needs are discussed. Reviews are definitely favored over compilations and more dealers are upgrading compilations to reviews. Audits...get a lot of discussion, especially in "going public" circles or when bankers discuss the desirability of having more reliable information...but audits still are comparatively less common than reviews or compilations.

Dealers presume a competence on the part of the CPA in connection with financial statement services and tax return preparation. This is a given if you're competing in the marketplace. However, many specialized activities (secondary financing, buy-here, pay-here, repossession losses, leasing, EPA cleanup, dependence on limited suppliers) require constant monitoring and application of the steady stream of technical pronouncements the profession...and the IRS...keep coming up with.

Most dealers and dealership controllers seem to emphasize the price/cost of the audit or review ahead of everything else, despite beliefs in our profession that other factors should be more important to them. This means that the opportunities for client satisfaction and value added services lie beyond the traditional audit, reporting and tax functions.

Most dealers welcome help with operating analysis and benchmarking...and CPAs need to be near the leading edge in applying new technology. There is now an overabundance of information and technology to compute ratios; CPAs can best help in pinpointing the problem areas and in implementing and monitoring corrective actions.

See page 3 for a self quiz: HOW MUCH ARE YOU INVESTING IN YOUR NICHE?

#6. UPCOMING CONFERENCES OF INTEREST.

Dealer Tax Issues. I have developed a brand new full-day seminar covering current specialized auto dealer income tax issues. It will be presented back-to-back with my LIFO Update for Auto Dealers seminar. This new seminar builds upon many of the dealer tax cases and practice guides that have appeared in the *Dealer Tax Watch* since 1994. See the enclosed brochure for details.

LIFO Update for Auto Dealers. These seminars also are scheduled over the next few months in various areas ...see the enclosed brochure for details.

Dealer Offshore Reinsurance Companies. Another conference coming up July 29-30 in Dallas is offered by CreditRe Corporation on tax issues affecting producer-owned reinsurance companies (PORCs). Topics include: (1) vehicle service con- →

tract issues, (2) an overview of producer-owned reinsurance, (3) multi-class stock PORCs, (4) IRS exam issues involving PORCs, (5) redomestication of a PORC and (6) the anticipated impact of President Clinton's proposals on the taxation of captive insurance companies.

This ties in with the case we referred to last quarter as one we were "watching out for" (*William Wright, et. al.* T.C. Memo 1993-328) where the dealer had formed a *"sham"* corporation which he used to avoid income taxes in a variety of ways. We plan to report on this in the very near future.

Ride the Used Car Profit Wave. Presented by *Car Dealer Insider*, September 12-13 in Washington, D.C.

AICPA'S Third National Auto Dealership Conference. This conference is scheduled for Phoenix on October 21-22. Speakers included Robert Zwiers (IRS Motor Vehicle Specialist), Peter Kitzmiller (NADA Legal Group) and other prominent consultants to the industry.

TAX & LIFO SEMINARS

Our Fall, 1996 Seminars are being scheduled around the country. These full day seminars will be presented on consecutive days at various locations.

DEALER INCOME TAX ISSUES...a **new** full day seminar covering dealer tax cases, IRS activity and practice guides on all the hot tax issues affecting auto dealers, updating many articles previously appearing in the *Dealer Tax Watch*.

LIFO for AUTO DEALERS...covering all aspects of making LIFO elections, eligibility requirements-Cost, **CONFORMITY**, and Consent/Form 970-and computation mechanics. This seminar will emphasize the LIFO conformity controversy and cover in depth any IRS revenue procedure or ruling that is issued between now and your seminar date.

HOW MUCH ARE YOU INVESTING IN YOUR NICHE?

SELF QUIZ

1. How many specialized conferences and seminars have you attended over the last year or two?
   - NADA Annual Conventions
   - AICPA Auto Dealership Conferences
   - Buy-Here, Pay-Here Operations
   - Secondary/Sub-Prime Financing
   - Project 2000 (*Car Dealer Insider*)
   - Dealer Self Insurance (PORC's Reinsurance)
2. On an annual basis, how many days have you devoted to learning more about operational analysis, benchmarking and the latest tools available (such as GM's "ProfitCenter" or DSC's "Profitech" for analyzing service, parts and body shop operations)?
3. Do you—not "your Firm"—belong to a special auto dealer CPA focus group (Dealer/CPA 21 Resource Groups, AutoCPA Group, AutoTeam America)?
4. During the last year or two, how many new consultants to the industry have you met?
   - Dealer consultants
   - Valuation specialists
   - Buy-Here, Pay-Here & other alternative secondary financing providers
   - Bankers
   - Brokers
5. How many specialized publications for auto dealers do you subscribe to and read regularly?
   - *Automotive News*
   - *Automotive Executive*
   - *Dealer Business*
   - *Dealer Tax Watch, LIFO Lookout,* etc.

   (Not: How many newsletters do you send out!)
6. What's your game plan? What steps have you taken—or are you taking—within your office/firm to perpetuate the development of your specialized automotive practice?
   - Is it all in your head? What's the risk, if it is?
   - Are your sharing the load—spreading the expertise—investing in your staff, as well as your niche?
   - Are you willing to risk seeing some of it go out the door?
7. Have you discussed the special services you are providing to dealers and dealerships with your insurance carrier to see if you are *"covered?"*
8. Are you willing to accept a higher (legal) standard for your professional performance than other CPAs who do not advertise dealership *specialization*?

**ON A SCALE OF 1 TO 8
HOW DO YOU RATE?**

PLANES & JETS
...IS THAT AIRPLANE REALLY DEDUCTIBLE?

E. W. RICHARDSON

In the case of *E. W. Richardson*, Tax Court Docket No. 27308-92, the IRS severely challenged the LIFO computations which the auto dealership had made on many grounds. The Service sought to change the LIFO calculations because factors *other than inflation* had entered into the computation of the inflation indexes. The taxpayer had also arbitrarily changed many item definitions and the Service objected. These LIFO disputes are discussed at length in the June, 1996 issue of the *LIFO Lookout*.

The other major area of controversy in this case—more appropriate for discussion in the *Dealer Tax Watch*—arose out of the company's ownership and use of a Lear jet. In this regard, several tax issues are raised.

First, were the expenses incurred by the management company, Richardson Investments, in owning and operating its Lear jet—in excess of the rental fees it received—incurred in the course of a *trade or business*? Second, if they were (incurred in the course of a trade or business), were these excess expenses *ordinary and necessary* expenses—as contrasted with *unreasonable and extravagant* expenses—under Section 162(a)? Finally, should the deduction the management company claimed in connection with its 13 hours of business use of the jet during 1988 be limited to $1,350 per hour flown?

FACTS

Prior to 1986, Richardson Investments, Inc. had owned three subsidiaries: Rich Ford Sales, Rich Ford Leasing and Richardson Properties. These subsidiaries were liquidated into Richardson Investments in 1986 after which they became operating divisions. During the 1988 and 1989, Investments had deducted the cost of owning and operating a Lear jet, model 25D, which had been used primarily to transport that corporation's sole shareholder and certain employees to Phoenix, San Antonio and Seattle where they performed management services for other auto dealerships which were not directly owned by Investments.

E. W. Richardson was the sole shareholder of Richardson Investments, Inc. *(Investments)* which had made an S corporation election in 1986. During 1988 and 1989, certain ranch properties were owned 50% by E. W. Richardson, individually, and 50% by Investments. Mr. Richardson owned individually—not through Investments—interests in eleven (11) other entities. Some of these eleven entities were auto dealerships in Texas, Washington and elsewhere, and other entities were involved with credit life insurance, extended warranty service insurance and other aftermarket products (paint sealants, theft deterrent products and other accessories). During 1988 and 1989, one other individual was part-owner in many of these other dealerships and entities. These entities were located outside of the immediate area in which the operating divisions of Richardson Investments were located.

There were different arrangements between the management company, Investments, and these eleven entities for charging management fees. Reimbursement for costs of the Jet took the form of "plane rentals." These arrangements were not always consistent among all of the entities serviced by Investments, as can be seen from page 5.

TRADE OR BUSINESS CONSIDERATIONS

The first question is whether the unreimbursed expenses Richardson Investments incurred in owning and operating its Lear Jet were incurred in carrying on a trade or business. I.R.C. Section 162(a) provides that there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred in carrying on any trade or business. Both terms...(1) ordinary and necessary and (2) trade or business...must be satisfied.

Investments position is that it was either in the business of providing management services or that it was in the business of renting its Lear Jet. The IRS position is that neither activity constituted a trade or business within the meaning of I.R.C. Section 162(a) because in order for there to be a trade or business there must be some element of profit and the taxpayer has not demonstrated to the satisfaction of the IRS any benefit to Investments from its providing management services to the other entities.

The executive vice-president—who was also a shareholder in some of the other entities—testified that the management services were provided in order to ensure that the other entities were profitable and that the provision of management services to those entities did nothing to make Investments more profitable. In fact, those services took Investments' employees away from its business.

The management fees which the other entities paid merely reimbursed Investments for amounts it paid to have its employees provide those services. Investments took the management fees into income and deducted the reimbursed expenses resulting in a wash. The management fees did not exceed Investments' expenses in providing those services. In several instances, Investments provided management services without collecting management fees. Since it made no profit, and made no effort to make a profit, from providing management services to the other entities, the IRS view is that Investments was not in the trade or business of providing management services.

see **PLANES & JETS: IS THAT AIRPLANE REALLY DEDUCTIBLE?**, page 7

MANAGEMENT FEES & AIRPLANE RENTALS

MANAGEMENT FEES

1. Employees of Richardson Investments—including E.W. Richardson and an individual who was the other shareholder in several other entities—performed management services for Investments' operating divisions and for the other entities. However, there were no written agreements for any of these management services.

2. The management fees charged to the operating divisions and to the other entities were based on an allocation of the time and effort which employees of Richardson Investments, Inc. devoted to the management activities for each of them.

3. These management fees were made up of the salary, expenses and overhead which Investments paid with respect to each of its employees who performed services for the entities.

4. Each year the comptroller of Richardson Investments took the divisional expenses <u>from the prior year</u> and made an allocation based on how he expected those expenses would be used in the coming year, he then added the salaries of E. W. Richardson and the executive vice-president and then <u>estimated</u> what management fees the operating divisions and other entities should be charged.

5. The estimated management fees were adjusted during the year and were subject to change from year-to-year depending on actual experience.

6. Investments paid the management expenses each year, collected those amounts from its operating divisions and from the other entities and included those amounts it collected in its income and deducted the expenses incurred in its tax returns. Accordingly, the management fees charged the operating divisions had no effect on the tax return of Richardson Investments. <u>There was no net income; there was no net profit</u>.

PLANE RENTALS & TRAVEL REIMBURSEMENTS

7. No travel was required by the employees of Richardson Investments during 1988 and 1989 in connection with the performance of management services for its three operating divisions...nor was any travel required by employees for the performance of management services for about half of the other entities.

8. Normally, the Lear jet was used only if four or more people were traveling.

9. Richardson Investments collected a separate rental fee from the other entities which required travel for the use of its Lear jet during 1988 and 1989. Although Investments collected airplane rental fees from four of these entities, it did not charge any management fees to them for management services rendered.

10. The airplane rental fees which were charged to the other entities were determined and billed separately from the management fees charged to them. These rental fees were based on an hourly rental charge of $700 per hour for use of the jet, plus the out-of-pocket expenses of Richardson Investments' employees for meals, entertainment and lodging. These out-of-pocket expenses were paid by Investments and then the amounts charged to the other entities were collected from those entities and included in Investments' tax return so as to result in a "wash" or no net effect for the meals, entertainment and lodging expenses.

11. The hourly airplane rental fee was not adjusted at year-end to the actual experience and total costs incurred. The costs of operating the Lear Jet are shown on page 6.

12. The same hourly rate, $700 per hour, was charged to the other entities for both 1988 and 1989 despite differences in costs and in the amount of use each year.

13. E. W. Richardson was charged $450 per hour for his personal use of the jet during 1988. This hourly rate was based on the direct costs which were incurred for fuel, hangar, tie down, etc. during each flight.

14. The charter rate for the jet would have been considerably more than $700 per hour, according to the IRS.

15. The other shareholder in the other entities, who was also the executive vice-president of Richardson Investments, testified that they had decided to provide management services to the other entities because they had invested in those businesses and had to provide the expertise to make sure that they were profitable. He admitted that it was to his own personal benefit if the other entities in which he had an interest became more profitable as a result of the management services they received. He also testified that providing management services to the other entities took Investments' employees away from their jobs at Investments. *

LEAR JET COSTS, USAGE & RELATED REIMBURSEMENTS

E. W. RICHARDSON

PLANE EXPENSES	1988	1989
Miscellaneous Repair & Expense	$ 64	$ -
Miscellaneous Expense - Airplane	410	2,923
Pilot Services	3,895	2,967
Fuel - Airplane	34,994	8,044
Depreciation - Aircraft	504	-
Insurance - Aircraft	10,197	-
Interest Expense - Aircraft	16,336	-
Repairs & Maintenance - Airplane	126,425	121,061
Travel & Entertainment - Airplane	24,573	7,631
Utilities - Airplane	1,054	(198)
TOTAL EXPENSES	$ 218,452	$ 142,428
RENTAL FEES & EXPENSE REIMBURSEMENT COLLECTIONS		
Rental Income (Use of Lear Jet @ $700/hour)	$ 48,049	$ 37,674
Meals & Entertainment	2,548	2,828
Travel & Lodging	10,519	8,895
Excise Tax	107	84
TOTAL RENTAL FEES	$ 61,223	$ 49,481
Excess of Expenses over Rental Fees & Expense Reimbursement Collections	$ 157,229	$ 92,947 (A)
Richardson Investments Hours of Business Use	13	-
Per IRS, Fair Rental Value Per Hour	$ 1,350	$ -
Limitation on Deduction	$ 17,550	$ -0- (B)
Excess of (A) over (B)	$ 139,679	$ 92,947
HOURS FLOWN		
Tests, Training, Maintenance & Repairs	33	10
Conventions & Seminars	13	-
E.W. Richardson Personal	3	6
Management Services	64	52
TOTAL HOURS FLOWN	113	68
COST PER HOUR FLOWN	$1,933	$2,094

CORPORATE AIRCRAFT PLANNING & DOCUMENTATION CHECKLIST

PRACTICE GUIDE

Without speculating about the final decision to be issued in *E. W. Richardson*, the facts and the IRS objections suggest the checklist below may be helpful in defending corporate plane deductions.

1. Be consistent in allocations among all entities that are part of an overall related group.
2. Allocate billings for service fees and for expense reimbursements consistently, or have a reason for any difference between the allocation of fees vs. the allocation of expenses.
3. Allocate charges to employees and shareholders for personal use. For determining the amount of income to be taxed to the employees for the value of personal flights on employer-provided aircraft, see Reg. Sec. 1.61-2T.
4. Document the reasons if employees and shareholders are being charged different rates from allocations for business use.
5. If projected expenses are part of a preliminary "budget," preliminary charges should be adjusted to year-end actual amount and final amount billed should be based on the actual expenses.
6. Analyze the line of cases now developing where the IRS is holding that major engine overhauls should be capitalized and depreciated, rather than fully expensed in the year paid for.
7. Maintain usage logs as meticulously as possible.
8. Collect contemporaneous information on the fair rental values of comparable planes. Document reasons for differences between published charter rates, etc. and "rates" charged for internal purposes.
9. Consider providing for reimbursement of plane operating expenses in the same agreement or document that covers management fees and services.
10. Watch out for the "facility" rules under Reg. Sec. 1.274 - 2(e)(2)(i) in which airplanes are listed as an example of property that might be considered to constitute a "facility used in connection with entertainment." In this regard, see also Reg. Sec. 1. 274-2(e)(4)(ii)(b) which relates to primary use determination. ✻

Planes & Jets: Is That Airplane Really Deductible?

(Continued from page 4)

E.W. Richardson, the sole shareholder of Richardson Investments, Inc., had an interest in each of the other entities. Richardson Investments had no direct ownership interest in any of the other entities (except in some Ranch properties) and it received no indirect benefit from providing management services to the other entities. According to the IRS, this hardly constituted a trade or business *of providing management services.*

The rental fees which Investments charged the other entities did not cover its costs of owning and operating the Lear Jet. Since the management fees were a wash, they did not cover the excess costs either. Investments charged a flat rental fee without any effort to have the excess expenses reimbursed or to increase the rental fees during either 1988 or 1989. Again, according to the IRS, this hardly represented a trade or business *of airplane rental.*

LOOSE RENTAL AGREEMENTS ARE NOT THE SAME AS TRADES OR BUSINESSES

In *Clymer, Jr. v. Commissioner*, T.C. Memo. 1984-203, the taxpayer paid his wholly owned corporation a fair rental value for his personal use of its airplanes. The Court rejected the taxpayer's argument that the corporation was in the separate business of renting airplanes or that it had used its airplanes for the production of income. The airplanes were never advertised for rent and only the taxpayer rented them. The corporation's deductions exceeded the rental fees it received. The Court stated that:

"As in other areas of the tax law, in determining whether an activity constitutes a trade or business, we must look beyond the form to the substance of the transaction...We cannot imagine that a 'rental agreement' such as the one in question would ever arise in an arm's length situation..." (Citation omitted).

see **PLANES & JETS: IS THAT AIRPLANE REALLY DEDUCTIBLE?**, page 8

 (Continued from page 7)

In this case, the charter rate for Investments' Lear Jet substantially exceeded the rental fees that it collected and these fees did not even cover the expenses of owning and operating the plane. Said the IRS, this arrangement was not the kind of agreement that an astute businessman like E.W. Richardson would have entered into in an unrelated arm's-length transaction and it did not constitute a separate trade or business of airplane rental.

"ORDINARY & NECESSARY:" THE ASTUTE (HARDHEADED) BUSINESSMAN TEST

According to the IRS, even if the provision of management services to the other entities were considered to constitute a trade or business, the excess expenses incurred in providing those services would not be ordinary and necessary expenses within the meaning of Section 162(a).

One case the IRS cited is *Austin Co. v. commissioner*, 71 T.C. 955, (1979). In *Austin*, the taxpayer had furnished technical personnel to its wholly owned Mexican subsidiary on a part-time basis during the taxpayer's off season. The subsidiary reimbursed the taxpayer for the salaries the taxpayer paid those employees while they were assisting the subsidiary. The taxpayer, in turn, reimbursed the subsidiary for a Mexican tax which the subsidiary had incurred as a result of this compensation arrangement and the taxpayer claimed a deduction under Section 162(a). The taxpayer argued that it paid the Mexican tax in order to reduce the overhead cost of maintaining its technical personnel on a year-round basis. Applying the test of whether a hardheaded businessman, under the circumstances, would have incurred the expense, the Court held that the payment was not ordinary and necessary:

"...We do not believe petitioner would have or did enter into a similar financial relationship with any unrelated company. As a result, we believe petitioner's payment of the Mexican taxes...was a gratuity; a payment incurred simply to aid its wholly owned subsidiary. This is hardly an expense an astute businessman would incur in an unrelated arm's-length transaction."

Richardson Investments had no idle employees and no ownership interest in any of the other entities, except in the Ranch properties. In fact, the activity of providing management services to the other entities took Richardson's employees away from its own business. This was hardly an expense an astute businessman, like E.W. Richardson, would incur in an unrelated arm's-length transaction. Consequently, the IRS argues, Investments' deductions for its airplane expenses, in excess of the rental fees it received, must be disallowed as expenses which were not ordinary and necessary expenses incurred in carrying on a trade or business.

"UNREASONABLE & EXTRAVAGANT"— LIMITATION OF EXPENSE DEDUCTIONS TO FAIR RENTAL VALUE

The last issue raised in connection with the use of the Lear jet was whether the deductions for the actual business use of the plane by *Richardson Investments* in its own business should be limited to a fair market rental value.

Investments' operating divisions were located in Albuquerque, New Mexico. During 1988 and 1989, *Richardson Investments* made no use of its Lear Jet in performing management services for those divisions. The only business use which Investments made of the Lear Jet during these years was to transport its personnel to conventions and seminars during 1988. It did not use the airplane for that purpose during 1989. Investments normally used its Lear Jet only if four or more people were traveling. The only other flight time, besides the management flights, was for maintenance and training or for the personal travel of the dealer, E.W. Richardson.

According to the IRS, the expenses related to owning and operating Investments' Lear Jet...just to transport its personnel to conventions and seminars in one year and to have it available for some other possible use...were unreasonable and extravagant. Consequently, the IRS sought to limit the deductions for the expenses related to those flights to the fair rental expense which it would have paid in renting a comparable airplane for that purpose. See *Harbor Medical Corporation v. Commissioner*, T.C. Memo. 1979-291, aff'd without published opinion, 676 F.2d 708 (9th Cir. 1982).

All things considered (i.e., in looking at the management fees and the airplane rental fees, usage, reimbursements and other related considerations arising out of the involvement with other entities), the IRS concluded that although the management fees exceeded the excess airplane expenses, the management fees represented reimbursements for amounts actually paid out by the company. Consequently, the arrangements provided no profit to the company for its services and left it to bear the excess on the airplane expenses claimed.

The taxpayer offered no evidence as to fair rental value. The IRS determined the fair rental value of the Lear Jet to be $1,350 per hour and it wanted to limit the deductions in 1988 related to the 13 hours (expended for convention and seminar flights) to $1,350 per hour flown. Since no other business use of the Lear Jet during 1988 or 1989 was shown, it would appear that the IRS would disallow all excess deductions incurred in 1989.

DEALERSHIP DEMOS ...STILL A HOT AUDIT ISSUE

IRS AUDITS DEMOS

On April 23, 1996, NADA mailed its members an update on recent IRS audit activity that has been especially heavy in New England and in Illinois (Chicago and suburbs). We acknowledge and appreciate NADA's permission to reprint this information, and only minor changes have been made for continuity or format purposes.

As a general rule, an employee must treat as compensation and pay tax on the fair market value of the personal use of an employer-provided car. The value of the employee's personal use generally is determined by establishing the fair market value of *the use of* the car and subtracting the value (if any) of the business use of the vehicle. If this rule applies, the employer generally must report the value of the employee's personal use of the car on the employee's Form W-2 at the end of the year and must withhold income and FICA taxes from that amount.

SALESPERSON EXCEPTION

There is, however, an exception to the general rule. A dealer may provide employees who meet the full-time salesperson test with demonstrators without the value of the personal use of such vehicles being treated as income. If the conditions of this exception are satisfied, the dealer does not have to become involved with the valuation, reporting and withholding requirements described above.

A "full-time salesperson" is any employee, regardless of job title, who meets all 3 tests below:

TESTS

- Works at least 1,000 hours per year;
- Spends at least 50% of a normal business day performing the function of a floor salesperson or sales manager and directly engages in negotiation of sales to customers (direct sales activities), and
- Earns at least 25% of his or her gross income directly from the sale of vehicles.

The preceding test is met by determining a person's activities and job functions. The test is not affected or influenced by his or her job title. Therefore, in some dealerships, general managers would qualify under the exception if they satisfy all 3 tests above. In most dealerships, all salespeople should certainly qualify, and in most cases, sales managers would qualify as well. F&I managers would only qualify for the exemption if it can be shown that in addition to selling finance and insurance, the employee also spends 50% of a normal business day negotiating or participating in the negotiation of car sales.

All other non-salespeople employees who drive a demonstrator are subject to the general rule—which is that all personal use of the demonstrator is taxable income to the employee.

IRS FORMULA

FMV OF USE OF VEHICLE
— BUSINESS USE

= TAXABLE PERSONAL USE BY EMPLOYEE

IRS AUDIT ISSUES

During the last 12 months, the IRS has conducted major audit programs specifically aimed at dealership demonstrator policies. A number of issues have been raised during these audits, but the two most significant involve (1) what constitutes adequate recordkeeping and (2) the application of a special $3 per day commuter rule.

ADEQUATE RECORDKEEPING

IRS Position: The IRS has taken the position that in order to qualify for the salesperson exemption, salespeople must keep daily logs to substantiate that their personal use was not excessive. The agents claim that if salespeople do not keep logs they do not qualify for the exemption.

Regulations Unclear: The regulations require that a salesperson or sales manager must maintain "adequate records" to substantiate that their personal use does not exceed the substantial restrictions imposed on this use. NADA does not believe that the "adequate records" requirement means that each salesperson must keep a daily log. There must be some restriction on personal use and "adequate records" of compliance must be maintained.

Demonstrator Policy: The "adequate records" requirement could possibly be satisfied by the use of a written demonstrator policy which substantially restricts personal use of the vehicle and which is monitored by dealership management or by a weekly

see **DEALERSHIP DEMOS... STILL A HOT AUDIT ISSUE,** page 10

 (Continued from page 9)

mileage report which is also monitored on a regular basis by management. NADA's A Dealer Guide to the Federal Tax Treatment of Demos, L-17, takes the conservative approach to the "adequate records" issue and suggests the use of some type of logs (not necessarily daily logs). In light of the recent increase in audit activity, dealers need to reassess their procedures relative to demonstrators and may want to consider instituting the more conservative practice of using logs to protect both the dealership and their employees.

$3 PER DAY COMMUTER RULE

A number of methods can be used to determine the value of a demonstrator. Many dealers have used the *$3* a day commuter rule method to value their own vehicles and also to value other non-salesperson employee vehicles. In order to qualify for the commuting method, in which the employee is charged *$3* per day for the use of the vehicle, only de minimis personal use (e.g., stopping at the store on the way home from work) is allowed.

Most dealership employees will not be able to use the commuter rule method to value their demonstrators because they exceed the de minimis personal use requirement. Even occasional use of the vehicle on weekends by the employee would exceed the de minimis personal use standard. Therefore, unless the employee is restricted to using the vehicle for commuting purposes only, the commuter rule method for valuation should not be used.

Most dealers and general managers will not be eligible to use the commuting method because it cannot be used by employees who are directors, 1% or more owners or where an employee's compensation exceeds $100,000.

CONCLUSION

NADA recognizes the burden and practical problems that a daily log requirement would create for dealerships and their employees. The term "adequate records"' as it applies to the salesperson's exemption is not clearly defined in the Regulations. NADA is working with the IRS to develop a reasonable solution to this recordkeeping issue and to clarify whether or not logs are required in order for salespeople to get the benefit of the salesperson exemption. In the meantime, dealers must institute and monitor a formal written demonstrator policy for all employees who drive dealership vehicles.

NADA RECOMMENDATIONS TO DEALERS

1. Develop a written demonstrator policy ...see NADA sample on facing page.
2. Make sure all full-time salespeople who are driving demonstrators have signed the policy.
3. Maintain records of all vehicles put into demonstrator service—stock number, date, mileage when put into service, and date and mileage when taken out of service or sold.
4. Designate someone in a management position to monitor compliance with the demo policy.
5. Determine what you will use as "adequate records" to show restrictions on personal use.
6. Review the entire demonstrator policy with your tax advisor and ask the following questions:
   - Do we have a written demonstrator policy?
   - Which employees are currently driving demonstrators?
   - Have they all signed the demonstrator policy?
   - Are "adequate records" being maintained to substantiate that personal use does not exceed the restrictions imposed?
   - Are we using the $3 A Day Commuter Rule method to value demonstrators? If so, why?
   - Have we selected a method for valuing demonstrators or non-salesperson employees?
   - How are we handling withholding tax for the personal use of vehicles by non-salesperson employees?
   - Have non-salesperson employees been notified regarding the method of withholding we have elected?

Source: NADA Tax Information Bulletin, dated April 23, 1996, "Federal Tax Treatment of Demonstrators," Reprinted with Permission.

DEMO POLICY

NADA SAMPLE POLICY STATEMENT ON
USE OF DEMONSTRATORS BY FULL-TIME AUTOMOBILE SALESPERSONS*

Under certain circumstances, salespersons (and certain managers who engage in sales activities and are treated as salespersons for this purpose) can use demonstrators on a tax-free basis. This statement outlines this dealership's policy regarding use of demonstrators by such persons. It is our intention to strictly enforce this policy.

(1) This dealership provides demonstrators to salespersons primarily to facilitate their performance of services for this dealership. Accordingly, each salesperson provided a demonstrator must have that demonstrator available for showing to customers during that person's working hours.

(2) The salesperson is not permitted to allow friends, family members, or associates to use his or her demonstrator. Further, use of the car is generally limited to the sales area in which this dealership is located, which area is the larger of (a) a 75-mile radius, or (b) a radius equal to the salesperson's one-way commuting distance.

(3) The salesperson must comply with the following substantial restrictions on the personal use of the car:

- The salesperson may not store personal possessions in the car.
- The salesperson may not use the car for vacation trips.
- The salesperson is to limit use of the car for other than demonstration rides to ___ miles per month.
- The salesperson must keep adequate records or other sufficient evidence to substantiate that his or her use of the car complies with these restrictions. A log or other record which contains all required information and which is maintained on a weekly basis to account for all use during the week generally is adequate. Nonetheless, it is advisable to make entries as close in time to actual use as possible.

WARNING

ATTENTION: Be advised that even if a salesperson satisfies these requirements there is no assurance that such person will be able to use a demonstrator on a tax-free basis. This uncertainty results from the fact that the law is unclear regarding the number of nondemonstration miles a salesperson can use a demonstrator and still satisfy these requirements. Thus, notwithstanding this dealership's ___ mile limit, salespersons using demonstrators should limit their nondemonstration use as much as possible.

Moreover, be advised that if a salesperson's nondemonstration use is excessive (i.e., because it exceeds either the dealership's ____mile limit or a lower IRS limit), or if the salesperson otherwise fails to comply with this dealership's policy, the salesperson and this dealership could be exposed to liability for additional tax, penalties and interest.

NOTE TO DEALERS	This policy statement should be reviewed by your tax adviser ***before*** being used by your dealership.
** SOURCE*	NADA Tax Information Bulletin, dated April 23, 1996, "Federal Tax Treatment of Demonstrators," Reprinted with Permission.

PROJECT 2000 AND DEALER DOWNSIZING

2000 OVERVIEW

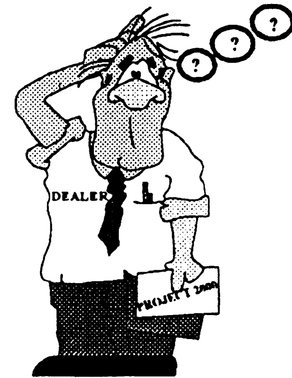
On April 29-30, 1996, *Car Dealer Insider* presented "Survive and Thrive Beyond 2000," at which more than a day was devoted to Project 2000 and its ramifications. Speakers included representatives from Chrysler and General Motors, several business consultants and brokers, attorneys and CPAs. All discussed the impacts that Project 2000 activities are having—and are expected to have—on dealers around the country ...as **all** manufacturers actively continue to cut back on the number of dealerships in the United States.

More questions were raised than were answered at the Conference...but it was interesting to see and hear how speakers from different backgrounds analyzed and reacted to the behavior of the Factories.

As Project 2000 activity intensifies, expect dealers to ask these questions:

QUESTIONS ? ? ?

- What are the Factories really doing?
- How does what they are doing affect me?
- What is my dealership ***really*** worth?
- What should my ***new*** exit strategy be?
- What's a prudent approach for getting this done?
- Is it worth it to me...at what price?
- How does all this affect my current income tax planning?
- How does all this affect my business succession and estate planning?
- What can I do about it...should I just sit back...or be proactive?
- Should I try to make a deal now...or should I just wait and see?



Although there is no definition, per se, for "Project 2000," many things are becoming clearer as more experience is gained and time goes by. Overall, here's the big picture.

1. It's everywhere: Every Factory or manufacturer has a Project 2000 plan for realigning its dealer franchise network...Chrysler has been going about this process since 1991. Ford, without fanfare or publicity, has a very aggressive program underway. General Motors has publicly described its activities as "Project 2000" and is much more out in the open about what it is trying to do. All of the other manufacturers have similar activities and aspirations in place.
2. These plans are continually changing in shape and impact ...and some are not as visible as others.
3. There is no specific cutoff date on which the Factories' attempts at dealer consolidation and managed attrition will cease. January 1, 2000 is only a few months away!
4. Factors influencing a manufacturer's "Plan 2000" at any given time include:
   - Local circumstances in the dealer's Relevant/Primary Market Area (RMA/PMA),
   - The degree of resistance or passivity dealers are offering,
   - The strength or weakness of state dealer protection laws in place, and
   - The willingness of the Factory to test dealer protection laws either sooner or later.
5. Dealers are not being treated consistently by the Factory under these programs...The Factories have different plans and these plans are not uniformly applied to all dealers...Expect some degree of confusion and inefficiency to accompany ongoing Project 2000 implementation...expect manufacturers' "minority" programs to supersede their Project 2000 program activities in many situations. This seems to be evident already.
6. Factory incentives, including cash payments, loans, lower financing costs, are often available...but you've got to ask about them...ask for them...bargain for them...even *fight* for them.
7. If the Factories could start all over again today, very few dealers would be found to be in the right location with the right product mix at this time...Although the Factory may *prefer* that something be done...or even put pressure on dealers to get something done..., some dealers are protected by their state laws to some degree...But that degree of protection varies from state to state.
8. Dealers more than ever before need competent attorneys, CPAs, brokers and advisors who understand their business and the quickly changing environment in which dealers operate.

→

9. Major decisions with major tax consequences may have to be made fast...very fast. With this possibility, start preparing...*now*...while relatively more time is available, or before time runs out. Reevaluate buy-sell agreements, estate and succession planning, dealership valuations, car line/franchise valuations (both before and after October 5, 1995) and corporate and individual income and estate tax planning currently in place.
10. Many dealerships have lost significant value almost "overnight." Dealers who don't have *realistic valuations* of their dealerships stand to lose even more. Dealers who have received a "not viable" letter...or whose fate has been linked to another dealership...or who have given up site control to the manufacturer...now have dealerships of far less value than previously.
11. An entirely new factor...*a wild card*...has been thrown into every dealership valuation. This factor defies professional judgment and measurement. In the form of a question, this factor is: *"What is the dealership's status with respect to Project 2000?"*

    What's worse is that whatever answer might be given to that question, one cannot be entirely satisfied with the valuation of Dealership A—even after his manufacturer's Project 2000 ramifications are taken into consideration—because Dealership A will undoubtedly be impacted by the effect of different manufacturers' Projects 2000 on all their other remaining dealers (B,C,D...X,Y,Z) in the same market area. And each of the other dealers will reimpact each other and reimpact Dealership A. This resettling and reimpacting process will continue in varying degrees of intensity and profusion as the "landscape" changes over the next few years, and becomes more littered with war stories. No one can readily measure anything out there, and appraisers/valuation experts will have to develop some new qualifying language to say so. If you think you know the answer, then maybe you really don't understand the question!
12. For dealerships just fighting to stay in, or planning to expand, be sure that capitalization is adequate. *New image standards* are being developed. ...Significant funds may be necessary to finance these outlays.
13. Those dealers who do survive...are expected to be better off and more profitable in the long run. *

SURVIVAL SUGGESTIONS & PRACTICE OPPORTUNITIES FOR CPAs

1. Review the dealer's selling agreement for vulnerability to termination conditions. When does the current agreement terminate? Under what circumstances? Where—or to what—is the dealer most vulnerable?
2. Write for a copy of the state laws which provide dealer protection. A written summary may be available from your state dealer association. Read the summary and then meet with the dealer and counsel.
3. Take a hard look at how prominently the value of the dealership is factored into satisfying the dealer's post-retirement cash needs and other planning.
4. Review any valuations for the dealership that were recently completed in light of Project 2000 ramifications and implications...See, in particular, comments 10 and 11 above regarding "Project 2000 Status" as a new uncertainty in dealership valuations.
5. Prepare a valuation by car line or franchise if you expect pressure from the Factory in connection with dualling or stand-alone status.
6. Review the "franchise file"...Prepare supporting financial information for claims or statements made in correspondence between the dealer and the Factory as the "franchise file" gets thicker.
7. Do a mini-compliance check to see if the dealer is "clean" in case Factory audits of warranty claims or other incentive programs ensue in conjunction with "negotiations" with the Factory under Project 2000.
8. Consider appropriate disclosures for dealership financial statements in light of either on-going activities or vulnerability to anticipated Factory pressures and/or demands.
9. Anticipate that your dealer clients will ask the questions on page 12—and start working on the answers now.
10. Develop your own firm's Project 2000 data bank or subject file. Seek to exchange information with other CPAs through groups in an effort to broaden your awareness and understanding of what is going on.

WHAT THE FACTORIES SAY

CHRYSLER'S *PROJECT 2000*

Joe Shady, Executive Director of Dealer Operations, said that Chrysler's policy statement for its Project 2000 calls for the consolidation of the Chrysler/Plymouth and the Jeep/Eagle dealer organizations. The project started in 1991 and is to be accomplished through managed attrition. When the opportunity arises, and it makes sense, Chrysler will permit consolidation of Jeep/Eagle with Chrysler/Plymouth or Chrysler/Plymouth with Jeep/Eagle. This effort will take years to complete, and essentially the entire decade of the '90's has been set aside to accomplish this task. The cooperation and interaction of the Chrysler/Plymouth and the Jeep/Eagle dealer organizations will be needed to get the job done.

"Managed attrition acknowledges that any effort to force consolidation is not feasible and, therefore, is not being considered." Chrysler sees the advantages of consolidation as providing a wide range of corporate products to a consolidated dealer resulting in increased dealer productivity and increased dealer profits. It will provide Chrysler Corporation with two strong dealer organizations—(1) Chrysler/Plymouth Jeep/Eagle and (2) Dodge Car and Truck. Chrysler anticipates greater geographic coverage for the Jeep/Eagle products because when Chrysler acquired AMC in 1987, Jeep was not in many of the rural markets.

One dealer consultant, Gordon Wisbach, pointed out that Chrysler is looking to eliminate about 600 dealers in order to get down to a dealer count of about 6,000 dealers by the year 2000.

FORD *"PROJECT 2000"*

Ford was invited to send a speaker to the *Car Dealer Insider* Project 2000 conference...but declined. Draw your own conclusions. See Gordon Wisbach's comments on page 19 about Ford's program, which he described as "clandestine and insidious."

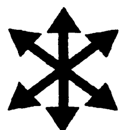
GM'S *PROJECT 2000*

Richard Sherman, Director of Dealer Relations, indicated that *jointly* GM and its dealer network recognized the need to manage future consolidations and throughout the entire decade of the '90's they have been attempting to manage dealership attrition in a more disciplined way. Having projected "normal" dealer attrition as decreasing from 8,500 to 7,000 dealers over several years, the decrease in dealer ranks—in GM's view—seemed both normal and uneventful. He stated that GM is simply attempting to "put some discipline in the process" and admits that much of what currently exists and what GM is trying to change today results from what GM condoned and encouraged in the past with its seven divisions and market proliferation and distribution strategies.

Sherman observed that where service business is discretionary, it is moving away from the dealership at which the vehicle was purchased. The "driving" (no pun intended) forces behind customer purchasing behavior today are (1) time, (2) convenience, (3) value, (4) the "Me" relationship in the marketing experience: I'm different, I'm special, I'm important, and (5) differentiation by customer-brand-product and dealer/retailer. He emphasized that ***"what has made dealers successful in the last five years may not transfer directly into the next five or ten years."***

Essentially, GM's Project 2000 is trying to align franchise and physical facilities in terms of (1) location—obtaining "right" or "better" locations, (2) upgrading facilities and image and (3) availability of product, product mix and product "cadence" in terms of make and model of brands.

→



De Filipps' DEALER TAX WATCH
Willard J. De Filipps, CPA, P.C.
317 West Prospect Avenue Mt. Prospect, IL 60056
(847) 577-3977 FAX (847) 577-1073
INTERNET: **http://www.defilipps.com**

Published Quarterly
March, June, September
and December
$325

Start my subscription for the next four issues of the ***Dealer Tax Watch*** with the ___________ issue.

☐ **YES!** My check for **$325** is enclosed for 4 issues.

Back Issues of the *Dealer Tax Watch* are available for $70 each. Please send me:

1996: ☐ 1Q (March '96) ☐ 2Q (June '96)
1995: ☐ 1Q (March '95) ☐ 2Q (June '95) ☐ 3Q (Sep '95) ☐ 4Q (Dec '95)
1994: First Issue → ☐ 2Q (June '94) ☐ 3Q (Sep '94) ☐ 4Q (Dec '94)

NAME(S):
FIRM NAME:
ADDRESS:
CITY: STATE: ZIP: PHONE: ( )

With respect to the alignment of franchises and physical facilities, the strategy is as follows (with hub towns/cities identified as being located in PSAs/primary shipping areas...as contrasted with simply identifying population size as ± 50,000):

DUALLING STRATEGY

- ***Wherever possible***
  - GM wants to stand alone,
  - Except for Pontiac and for GMC.
- *Metro exclusives*
  - Chevrolet / Olds / Cadillac
  - Buick / Pontiac / GMC.
- *Metro strategic dualling*
  - Chevrolet or Chevrolet / Olds
  - Olds / Cadillac
  - Buick / Pontiac / GMC
- *Hub cities*
  - Chevy / Olds / Cadillac
  - Pontiac / Buick / GMC
- *Rural*
  - Chevrolet / Olds / Pontiac / Buick

WHAT...ME WORRY?

He asked the attendees at the *Car Dealer Insider* Conference: If you're a dealer, should you worry? His answer: *"NO."* He then asked: Is everything all right?...to which he also answered: *"NO."*

Sherman indicated that if by the year 2000 General Motors had accomplished 60-85% of the above realignment strategy, that would be acceptable. Apparently, the "minority program" is likely to take precedence over any specific Project 2000 relocation or consolidation activity.

Under the present program, dealers will be contacted by GM personnel who have monthly goals to contact all 8,500 dealers. Contact emphasis begins with the hub dealers, then the metros, and finally, the rural dealers. Significant interaction is expected between the dealer (and his CPA), the Zone/Branch and members of GM's implementation team. Implementation teams are in place in proportion to the effort anticipated to be necessary to accomplish the Project 2000 goals. Also, the actions of these teams will be responsive to the differences that exist geographically in the dealer network across the country.

At the present time, greater efforts and activity appear to be focused in California, although the teams apparently were initially starting in the Northwest and in the Northeast.

STATED DIFFERENTLY...

In other recent GM presentations, Project 2000 has been outlined as consisting of the following elements and objectives:

ELEMENTS

1. Purpose: To remake the GM dealer organization within 5 years by shifting dealers to where the customers are (i.e., relocating dealerships to better markets).
2. Offer incentives on a case-by-case basis to move and combine dealerships.
3. There is no formal incentive program.
4. Eliminate non-GM cars from GM showrooms.
5. Promote Motors Holding stores to control key sites.
6. Prescribe new dualling patterns (for example Pontiac with GMC Truck—and with Buick where necessary...and Oldsmobile with Cadillac or with Chevrolet if necessary).
7. Increase DNID (Dealer Network Investment & Development) staff by transfer from divisions of 40 employees with field experience to coordinate Project 2000 activities.

FACTORY ACTIONS SPEAK LOUDER THAN WORDS

In May, an Ohio court ruled that GM could override dealers in the Cleveland area who objected to the placement of another dealership near them as part of GM's Project 2000 program for that area. The State (Ohio) Dealer's Board had opposed the relocation of a Chevrolet store, but that decision was overruled by the Franklin County Court of Common Pleas.

The Court believed that the market could support another dealership. It stated that "while all of the dealers in the relevant market area claim that they will lose sales if the dealership is permitted to relocate, the market opportunities are there for additional Chevrolet dealers who are willing to meaningfully compete for the sales."

If this decision is not reversed on appeal, what do you think the impact of Project 2000 will be on the value of the dealerships in that Cleveland area?

WHAT THE DEALER CONSULTANTS SAY

ROBERT DILLMORE

THE REALITY OF PROJECT 2000

MANAGEMENT PERFORMANCE GROUPS, ATLANTA, GA (770) 587-1500

Bob Dillmore addressed three "agendas" out there: (1) the manufacturers', (2) the dealers' and (3) the customers'. Realistically, no one knows the **customers' agenda** because there haven't been any meaningful studies to date that answer the question: How do customers prefer to buy a new car? Nevertheless, Dillmore suggests that it will be the customers who will be the agents of change over the next few years...and not the manufacturers. The **manufacturers' agenda** is to push for ways to cut their costs via changing and streamlining their distribution methodology. This will force a movement away from the dealer network franchise system as we know it today. Some manufacturers are pressing for exclusivity for their products and brands in stand-alone stores. Others—notably Ford and Chrysler—are not because they already have strong product lines, solid value inherent in their franchises and customer proactive programs.

Dillmore poses the question: "When you think about exclusivity, how can anyone seriously think that in the year 2005, there will be stand-alone stores representing exclusively a single automobile product?" This press for exclusivity, he believes, will not yield the kind of results those manufacturers pushing for it hope it will. He sees many "exclusives" (i.e., stand-alone stores) as endangered species. See "At Risk Stand-Alones" below.

As far as the **dealers' agenda** goes, he observes that many dealers would have been better off last year having their money invested in money market funds, than in their dealerships. For many dealers, the business just isn't fun anymore as they find themselves pressured by increasing demands from the Factory, still greater demands from their customers, and...if they make a profit...42% of that being siphoned off in income taxes. Accordingly, the happiness of a dealer today has a direct relationship to the value of his franchise(s) and this, in turn, is related to the value of the brand(s) he is selling.

FOUR TIPS FOR SURVIVING AND THRIVING IN 2005.

Dillmore suggests first and foremost that dealers listen to their customers and be customer driven in their marketing, sales and service efforts from here on forward—if they are not already so.

Second, Dillmore advises dealers to become proactive with their state legislators and to really understand how their state laws either do or do not protect them. He observes that the laws in some states do not provide adequate protection for dealers in all areas where the dealers need to be protected. His suggestion was that dealers not be lulled into a false sense of security at this time by what might appear in some cases to be less aggressive behavior by the Factories. He believes the only reason some manufacturers are taking a passive stance right now is so that dealers will not run off to their state capitols to try to protect their rights with stronger dealer protection laws. Eventually, come January 1, 1999, those manufacturers may begin to act very aggressively ...because then they know the dealers will not have time to get laws in place to protect themselves. So beware of the siren song, he advises, about not worrying about things because the Factory is "just going to pick the low hanging fruit"...Come January of 1999, "they will shake the whole damn tree."

His third suggestion is that a dealer should not make any brick and mortar decisions without a substantive business plan and lots of thought and advice. According to research conducted by his firm (MPG), with the exception of certain high line luxury vehicles producing high new and used grosses, most stand-alone brands must have 7.3% of light-duty market share and should include a truck, minivan or sport utility vehicle in order to stand alone today and make the kind of profit they should. Furthermore, as time goes on, that minimum percent of market share will have to increase.

Fourth, a dealer should strive to achieve a 15% to 20% annual rate of return on total assets in order for that franchise to be a worthwhile investment and for that franchise to have value. At MPG, their client goal is set at a 20% return on adjusted assets on a mean average over a 5-year period. If the franchise cannot provide that kind of return—if the dealership is properly run and all of the profit opportunities are being taken advantage of—that franchise on a stand-alone basis is at risk and is not a good investment. Comprehensive worksheets are available for determining and projecting performance and ROI on an overall dealership and departmental basis.

Dillmore observes that the Profit 2000 publicity by General Motors has probably taken $1,000,000 or more out of the value of a Buick, Oldsmobile or Cadillac franchise. This, if true, is sobering news for dealers in the throes of estate planning and relying on their dealerships to yield higher values when sold or transferred to fund their retirement (or semi-retirement) years. He asked another sobering question: As an outside investor looking

→

for an adequate return on investment, what prudent businessman or woman would buy a Buick, Cadillac or Oldsmobile franchise during the next four years when faced with GM demands?

AT RISK STAND-ALONE FRANCHISES... DO YOU HAVE ONE OR ADVISE ONE?

Some of the franchises at risk on a stand-alone basis, in the order of greatest risk, are: Oldsmobile, Buick, Cadillac, Saab and Saturn in the GM family. In the Ford family, Mazda, Jaguar and Lincoln/Mercury were identified as being "at risk" stand-alones. Others identified were: Chrysler/Eagle; Toyota/Lexus; Nissan/Infiniti and several others such as Kia, Mitsubishi, Hyundai, Volvo, Acura and Land Rover.

For dealers who have these "at risk on a stand-alone basis" dealerships, Dillmore suggests: Immediately, find out what the Factory "plan" is for your dealership...even though you may have to press the Factory to find out. Find out if there will be a satisfactory channel dual available to you to solve your problem. If there is, investigate the possibility of purchasing it now...but don't overpay. Be sure you have a sound valuation of that dealership as a prospective purchaser. If you can't foresee obtaining at least a 15% return on your investment, then seriously question the advisability of buying the dealership. Be sure that any valuation relied upon incorporates a valuation approach based on earnings, and do not rely on rules of thumb about how much to pay for blue sky.

The second option available to dealers who currently have at risk stand-alones is to get a valuation of the dealership and sell it now, either to another dealer or to the Factory. The key point is to have a solid valuation so the dealer really knows what the dealership is worth.

The third option for dealers with at risk stand-alone dealerships is, if they are real gamblers, to just hang in there or do nothing, anticipating that the Project 2000 initiative will lose its steam over a period of time. Many feel that once some of the prime movers high up in the Factory who are pushing the project now are gone, the franchise realignment project will lose momentum. Dillmore believes that, over time, the divisions will go away, but the brands will stay...leaving the Factories to consolidate their marketing arms which may be part of their long-term hidden agenda anyway.

DUALLED SITUATIONS

Dillmore asks: What if you are dualled with a so-called non-channel line and the Factory is urging you to conform? His advice is to stand pat, don't flinch and don't overact. Get your house in order, especially in terms of warranty claims, sales contests, etc. He suggests that dealers should become familiar with their state laws so that if they do not find themselves protected, they can try to get laws that allow dualling, if they have duals already in place. (By the way, there is no law that says a CPA cannot ask for a summary of the dealer protection laws in his or her state!)

Another strong Dillmore suggestion is that regardless of what concessions the manufacturer may offer, under no circumstances should a dealer give up site control to the manufacturer. In his opinion, giving up site control may cost $1,000,000 or more in terms of a dealership's overall valuation.

Finally, Dillmore suggests that dealers develop a 5 to 10-year business plan, and heavily take into consideration the results of customer focus groups and other customer-oriented feedback in attempting to plan activities and operations in the near future.

DILLMORE'S ADAGES

1. Don't buy or sell anything—especially to the Factory—without a business valuation.
2. Don't let the Factory push you around—be a tough negotiator—if that's not your style, get help.
3. Don't build buildings for stand-alone franchises.
4. Don't build salons, satellites or a staff of showroom people just to please the franchisor without having a solid business plan to justify it.
5. Acquire as many franchises as you can in your specific area and consolidate, consolidate, consolidate.
6. Strive to make a 15% to 20% return on your investment by using the ratios, benchmarks and worksheets MPG (and others) make available.
7. Look deep within the business for additional profit opportunities.
8. Change your mind set, if necessary, to move away from tax avoidance to profit performance accounting. This will have a profound effect on your business if you should decide to sell it.
9. Be proactive; don't be overreactive.
10. Be sharply focused to concentrate on those things you can do something about.
11. Quit worrying about those things over which you have no control.

see **WHAT THE DEALER CONSULTANTS SAY**, page 18

 (Continued from page 17)

JOHN KITZMILLER
LEVERAGING PLAN 2000 IN BUY-SELL DEALS
KITZMILLER & ASSOCIATES, HOUSTON, TX (713) 827-1414

John Kitzmiller shared his expectation that the dealer body is likely to suffer ...at least for the near term ...because GM does not really have anyone "up there" who has had a meaningful ongoing relationship with the dealer body in the United States. Accordingly, changes are being made that are likely to adversely impact dealers in the short run. Kitzmiller foresees fewer dealers, larger areas of sales and service responsibility, more multiple dealership owners and public ownership for many dealerships.

Kitzmiller believes many of the other manufacturers will sit back and observe what results General Motors achieves as a result of its decision to "go public" with its Project 2000 plans. These other manufacturers will then, in varying degrees, adjust their own dealer networks to keep up with market trends and situations.

GM'S PLAN 2000 ELEMENTS

1. *Metropolitan* markets where a dealer has *non-conforming* GM duals...These will have to be undualed.
2. *Metropolitan* areas where there are *too many stand-alone* GM dealerships...a thinning of the ranks will be necessary. For example, in a metropolitan area where there are currently four stand-alone Buick dealerships, it may be determined that only two are necessary—but right now no one knows which two will survive and which two will not. As a result, GM may go into the major metropolitan areas and attempt to undual situations where the "channeling" is not right and it may also attempt to reduce the absolute number of dealers in that area.
3. In *sub-metro areas*, primarily where *non-conforming duals* exist...GM will attempt to come in and rearrange dealerships by moving them around.
4. In the *"hub cities"*, more than anywhere else, GM will probably attempt to *reduce the number of dealerships* that exist. Kitzmiller's point of reference for a "hub city" was cities with population of more than 50,000. (Note: Richard Sherman clarified that GM's concept of a "hub city" was more along the lines of primary shopping areas (PSA's).)
5. *Rural market areas* will be considered "non-essential" ...and GM is expected to make *efforts to remove many dealerships in these areas*. Markets not identified in 1, 2, 3, or 4 above...loosely identified as dealerships outside a 25-mile radius of a "hub city"...will be considered a rural market.

KITZMILLER'S KICKERS

1. Review the dealership franchise agreement. Are there any troubling contingencies in it?
2. Look at the long-term succession plan and, if it's incomplete, shore it up quickly.
3. Analyze the local market for trends to see how effectively the dealership is competing.
4. Determine the sales effectiveness of competing dealers within the dealer's market area.
5. Objectively analyze your sales, CSI performance, and other Factory measurements.
6. Analyze the adequacy of the dealership's facility and long-term facility requirements.

By "having a plan" that encompasses responses in the above areas, the dealership should be prepared for any eventuality when visited by the Project 2000 implementation team or in any other discussions with the Factory involving the franchise.

If the dealership is not properly channeled, then the Factory will have some control over what the dealer might want to do when any one of three "triggering events" occurs. These triggering events are (1) entering into a buy-sell agreement when the dealer decides to sell the dealership, (2) relocation of the facility and (3) any other change in the use of the facility or other related considerations—such as EPA problems.

Kitzmiller suggests having a valuation of the dealership immediately before October 5, 1995, which is the date when Ron Zarella sent his now famous "letter" to GM dealers, after which followed his tactful December holiday message.

CAR LINE VALUATIONS

For dealers, especially those in hub cities, it may be important to *develop valuations for each car line.* For example, assuming a dealer has Pontiac, Cadillac and GMC Trucks in a hub city, it is reasonable to expect that the Cadillac franchise will have to go. How much is the Cadillac franchise worth on its own? By going back over
→

a 5-year or longer period and analyzing new, used and service operations for the Cadillac line, it should be possible to come up with percentages that can be applied to a long-term sales forecast. A long-term sales forecast reflecting the Cadillac performance alone may suggest a value for that franchise alone which may be far different than the amount the Factory is offering the dealer as an incentive to give it up. This could even involve present value analyses in situations where more refined analyses can be performed. What might seem like a good deal (i.e., if GM were offering $1,000,000 for the Cadillac franchise) might turn out to be too low under the circumstances if the valuation by car line supports an even larger payment.

Kitzmiller also observed that if a dealer is planning to fight to keep some of the franchises currently within his dealership—or to add some new franchises—then the dealer should expect to be asked to spend money in order to bring these franchises up to the new image standards that are now being developed. Strong capitalization must be anticipated to cope with these circumstances...threadbare capitalization just won't cut it.

Kitzmiller sees the Project 2000 momentum as increasing and accepts as inevitable the varying degrees of confusion and inefficiency that accompany the implementation process. He can think of no reason to believe that the pressure will decrease in the near future. In these short-term activities, proper channeling (i.e., the combination of compatible franchise mixes) is expected to take precedence over performance. Meanwhile, dealers still have to concentrate on continually improving operating results while striving to obtain the right franchise mix ...or while fighting to retain the mix they already have.

GORDON WISBACH
ANATOMY OF A DEAL
GW MARKETING SERVICES, SUDBURY, MA (508) 443-8679

Wisbach indicated that Chrysler is looking to eliminate about 600 dealers in order to get down to a dealer count of about 6,000 dealers by the year 2000. Where Chrysler is involved, it is important to find a "feature" in the deal—such as a lease or value in other hard assets—so that a price tag can be put on that feature (other than on blue sky). He indicated that in the New England area, GM dealers now involved with GM's Project 2000 are advised to negotiate early and forcefully while GM's money lasts. Apparently, Factory inexperience in negotiating—or maybe just willingness to get some early results—has produced in some artificially high payments for blue sky which Wisbach anticipates "can't last forever."

He described Ford's franchise alignment and consolidation activities as "clandestine and insidious." He indicated that some dealers had come up for extensive scrutiny in connection with sales contests and warranty claim audits which bordered on the fringe of harassment. In other instances, it appeared that Ford was willing to step in and pay for some blue sky where that would enable a minority dealer to become involved. But for the most part, no one really knows what Ford's game plan is because nothing has been announced and Ford has kept everything quiet and under wraps.

In the New England area, Mercedes and BMW both appear to be basing their strategies on reducing their stand-alone units from existing numbers to the number of stand-alone units that Lexus has in that area. For Mercedes, this might involve a reduction from almost 350 dealerships down to 125 over a period of time. He described Volvo and Saab as both willing to make payments to terminate dealerships in order to eliminate excess points or to eliminate a weak dealer in a primary location.

DEFENSES & CHOICES: ALL AFFECTED BY FACILITIES, FINANCES & MANAGEMENT

Wisbach points out that at this time, dealers are being called upon to make what in essence may be a *lifetime decision*. Does the dealer want to expand by buying a deal?...retire by selling out?...or just do nothing? He deems doing nothing to be the most dangerous of all three, since the market place for dealerships is changing so quickly. **A DEALER'S DEFENSE INCLUDES** (1) knowing what the competition is doing, (2) assessing how the dealership is competing relative to the competition, (3) knowing what the manufacturer is asking for and (4) attempting to assess the future viability of the franchise. In evaluating the dealership's ability to compete, attention must be paid to three primary resources: facilities, finances and management. If one or more of these is inadequate, that may prevent any real forward action.

ULTIMATELY, THE CHOICES ARE: (1) to dual or not to dual, (2) to sell or not to sell or (3) to buy or not to buy. In considering these alternatives, a judgment has to be made—and a bottom line decision reached—as to what is expected to happen in the dealer's general area to his franchise and what is not expected to happen

see **WHAT THE DEALER CONSULTANTS SAY**, page 20

What the Dealer Consultants Say (Continued from page 19)

to his franchise in his area. Then decisions must be made in his specific situation based upon analyses of the major strengths and weaknesses in his dealership's facilities, finances and management.

BLUE SKY AND ITS METAMORPHOSIS

Blue sky is the amount a dealer is either willing to accept or to pay for the "expectation of future profits." Wisbach calls it *"THE DREAM"*...and he identifies three elements or categories of information that go into arriving at the amount to be paid, or asked, for goodwill or blue sky.

First: The market potential, vehicle registrations and other market data which have to be analyzed.

Second: The financial record/operating results of the franchise and the dealership over the last three years. (Note: Butch Williams, speaking on valuation, suggests a five-year yardstick.) Also, it is necessary to focus on the most recent year, as well as to focus on a forecast of future operating potential.

Third: The situation and exposure relative to the Factory Project 2000 and to any Factory participation incentives that may be available.

Years ago, the major question asked in connection with goodwill determinations was: "What's the planning potential?" That question eventually was replaced by: What's the dealership absorption ratio? Now, these questions are overshadowed by: "**WHAT'S THE PROJECT 2000 SITUATION?**" In acquiring a franchise to dual, a buyer now has to take into consideration that the acquired franchise is adding to the profit structure of the existing store and approximately two-thirds of the gross profit generated by that franchise should go to the bottom line pre-tax. The one-third is the variable cost of bringing that franchise in and selling those units. If you have to build onto the dealership to accommodate the dual, then you'll have to figure in those costs.

The multiple of earnings figure used for dualling would be multiplied by the respective franchise gross profits on a yearly basis. The multiple that's used is influenced by how much potential the franchise is believed to have. You also have to consider what the facility requirements would be. In terms of dualling, for example, a Buick dealer might want to buy a Pontiac franchise in order to bring it in and dual it. Pontiac should add service and parts gross profit and new vehicle gross profit (but probably as a Buick dealer, not much would be gained on the used cars). Therefore, a buyer can afford to pay more blue sky to dual... or a seller should ask for more blue sky when selling the franchise to a buyer who intends to dual it.

When the entire dealership is being sold, then the focus is on the net profit of the overall operation, rather than on the gross profit as in the dualling situation. Selling the entire dealership involves a different approach to determining blue sky. Since the dealership has its own complete overhead structure, the net profit of the operation is used to determine the blue sky, not the gross profit as in the dualling situation. The multiple of earnings figure used for an outright sale or acquisition would be multiplied by the real (i.e., normalized) net profit as determined by a financial analysis. Again, the multiple used would be predicated on the appeal of the franchise and the overall feeling for market potential for that franchise in that particular market. Different franchises have different multiples. In New England, an outright purchase can involve earnings multiples of as low as two times earnings...up to as high as five times earnings.

WISBACH WISDOM

1. Define goals.
2. Analyze alternatives.
3. Establish a plan.
4. Prioritize steps in the plan.
5. Marshal assets to implement the plan.
6. Activate a flexible and realistic schedule.
7. Form opinions as to likely events.
8. Constantly reevaluate the changing franchise situation.
9. Take action.
10. Monitor progress...and readjust plans and strategies accordingly.

WHAT CPAs SAY ABOUT ...DEALERSHIP VALUATIONS

2000 CPAs

CPAs on the podium at the *Car Dealer Insider* Conference addressed the need for a dealer either buying or selling a dealership to do so on the basis of a competent dealership valuation. As James "Butch" Williams stressed, it's extremely important for CPA's to put the dealers in touch with economic reality. And the valuation serves as a catalyst to get the deal going. The party—whether it is the buyer or the seller—who has obtained a valuation almost always ends up with a significant advantage as the transaction moves forward.

QUESTIONS

There are two fundamental questions involved: First, if the dealership were liquidated today, what would you be able to sell all of the assets for? Second, what is the earnings capacity of the dealership? The buyer of a dealership is buying based on the anticipated future earnings *that* dealership, if properly managed, is expected to generate.

Related questions include:

1. Who is going to handle the negotiations? Will it be the dealer under the Project 2000 constraints or will it be the Factory?
2. What time constraints are involved?
3. What monies are available from the Factory to assist in the financing? This includes, but is not limited to, loans, subsidies, incentives, favorable interest rates, etc. How can the parties determine this...and how can they get what is available?
4. Who will control the preparation of the documents? William suggests that in every situation, the party in control of the document preparation has the advantage.
5. Numerous considerations in connection with the real estate: Who pays the phase one costs? If there are EPA problems, how will they be resolved? Can the dealership assets be transferred without bundling in the real estate? Is any special financing available for the real estate portion of the transaction?

TIPS ON "SLIPPING THE *MICKEY*"

By being in control of the document preparation, you may be able to insert a number of key provisions in the document (assuming you're the buyer) that may reduce the overall purchase price indirectly. In many cases, read this as "you may be able to get by with inserting key provisions...if the other side doesn't catch them, question them, or neutralize them through negotiations." For example, by specifying that you are buying all the parts but that you're only paying for the parts that are in the original, unopened factory packages, a considerable amount of inventory may pass to you, the buyer, free of charge.

Stock sales are extremely rare when dealerships change hands. Far more common are asset sales, in which the dealership value is a function of hard asset values, subject to adjustments, and an amount paid for blue sky. Williams suggests a rule of thumb *sanity check* on the amount paid for blue sky: The amount paid for blue sky should be in the range of one to one and one-half times the amount of the average pre-bonus, pretax profits over three years.

In structuring the deal to minimize income taxes, keep in mind that the allocation of the purchase price must be realistic. This is where the valuation of real estate, in turn, may become important. If excess rentals are deemed to be goodwill, they would be written off over 15 years by the buyer. Capitalized building costs are written off over 39½ years...which is now far longer than the 15 years goodwill write-off period.

NORMALIZATION ADJUSTMENTS FOR FINANCIAL STATEMENTS

It is critical to adjust balance sheet accounts and income statement results in order to arrive at realistic results and to reflect special factors that might otherwise result in some Balance Sheet assets being undervalued—for example, LIFO inventories, fixed assets and/or real estate. Conversely, there may be unrecorded liabilities that should be taken into account in reducing the adjusted asset value of the dealership.

As far as the Income Statement goes, there may be expenses which the purchaser does not reasonably expect to incur, even though these were previously incurred by the current owner. Common adjustments to normalize the Income Statement included adjustments for

NORMALIZE

- Excessive compensation in the form of salary or bonuses to owners,
- Excessive rent...if the rent exceeds 10%—some say 12%—of the fair market value of the real estate on an annual basis,
- Excess fringe benefits, such as the cost of demonstrators provided to non-working family members, non-essential travel expenses or non-recurring gains and losses from the sale of assets.

see **WHAT CPAS SAY ABOUT DEALERSHIP VALUATIONS**, page 24

WHAT THE LAWYERS SAY

The four attorneys at the "Survive and Thrive Beyond 2000" Conference were: Dan Myers of Myers & Forehand, Tallahassee, FL (904) 878-6404; Eric Chase of Bressler, Amery and Ross, Morristown, NJ (201) 514-1200; Steven Winter of Miles & Stockbridge, Towson, MD (410) 821-6565; and Joseph Aboyoun, Fairfield, NJ (201) 575-9600.

Dan Myers emphasized that all manufacturers have dealer attrition plans, by one name or another, which approximate in shape and form what General Motors has publicized so widely under the name of "Project 2000." He emphasized that state laws are really all that the dealers have to protect themselves. He commented that Chrysler's activities, most of which he thought have already been accomplished, involved overutilization of site control more than anything else in an attempt to ensure that its dealership structure would remain intact well into the future. Ford, although saying little publicly, is active and aggressive in franchise alignment and consolidation programs of its own.

PHASES OF PROJECT 2000

General Motors' Project 2000 keeps on changing and evolving. To Mr. Myers, there now appear to be four distinct phases in the overall Project 2000 approach. **Phase One** involves a committee decision as to what the mix of dealers in an area is going to be. **Phase Two** involves ensuring that the heir apparent (or successor dealer) is ready, willing and able to buy in or be financially able to borrow enough money to grow with the program.

Phase Three is the negotiation stage, during which the "negotiations"—often between unwilling and hostile dealers forced to negotiate with each other—take place. This occurs after "the Committee" has identified what it wants to do and who it wants to do it to or with. In some cases, this has been reported as a clumsy, awkward situation initiated when one dealer gets a call from another saying they ought to get together and "work things out." Some dealers really don't know whether they're the hunter...or the hunted. In this phase, as far as coming up with incentives to get dealers to cooperate, GM has shown no consistency and different divisions behave differently. Pontiac says: "We don't have any money." Oldsmobile seems anxious to write checks to facilitate the completion of deals. Cadillac seems pretty agreeable, and even innovative, in helping to get some deals done. GMC seems to be a "hodge podge."

Phase Four involves actually "coughing up the money"...but not many deals reach this last phase because the system keeps changing. In any event, the financial considerations may show up in the real estate, or in other ways such as additional vehicles or better allocations, low interest loans, advertising subsidies, assistance in facility expenditures...to name but a few.

Dan Myers suggested there are two questions dealers need to ask: First, should I just sit back passively and wait for phases one, two and three, or should I become active and seek out new franchises or get out now by selling my franchises? Second, is it in my best interests to make a deal now...or to make it a year from now? Dan's opinion is that the money is better now than it may be in the future, so dealers should grab it while they can.

KNOW YOUR RIGHTS AND BUILD A FRANCHISE FILE

Eric Chase's main theme was that dealers should be sure to know their rights so they would know to what extent they might be vulnerable under their own state laws. There is little effective protection available to dealers under Federal law. It is also important for dealers to know their rights because Factory representatives at times may—unintentionally(?)—misstate them. He suggested getting competent legal help and developing a ***"FRANCHISE FILE"*** because doing nothing could be a serious mistake. He advised dealers to put everything received from the Factory in the file.

He also suggested that dealers should reply to all threatening correspondence they receive from the Factory. Tell the truth, state that you don't understand why the Factory has made a particular statement, ask the Factory to provide more information. Ask the Factory to provide advice. The dealer knows the facts of his own dealership better than anyone else, and it can be damaging from a legal standpoint not to have a written response to ***all*** correspondence—even form letters, which the Factory sometimes sends out as a matter of strategy.

Often one of the "higher ups" at the Factory may not know what someone else (or an underling) from the Factory is telling or writing the dealer. It may be advisable to send a copy of the letter to the original sender's superior, in order to give the originator of the letter the opportunity to correct the letter that is now "on the record."

Just because Project 2000 evidences GM's strategy and its preference for how it would like to realign its dealership organization, that does not necessarily mean that GM has the right to force those changes upon dealers. For some dealers, they may be happy

→

to go along with the changes GM would like to see take place; others who might not want to change often have strong defenses and remedies available to them.

As he sees it, the overriding question for a dealer to consider is: What is it you want to do? From that, the next question is: What is a prudent business approach for getting this done? Is it worth it? At what price? Answers to these questions should shape the next activities. Dealer strategies will vary, depending on whether the dealer is targeted for elimination, subject to the "exclusivity" preference, involved with pressure to divest non-GM brands, or relocation and facility issues. Sometimes, more subtle forms of action may be taken by the Factory with adverse effects on the dealer's interests. The adverse actions may involve "termination by indirection" under which better allocations may be given to others or there may be relocations into the dealer's zone, as happened recently in the Cleveland area. (See page 15).

He commented that a dealer receiving a "not viable" letter or otherwise having the fate of his dealership linked to that of another dealership is obviously going to suffer a tremendous loss in the value of the dealership. Mr. Chase strongly recommended that dealers should always ask for Management Review since that is a standard "option" open to them under their dealer agreements.

DEALER CASES AND PENDING LEGISLATION

Steve Winter discussed recent cases in which both Chrysler and Ford Motor unsuccessfully attempted to terminate dealer franchises because of low CSI ratings and location/facility difficulties, respectively. He also discussed pending legislation to assist dealers in Maryland which would impose a requirement that the Factories cannot require dealers to take certain actions if those requirements will impose a "substantial financial hardship on the business of the dealer." If this law is passed, assisting in such a determination will become another area where CPAs can assist in litigation support.

KEYS TO A SUCCESSFUL BUY-SELL AGREEMENT

Joe Aboyoun covered buy-sell transactions and agreements from both the seller's perspective and the buyer's perspective.

FROM THE SELLER'S SIDE, he suggested that a seller should have a presale analysis of the deal to project the true return on the sale after considering all indirect and hidden charges that sometimes come back to the seller via chargebacks, holdbacks and various fees. Not to be overlooked in this regard are regular income tax burdens, as well as potential LIFO recapture. He suggested that the seller qualify the buyer and select the right professionals to assist in the sales process, using only attorneys and accountants who specialize in automobile dealership buy-sell transactions. Finally, the seller's protection in a buy-sell agreement would have to come from ways to maximize the price, reduce contingencies and obtain the most favorable allocation of the purchase price between capital gains and ordinary income alternatives.

FROM THE BUYER'S SIDE, Aboyoun suggested four keys for success. First, qualify the dealership for sale by asking questions like: Why is the deal for sale? How is this dealership impacted by Project 2000 plans? What is the outlook for the franchise?

Second, try to make it impossible for the manufacturer to exercise its right of first refusal. This can be done by putting the real estate into the deal, or by other means. Third, analyze the true cost of the deal, especially taking into account working capital requirements and computer and other lease contracts that may have to be assumed. Finally, be sure the buy-sell agreement is properly drafted and be sure that all assets, including intangible assets, are properly identified and treated. Little things, like making sure that parts inventories being purchased are not in excess of the minimum Factory requirements, do make a difference.

PROJECT 2000 INFORMATION BANKS

Recently, one law firm advisory to the Indiana Auto Dealers Association announced that it was forming a "Plan 2000 Information Bank" to gather information from dealers throughout the state affected by GM's Plan 2000. Stories being told to dealers in some areas of the state are remarkably different than information being given to dealers in other areas.

This Indianapolis firm, Stewart & Irwin, observed that the realignment of franchise lines and the avowed elimination by the Factory of a significant number of dealerships leads to the inescapable conclusion that there will be some hard negotiating as well as some hard litigating. It also pointed out that there was a section in the Indiana Dealers Rights Act that makes it an unfair practice for the manufacturer to do anything or attempt to do anything which would deprive a dealer from receiving fair market value for the dealership "as a going concern." For example, failure of the Factory to approve a sale because the product lines are not in what they perceive to be proper order arguably violates this (Indiana) section. Possibly, the same objection could be raised where the Factory refuses to approve successors.

Other states and dealer groups may be adopting similar "information bank" approaches.

In a similar manner, we will gladly act as a "Project 2000 Information Bank" for any information or materials readers send in for our use in followup articles on Project 2000. ✲

 (Continued from page 21)

Also, it is important to look at a 5-year period, rather than looking only at a 2-year period. In other words, better you should have 5 year farsightedness rather than 2 year myopia.

In terms of maximizing the value on furniture and equipment, if you're selling, Williams recommends that you get an appraisal of the fixed assets and work from that figure. If you're buying the dealership assets, then typically you would rather not have a fixed asset appraisal. Instead, you would want to pay for the assets at their net book value which is usually less than fair market value because of the accelerated depreciation that may have claimed against them for tax purposes. Another dealer consultant expressed his rule of thumb to be that fixed assets should be valued at net book value plus 25% or 50% of the depreciation that had been written off over the years.

Another reason for having the fixed assets appraised is that the appraisal will better support the allocation of the purchase price in the buy-sell agreement. Furthermore, it will establish a more realistic basis for insurance coverage and for personal property tax purposes.

In terms of amounts paid for vehicle inventories, demonstrator vehicles require special care. Vehicle demonstrators with less than 6,000 miles on them may be treated—if so defined in the buy-sell agreement—as new and priced accordingly. Conversely, demonstrators with over 6,000 miles may be treated as used vehicles—if so defined in the agreement—and treated accordingly. For the valuation of used vehicles, it may be more practical to simply let the two used car managers—one from the buyer's dealership and one from the seller's—get together and negotiate the amounts to be paid for each used vehicle. If there are any used vehicle prices they cannot resolve, those can usually be worked out by the dealer principals in less than 30 seconds!

WATCH THAT LIFO!

In William's listing of normalization adjustments impacting the net book value of a dealership, LIFO reserve adjustments are referred to as necessary to bring the inventory up to FMV on the balance sheet. LIFO reserve adjustments are also referred to in his listing of normalization adjustments to be made to the earnings capacity of a dealership.

There are some who would not agree with reversing routine inflationary increases in the LIFO reserve in the attempt to normalize earnings, since LIFO is a generally accepted method of accounting ...even though most dealers use it only because of the tax deferral it affords. For example, the NADA Management Guide, "A Dealer Guide to Valuing an Automobile Dealership" authored by David A. Duryee does not include LIFO adjustments in his listing of "adjustments to earnings," ...although it does reflect a LIFO addback (net of tax) as an adjustment to inventory book values in the balance sheet.

This suggests that some recent valuations heavily based on "earnings" may warrant a second look! ✱

The *De Filipps' Dealer Tax Watch* newsletter is a quarterly publication of essential tax information by Willard J. De Filipps, CPA, P.C., 317 West Prospect Avenue, Mt. Prospect, IL 60056. It is intended to provide accurate, general information on tax matters and it should not be construed as offering accounting or legal advice or accounting or legal opinion on any specific facts or circumstances. The contents are intended for general information purposes only. Readers should consult their certified public accountant, attorney and/or other competent advisors to discuss their own situations and specific income tax questions. Mechanical or electronic reproduction or photocopying is prohibited without permission of the publisher. Annual subscription: $325. Back issues available for $70 each. Not assignable without consent. Any quoted material must be attributed to *De Filipps' Dealer Tax Watch* published by Willard J. De Filipps, CPA, P.C. Editorial comments and article suggestions are welcome and should be directed to Willard J. De Filipps at (847) 577-3977; FAX (847) 577-1073. **INTERNET**: http://www.defilipps.com. © Copyright 1996 Willard J. De Filipps.
De Filipps' Dealer Tax Watch format designed by *Publish or Perish, Inc.* (708) 289-6332.

PLEASE NOTE: All articles and the entire contents of this publication are the proprietary intellectual property of the author and publisher, Willard J. De Filipps. No article, nor any portion of this publication, is to be reproduced or distributed without the express written authorization of Willard J. De Filipps. Any prior permission to reproduce and/or distribute, unless expressed in a written document, is null and void.

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

First-class