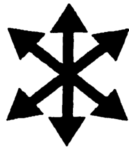
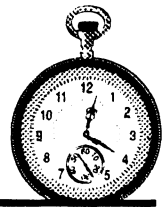


De Filipps' **DEALER TAX WATCH**



A Quarterly Update of Essential Tax Information

Volume 3, Number 2 Publisher: Willard J. De Filipps, C.P.A. September 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. The two areas still receiving the greatest attention involve demonstrator use and the assertion by the IRS that dealers ought to be paying FICA tax—and other payroll taxes—on incentive payments made by the manufacturers directly to dealership employees. NADA's September, 1996 *Automotive Executive* reports that it will be meeting with the manufacturers to discuss and attempt to resolve the treatment of incentive payments to dealership salespersons. It comments: "to confuse matters, the IRS is auditing both dealers and auto makers and telling both they should withhold taxes from these payments."

In July, *Automotive News* reported that IRS agents were reaching contradictory conclusions ... one saying the dealer should do the withholding, while another did not state whether the dealer or the manufacturer should be doing the withholding.

Robert Zwiers, the IRS Automotive Specialist in Grand Rapids, was reportedly unsympathetic to taxpayers claiming defense under Revenue Ruling 70-337 or Letter Ruling 9525003 (discussed in the June, 1995 *Dealer Tax Watch*). Dealers and CPAs wanting "sympathy" on this should send each other Hallmark cards, rather than calling the IRS and asking for *opinions.*

#2. FACTORY INCENTIVE PAYMENTS... ARE THEY SUBJECT TO FICA TAXES ... NO!

I'd like to be able to say that the IRS recently conceded the point raised in Letter Ruling 9525003 and that dealers are not required to pay FICA taxes and withhold income taxes on factory incentive payments. But as you can tell from the IRS comments above, that's not really the case ... yet!

However...being an optimist...I do see hope...or opportunity...in the analysis and wording of the decision recently filed (July 3, 1996) by the Ninth Circuit U.S. Court of Appeals in the case of *Martin L. Springfield.* (See Update #4 and page 14.)

In this case, the court's analysis of Section 530 relief may be very appropriate...in the hands of skilled taxpayer advocates...in refuting the IRS on whether dealers are liable for FICA taxes and income tax withholding on Factory payments directly to dealership employees.

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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

#3. LIFO CONFORMITY: PENDING IRS REVENUE PROCEDURE PUNISHING DEALERS FOR FINANCIAL STATEMENT CONFORMITY VIOLATIONS. The last report from NADA was that the IRS technicians had completed a revenue procedure, but that three levels of review and approval were ahead. The first level of approval had been completed; that left two remaining. Timetable for ultimate release: Anyone's guess. Contents of conformity pronouncement: Not revealed as yet; apparently extremely confidential at this point. As we said previously, when the IRS releases its document, we'll analyze it and highlight it in the *Dealer Tax Watch* and provide all the details in the *LIFO Lookout*.

The recent case of *Martin L. Springfield d/b/a Douglas Motors* which reached the Ninth Circuit Court of Appeals provides some language that may be useful for auto dealers who may be subject to the unduly harsh application of the IRS' interpretation of the financial statement conformity requirement.

This would especially be the case for dealers whose alleged LIFO conformity violation cases might end up in the Ninth Circuit Court of Appeals. That forum may be more inclined to take "real world" conditions into account in judging just how realistically the IRS is in its interpretations.

#4. RECENT TAX LITIGATION: *E. W. RICHARDSON...* AND *MARTIN L. SPRINGFIELD*. The last issue of the *Dealer Tax Watch* analyzed the IRS' challenge to the deductibility of airplane (make that Lear jet) expenses in connection with one dealer's overall organization of dealerships and related entities. We are happy to report that the Tax Court supported the dealer's deductions and reversed the IRS on this issue. That same case also involved some complex LIFO calculation issues ... which were resolved against the taxpayer who was held to have made unauthorized changes in accounting methods. The LIFO issues in *E. W. Richardson* are discussed in the current issue of the *LIFO Lookout*.

Martin L. Springfield was the independent used car dealer in San Diego whose audit by the IRS was covered in the March, 1995 *DTW*. In that case, the U. S. District Court in Southern California held that used car salespersons were employees—and not independent contractors—and that relief was not available under "Section 530."

The good news for Mr. Springfield was that the District Court's holding was reversed by the 9th Circuit Court of Appeals in July, 1996. Particularly gratifying is the comment Judge Hawkins made that: "When the Government ignores a taxpayer's contentions as to the real world conditions of the market place, despite the requirements of Congress that it consider them, it invites the result reached here." In other words, when the IRS ignores what's going on in the "real world," at least some judges are not too sympathetic. I would hope that auto dealers, particularly those in Southern California, whose cases might ultimately wind up in Judge Hawkins' court, would resist the IRS, rather than cave in to unrealistic demands or theories. Case in point: Withholding on incentives paid by the Factory to dealership salespersons ... Another case in point, LIFO conformity requirements on the Factory financial statements. Both of these represent significant examples of the IRS ignoring "real world conditions of the marketplace" and warrant the strongest resistance possible to the IRS.

#5. IRS RELEASES INDEPENDENT USED CAR DEALER AUDIT GUIDE. This training guide was released in final form recently. We had reviewed a preliminary draft one year ago in the September, 1995 *DTW*.

The recent update contains discussions of many areas that we all know the IRS is looking into when it audits new car, as well as used car, dealerships.

As suggested a year ago, any CPA looking to provide a higher level of service to its dealer clients can do so by making checklists of what the IRS agents are being told to go in and look for ... and then going in and looking for it before the IRS comes in and spoils the party. Call or fax a request for a complimentary copy of our articles in the September, 1995 *DTW*, if you're a new subscriber and don't have that issue.

#6. TAX COURT PETITIONS. In watching the flow of petitions into the Tax Court, three recently caught our eye.

KICKBACK INCOME. The first involved one of those "small things" that ends up being big scale trouble. This petition, *Joe Ivison Chevrolet, Inc.* (Docket 10695-96), involves the IRS picking up income from kickbacks in connection with vending machines on the premises of the dealership.

The dealership was controlled by General Motors which at all times owned all of the voting stock and controlled the Board of Directors and all corporate policy. The dealership claims that "with the exception of commissions paid, General Motors Corporation had no reason to know of any kickbacks being paid directly to the dealer and that the dealership's books and records contained no items pertaining to alleged kickbacks." The vending machines were owned by the dealer personally and the →

corporation is seeking to distance itself from the alleged kickback payments made directly to him.

NON-COMPETE PAYMENTS CHALLENGED. Another petition filed by a California Chevy dealership claims that $1,500,000 paid out over five years in equal $300,000 amounts was amortizable as covenant not to compete and consulting agreement payments. The IRS disallowed those amortization deductions.

The IRS is looking to make the adjustment under Section 481 to the most recent year (1992) while the taxpayer asserts that the statute of limitations had already run on the years 1988 through 1992. The non-compete and consulting agreements arose out of the purchase of the assets of a dealership in 1987 with a total price of $7,200,000, of which $200,000 had been allocated to goodwill by the taxpayer.

The IRS is seeking to bunch the entire $1.5 million payment into taxable income into 1992 by a two-pronged approach. First, it has disallowed the amortization of the covenant not to compete in the amount of $300,000 for 1992. Second, it has added $1.2 million to 1992 income under the following rationale: "It has been determined that you understated income on your return for the taxable year ending June 30, 1992 in the amount of $1,200,000 as a result of claiming a deduction of $300,000 for each of the four prior years based on a covenant which has been determined to have no substance. The understated amount is determined to be taxable to you because you have failed to establish that it is excludable from gross income under provisions of the Internal Revenue Code. Accordingly, income is increased $1,200,000."

We plan to follow this case (*Mealey-Serra Chevrolet, Inc...*Docket No. 4741-96) to see if it presents any additional insights not already evident from the *Heritage Auto Sales* litigation. Both cases involve the pre-Section 197 change in the law.

AUTO SALVAGE BUSINESS. In this petition, the taxpayer is operated as an S Corporation called Anything Automotive, Inc. The company buys used, wrecked or badly damaged vehicles from insurance company auctions, police auctions, the local County Sheriff's Department, auto wholesalers and private individuals. The salvage yard holds approximately 400 wrecked or badly damaged autos. Normally, if the engine looks good on any incoming wrecked vehicle, the engine is removed and given a compression test. If the compression test is good, the engine is tagged as a salable engine and removed to a separate shed for storage. Any engine that fails the compression test is sold as junk on a per pound basis. Any warranty information is entered on the back of the tag or ticket attached to the engine. Usually, any warranties on parts do not exceed 30 days. The engine is also entered into the company computer.

The company also salvages engine heads, manifolds and other motor accessories, logging this data on its computer as well. Usually, transmissions and differentials are left in the wrecked auto until a buyer is interested. All vehicles are entered into the computer as to year, model and location on the lot. A few common parts, such as alternators, may be pulled by the company and placed in bins in the store. However, these parts or inventory are not substantial because of space limitations.

No work of any kind—cleaning, rebuilding, refurbishing or reconditioning—is performed on any parts. The parts are sold to the purchaser on an "as is basis." No salvage or wrecked autos are sold as a vehicle or unit. After a year or two, any wrecked automobile whose parts are not selling is sold for approximately $45 per ton. A wrecked Cadillac, without the engine and transmission, weighs approximately one and a half to two tons (except for the one Odd Job drove off with in *Goldfinger*.)

see **DEALER TAX WATCH OUT**, page 4

DEALER 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:

- Orlando,FL .... Oct 2-3
- Baltimore,MD .... Oct 7-8
- Indianapolis, IN .... Oct 10-11
- Dallas, TX .... Oct 31 - Nov 1
- Burbank, CA .... Nov 7-8
- Chicago, IL .... Nov 25-26

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.

(Continued from page 3)

The taxpayers valued their ending inventory each year based on the crusher value of the wrecked vehicles on the lot. The IRS agent used a formula approach, which the taxpayer contends is "unreal and unrealistic for the auto salvage industry."

This case—if it isn't settled before going to court—will be of some interest to dealers who have larger used car/body shop operations or other involvements with the auto salvage business.

#7. PROJECT 2000 WATCH. Without going into details here, we note that the September, 1996 *Automotive Executive* contains an article on rural route auto dealerships: "Is There Still A Place At The Table For Small-Town Dealers?" At the end of that article, there is a very interesting piece, "Downsizing Small Dealers," which talks about the pressures now being placed on smaller, rural dealers ... especially where the Factory is enforcing "exclusivity."

Automotive News, September 9, 1996, reported that Volvo would like to cut about 25% of its dealer body over the next few years and apparently is planning to do so based upon research and a 3-year incentive program and low interest loans for buy-outs.

Numerous articles have appeared in the press mentioning dealer suits against the Factory to protest or try to prevent termination.

Also, in the Project 2000 context—as well as in the general dealer retirement planning context—the IRS occasionally issues a Private Letter Ruling in which the restructuring by the dealer of his corporations seems to have an underlying Project 2000 impetus.

#8. PPC STEPS IN, REPLACING AICPA WITH "GUIDE TO DEALERSHIPS." The AICPA *Auto Dealership Engagement Manual* has been discontinued and Practitioners Publishing Company (Fort Worth, Texas) has picked up the slack with its new *Guide to Dealerships.* This *Guide* contains a full chapter on tax considerations (discussing LIFO, valuing used vehicles at lower of cost or market, Section 263A Cost Capitalization Rules, extended warranty contracts and environmental cleanup costs). The *Guide* also contains a complete chapter on valuing dealerships. Unfortunately, this valuation chapter does not include a sample valuation report with all the dressing and "good stuff" for an auto dealership.

Comparing the AICPA's *Dealership Engagement Manual* with PPC's, one notes that the AICPA *Manual's* chapter on "Advisory Services," including benchmarking, does not have an equivalent or counterpart in the PPC *Guide.*

The PPC *Guide* contains all the usual questionnaires, audit correspondence, audit programs and other practice and procedures checklists. Useful accounting discussions appearing in Chapter 3 include: Inventory considerations, financing and insurance activities, extended warranty contracts, leasing activities (both as lessor and as lessee), customer deposits, environmental cleanup costs and deferred taxes.

The PPC *Guide* is moderately priced (approximately $100) ...more than a bargain at that price.

#9. BUY-HERE, PAY-HERE & RELATED FINANCING COMPANIES (RFCs). The IRS Used Car Dealer Guide contains some interesting information on related financing companies. Other interesting developments in this area include the activities now being pursued by Indiana auto dealers in the Greater Indianapolis area. A new Indiana dealer-owned sub-prime finance company, Auto Trade Acceptance Company (ATAC) is being formed as a limited liability company. It will be made up exclusively of Indiana franchised new vehicle dealers. This company will offer a sub-prime finance source to provide (Indiana) dealerships with a "safe and dependable finance source, void of any hidden discounts or holdbacks."

#10. "ONE MAN'S GAME PLAN." In the course of thoroughly analyzing the briefs and Tax Court decision involving *E. W. Richardson*, it became apparent that there was some underlying theme to the organization of the taxpayer's corporate and non-corporate activities.

As a stimulus to some readers whose dealers have not yet organized their overall affairs—or at least structured them with some general symmetry or plan in mind—the "organization chart" of one dealer's setup may be useful as a jumping off point for other "getting organized" discussions.

Note from pages 11-12-13 which show the entity arrangement how it is possible to have different family interests and key employee interests in different entities and how these can be changed, over time, as part of one's overall tax and/or estate planning.

#11. UPCOMING CONFERENCES OF INTEREST.

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

PLANES AND JETS

THAT AIRPLANE REALLY IS DEDUCTIBLE! CLEAR SAILING IN THE FRIENDLY SKIES

E. W. RICHARDSON

In the June, 1996 issue of the *Dealer Tax Watch,* we analyzed the brief filed by the IRS in the case of *E.W. Richardson v. Commissioner* (docketed in the Tax Court as No. 27308-92). We covered the controversy over the deductibility of expenses incurred by the dealer in connection with the use of a Lear jet. The Tax Court issued its opinion on August 12, 1996 as Tax Court Memo Decision 1996-368.

On its face, that case involved LIFO adjustments and the airplane controversy. The Tax Court held in favor of the IRS on the LIFO issues and this is discussed in the current *LIFO Lookout.* However, the news was better for the taxpayer on the plane issue.

The Tax Court held that although the airplane expenditures were large for the taxable years involved, use of the airplane was an ordinary and necessary part of the taxpayer's businesses and generated substantial income during the years at issue. Accordingly, the Tax Court held that the expenditures associated with owning and maintaining the airplane were reasonable.

The IRS had challenged the taxpayer's use of the aircraft and the deductions relating to it by raising three issues:

1. 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*?
2. 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)?
3. 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?

CONSTRUCTIVE DIVIDEND ISSUE WAS DROPPED

The IRS had originally intended to charge Mr. Richardson, sole shareholder of the S Corporation, with a constructive dividend related to the excess airplane expenditures. However, this constructive dividend issue was conceded by the IRS before trial. The petition filed in the Tax Court indicated that the IRS had determined that the disallowed aircraft expense deductions should be $190,053 in 1988 and $139,010 in 1989 ...87% of the total plane expenses of $218,452 in 1988 and 97. 6% of the total plane expenses of $142,428 in 1989.

From this, it appears the IRS determined that the flights resulted in benefits valued at $176,651 in 1988 and $86,917 in 1989. Accordingly, the IRS proposed to adjust the Accumulated Adjustments Account for 1988 and 1989 with respect to these alleged benefits...and that boiled down to a constructive dividend of $18,168 to Mr. Richardson in 1989 as a result of personal aircraft usage. Possibly, that constructive dividend might have been significantly larger if the composition of the AAA (Accumulated Adjustments Account) were different. In any event, the IRS did concede the constructive dividend issue before trial and it was not an issue the Court had to decide.

WIDE RANGE OF ISSUES CONCEDED BY PARTIES AND NOT TRIED AT TAX COURT

Probably the biggest issue involved the attempt by the IRS to increase the extended service contract income by requiring amortization of the service contracts purchased by the dealer. The position of the taxpayer was that these plans were offered by *Investments* as a sales agent of the manufacturer and that *Investments* was not the principal in the extended service contract transactions. Its position was that Ford Motor Company was the principal and that *Investments* received the full amount of the contract and then purchased an insurance contract to ensure the customers' risk...with the difference being the commission earned on the transaction by *Investments.* Accordingly, *Investments* took the position that it properly reported its commission income, that it did not have to recognize as income any other amounts received on the extended service contracts...and that it was not required to amortize over the period of the contracts purchased the amount paid for insurance under each of the extended service contracts. Ultimately, the IRS conceded these issues.

Section 263A cost capitalization: Apparently two of the dealerships involved did not capitalize any costs, including overhead costs, under Section 263A incident to purchasing activities. The taxpayer claimed that by checking the box in Schedule A of the tax return and not capitalizing any additional Section 263A costs, *Investments* had made a deemed election to utilize the simplified resale method under Section 263A. Taxpayer

see **PLANES & JETS... THAT AIRPLANE REALLY IS DEDUCTIBLE!**, page 6

 (Continued from page 5)

stated that because no employee of the dealership spent more than 1/3 of his time in or related to purchasing activities, no amount of labor costs were allocable under the Section 263A regulations.

In connection with the LIFO computation challenge, the IRS first attempted to correct the dealership's LIFO calculations by requiring that the LIFO reserves be recomputed from inception using 80% of the Producer Price Index (as determined by the BLS) and spreading any resulting adjustment over a three-year period. This initial position was refined and dropped as the IRS developed its more comprehensive challenge.

When the taxpayer elected to apply LIFO in 1983 to its used cars and truck inventories, no Form 970 was filed with the tax return for that year...leaving the taxpayer to assert that "the information included with the return was sufficiently detailed so that an informal LIFO election should be deemed to have been made."

Another adjustment raised and later conceded by the IRS was that the dealership should have additional taxable income from customer lease deposits...where under the applicable consumer net lease agreement with each customer, the cash security deposit paid by the customer was required to be refunded to the customer upon expiration or termination of the lease subject to off-set of any sum then due the lessor from the customer. In its petition to the Tax Court, Richardson cited the *Commissioner v. Indianapolis Power and Light Company*—a Supreme Court case—as support for its position that these security deposits which were required to be repaid did not constitute advance payments and were not taxable upon receipt.

The IRS had also challenged the deduction of legal fees and professional fees and the payment of a sizable settlement sum. All of these were allowed either totally or in substantial amount as a result of the IRS' concessions. Finally, although penalties had been asserted for additions to tax under Section 6653(a)(1), 6661(a) and 6662(e), the IRS conceded the penalties to be not applicable.

ARGUMENTS IN THE BRIEFS THAT THE TAX COURT DID NOT MENTION

The IRS in its brief filed with the Tax Court claimed that the reason that *Investments* wanted its employees' travel time to be as short as possible was because it was not receiving arms-length compensation for their services...and that every hour of travel time was an hour away from the conduct of *Investments'* own business. The taxpayer, in its reply brief, asserted that although there were no written management agreements, it is uncontested that services were performed and paid for on a monthly basis and that full performance of the agreement negated the need for a written contract. Furthermore, management services were performed pursuant to oral management service contracts, an arrangement which was common in the industry.

Taxpayer further asserted that part of each employee's job was to provide services under the overall management agreements and, therefore, the IRS was incorrect in asserting that work by these employees in rendering management services to the other entities was not "part of their job or jobs."

Interestingly enough, two cases cited and discussed extensively in the briefs and reply briefs filed by both parties were not discussed at all by the Tax Court in its opinion *(Austin Co v. Commissioner* and *Clymer, Jr. v. Commissioner)*. These cases were discussed in the June, 1996 *DTW* coverage of the Richardson brief.

In analyzing the IRS' objections to the use of the plane and the related deductions, the Tax Court appears to have been willing to extend the "benefit of the doubt" to the taxpayer on these issues.

CONCLUSION

Before you decide, based on *Richardson*, that it's safe to fly the friendly, tax deductible skies, with your own corporate aircraft... you may want to consider the following:

FIRST: The facts in your dealership situation will have to be at least as good —if not better— than Richardson's. How close can you come or do you come? See the June, 1996 *DTW* for the detailed write-ups of the facts, narrative information, calculations of the jet usage and related reimbursements and the management fees and airplane rental arrangements.

SECOND: What about the accessibility to airports and the geographic spread of the dealerships for which management consulting services are being provided?

THIRD: Are you willing to carry the fight for tax deductibility all the way to the Tax Court? The IRS is not likely to accept its defeat in this case as any kind of limiting precedent.

FOURTH: Might the constructive dividend issue be lurking? Could it involve more sizable additional tax?

FINALLY: Have you reviewed the checklist for Corporate Aircraft Planning and Documentation that was included in the June, 1996 *DTW* on page 7?

THE "FACTS" RELATING TO THE USE OF THE LEAR JET

The Court's findings of fact are always important. Some facts were stipulated and agreed to by both parties. Other "facts" are the result of precise jockeying for semantic position or innuendo and either successful or unsuccessful attempts by the petitioner (Richardson) or the respondent (the IRS) to influence the Court to interpret certain events or activities in the way the respective parties believe they should be interpreted.

In addition to operating its automobile dealership through its Rich Ford Sales division, *Investments* provided management consulting services to its operating divisions and to thirteen (13) "other entities". For a "bird's-eye" view of the overall setup, see pages 12-13.

The management services provided, both periodically and on an as-needed basis, by *Investments* included consulting in: Accounting, finance, legal, sales, marketing, and personnel management.

The fees *Investments* charged for management services were billed and paid monthly. During 1988 and 1989, *Investments* billed management fees of $814,452 and $970,997, respectively, and it owned a Lear Jet Model 25D airplane which was used for travel associated with the operating divisions and travel associated with its management services activity.

In regard to the operating divisions, the airplane was used by Rich Ford Sales to transport its employees to conventions and seminars. The airplane was also used to fly key management personnel to Detroit, Michigan, to respond to urgent business Rich Ford Sales had with Ford. Also, Rich Ford Sales used the airplane to take employees to automobile shows.

In connection with the performance of management service activities, the airplane allowed *Investments'* employees to provide management services <u>in person</u> to each of the out-of-town dealerships located in Phoenix, AZ... San Antonio, TX... Kirkland, WA... and Apple Valley, CA.

Investments generally used the airplane only if four or more people needed to travel. If fewer than four people were traveling, the employees would usually fly commercially, as use of the airplane in such circumstances was inefficient. <u>Use of a private airplane saved time</u>, as employees could fly to an out-of-town dealership and return to Albuquerque, New Mexico (i.e., the home town), in the same day, or they could visit two dealerships in the same day. This was important, because the down time associated with having a number of employees waiting for a commercial flight was costly. <u>Use of the private airplane also saved travel expenses</u>, because the reduced travel time often reduced the room and board costs that would be associated with commercial travel.

Overall, the airplane was flown a total of 113 and 68 hours in 1988 and 1989, respectively. This included 64 and 52 hours [56% and 77% of the time] for management services.

The airplane was also used to fly employees to conventions, seminars, and training in 1988. It was used 13 hours for this purpose, or 11% of its total 1988 use. In addition, the airplane was flown for crew training, maintenance, repair, and testing purposes. This use amounted to 33 hours in 1988 and 10 hours in 1989, representing 30% and 14% of the total use, respectively. Finally, the taxpayer used the airplane wholly or partially for personal reasons on five occasions during the years at issue. The taxpayer used the airplane for 3 hours in 1988 and 6 hours in 1989, or 3% and 9% of the total time, respectively.

When the airplane was used to provide management services, airplane service fees incurred for such travel were billed separately from the management fees. In these situations, the airplane pilot would prepare the airplane service bill, and *Investments'* accounting department would process the bill and <u>separately charge the customer involved</u>. For the years at issue, the airplane rental fees charged the other entities were $700 per hour, plus out-of-pocket expenses of *Investments'* employees for meals, entertainment, and lodging. The airplane pilot set the $700 hourly airplane rental fee, based on the anticipated expenses associated with 200 hours of billable flight time. That estimated hourly fee was low for 1988 and 1989, but it was subsequently adjusted upward.

When the taxpayer used the airplane for personal use, he was billed for and he paid for the direct costs of the flights. Direct costs included fuel, hangar storage, tie-down, etc., for each flight. These charges varied from $450 per hour to $760 per hour during 1988 and 1989.

Investments' total costs of owning, operating, and maintaining its airplane, exclusive of pilot salary, during 1988 and 1989 were $218,452 and $142,428, respectively. *Investments* collected a separate rental fee from five of the dealerships and from the Ranch entity for the use of its airplane during 1988 and 1989. These rental fees collected by *Investments* during 1988 and 1989 were $48,049 and $37,674, exclusive of meals, lodging, etc. (Note: All numbers and percents rounded—See Table on Page 6 of June, 1996 *Dealer Tax Watch* for details.) ✻

WHAT THE TAX COURT SAID IN *E.W. RICHARDSON*
LEAR JETS, BUSINESS USE & DEDUCTIBLE EXPENSES

The IRS disallowed the deductions arising from *Investments'* operation of the airplane to the extent that those deductions exceeded the airplane rental fees it received. The IRS based its determination on alternative arguments; specifically, that the excess expenses were

1. Incurred primarily for the benefit of the taxpayer, E.W. Richardson,
2. Not ordinary and necessary, or
3. Unreasonable in amount.

The taxpayer claimed that the excess expenditures should be allowable. **HERE'S WHAT THE TAX COURT SAID:**

Deductions are a matter of legislative grace, and the taxpayer bears the burden of proving that he is entitled to the deductions claimed (...).

Section 162 (a) allows a taxpayer to deduct ordinary and necessary expenses paid or incurred in carrying on a trade or business. If a corporation owns and maintains property primarily for the benefit of a shareholder, the deductions arising from such property will not be allowable, as such deductions are not incurred in carrying on a trade or business (...).

In contrast, "where the acquisition and maintenance of property such as an automobile or residence is primarily associated with profit-motivated purposes, and personal use can be said to be distinctly secondary and incidental, a deduction for maintenance expenses and depreciation will be permitted" (*International Artists, Ltd. v. Commissioner*). Furthermore, if substantial business and personal motives exist, allocation of the expenditures becomes necessary (...).

In addition to the requirement that a deduction be incurred in the conduct of a trade or business, Section 162 (a) provides that a deduction will be allowable only if it is "ordinary and necessary". An "ordinary" expense is one that is normal or common in the particular trade or business (...). "An expense is necessary if it is appropriate and helpful in carrying on the trade or business" (...). Finally, for an expense to be considered ordinary and necessary, it must also be reasonable in amount in relation to its purpose (...). We examine the facts and circumstances of the particular case to determine whether an expense is ordinary and necessary (...).

"INCIDENTAL BENEFIT" FROM OWNING PLANE

The IRS first argues that the airplane expenditures were incurred primarily for the personal benefit of the taxpayer. The IRS does not premise this argument on the taxpayer's concededly personal use of the airplane, which accounted for 3% and 9% of the total use of the airplane for 1988 and 1989, as the taxpayer paid the actual cost associated with such secondary and incidental use of the airplane. Rather, the IRS focuses on the taxpayer's relationship with the other entities and the use of the airplane in providing services to those entities.

During the taxable years at issue, the airplane was used to transport *Investments'* employees to six of the other entities so that the employees could provide management services. Since the taxpayer had an ownership interest in five of these six entities, the IRS argues that the airplane was used primarily to benefit E.W. Richardson as an owner of these entities...not to benefit *Investments*. Basically, the IRS argues that the airplane was used to improve the value of the other entities by making *Investments'* employees available for management consultations. It is true that the airplane facilitated the availability of *Investments'* employees to the other entities. Accordingly, assuming the management services were beneficial to the other entities, it is true that the expenses of the airplane benefited the taxpayer, since he had an ownership interest in all but one of the other entities serviced during the taxable years at issue. Nonetheless, we (the Tax Court) find this was an incidental benefit of the acquisition and maintenance of the airplane.

"PRIMARILY FOR BENEFIT OF BUSINESS RELATED ACTIVITIES"

We find that *Investments* owned and maintained the airplane for the benefit of its business-related activities, including its management services activity and its Rich Ford Sales activity.

Investments charged substantial fees for its management services during the years at issue.

When the airplane was used in the conduct of the management services activity, *Investments* received reimbursements for some of the actual costs associated with the maintenance of the airplane. Overall, 56% and

→

77% of the airplane's total flight time during 1988 and 1989, respectively, was associated with providing management services: 11% of the airplane's total flight time for 1988 was for the benefit of Rich Ford Sales.

In contrast to his substantial business-related use, the taxpayer's actual use of the airplane was minor, and he paid for such use.

Accordingly, we reject the IRS' argument that the airplane was maintained primarily for the benefit of petitioner, and we hold that the airplane was owned and maintained primarily for the benefit of *Investments'* business activities.

"ALLOWABLE"...BECAUSE... "ORDINARY"

The IRS next argues that the airplane expenditures were not allowable because they were not ordinary and necessary. Each of the other entities was a substantial distance from Albuquerque, New Mexico. By maintaining an airplane, *Investments* could provide the other entities with management, accounting, and legal support within a short time period.

In addition, the airplane enabled *Investments'* employees to visit more than one of the other entities in a single day, and it allowed the employees to visit one of the other entities for part of the day and return to *Investments'* home office (in Albuquerque, NM) for the remainder of the day. Based on...(three factors)... we find that *Investments'* maintenance of an airplane was an ordinary expense (...).

THREE FACTORS

1. the location of the other entities,
2. the service provided to the other entities, and
3. *Investments'* conduct of a management consulting service

"ALLOWABLE"...BECAUSE... "NECESSARY"...TIME & COST SAVINGS

Next we must examine whether the expense of maintaining the plane was "necessary."

The airplane was used by *Investments* in the conduct of both Rich Ford Sales and in the provision of management services. Use of the airplane in either activity produced time and cost savings because it:

- Allowed *Investments'* employees to travel when necessary, not when commercial flights were available,
- Allowed *Investments'* employees to visit more than one location in a single day, which often could not be accomplished on a commercial schedule,
- Saved other travel expenses, as traveling in 1 day, instead of 2 or more days as would be required via commercial airlines, saved room and board expenditures,
- Allowed *Investments* to quickly respond to emergency situations arising in either the Rich Ford Sales business or in the management services activity.

Based on the foregoing facts and circumstances, the Tax Court held that the ownership and maintenance of the airplane were both appropriate and helpful to *Investments*; and accordingly, that the expenditures arising from the ownership and maintenance of the plane were necessary.

EXPENDITURES WERE NOT UNREASONABLE

The Court dealt last with the IRS argument that the airplane expenditures were unreasonable in amount compared to the objectives to be accomplished.

Although the total costs of owning, operating, and maintaining its airplane, exclusive of pilot salary, during 1988 and 1989 were $218,452 and $142,428, respectively, the Court found that the airplane was both an ordinary and necessary expense of the operation of *Investments'* Rich Ford Sales division and the operation of its management services activity. The latter activity alone generated sizable management fees ($814,452 and $970,997) for the same years. In addition, for those years *Investments* received reimbursements for airplane expenditures of $48,049 and $37,674.

The Court said... "Although the airplane expenditures were large for the taxable years at issue, use of the airplane was an ordinary and necessary part of *Investments'* businesses and generated substantial income during the years at issue. Accordingly, we find that the expenditures associated with owning and maintaining the airplane for the years at issue were reasonable."

(...) SEE TAX COURT MEMO 1996-368 FOR CASES & CITATIONS IN THE TAX COURT'S OPINION

PRODUCER OWNED REINSURANCE COMPANIES

PORCs

In last quarter's Update, I referred to the Dealer Offshore Reinsurance Company Conference held July 29-30 in Dallas offered by CreditRe Corporation. This 2-day Conference was excellent. The official title of the Conference was: "Tax Issues Affecting Producer Owned Reinsurance Companies and Vehicle Service Contracts." The extremely knowledgeable speakers, Mark Anderson and Regina Rose from KPMG Peat Marwick and Gary Fagg from CreditRe Corporation thoroughly covered all aspects of these subjects. The Conference Manual is voluminous and extremely thorough also. You can purchase last year's Manual/Compilation for a very reasonable price and thus obtain a comprehensive set of reference materials on these subjects.

Two unexpected "treats." First, was the opportunity to hear Mr. Robert Burns, President of Trans City Life Insurance Company describe, in detail, what it is like to be the CEO of a relatively small corporation undergoing a massive IRS examination and fighting it all the way through Tax Court...Truly Frightening!

Second, Robert Zwiers, the Motor Vehicle Industry Specialist, presented vehicle service contracts and PORC issues as the IRS sees them.

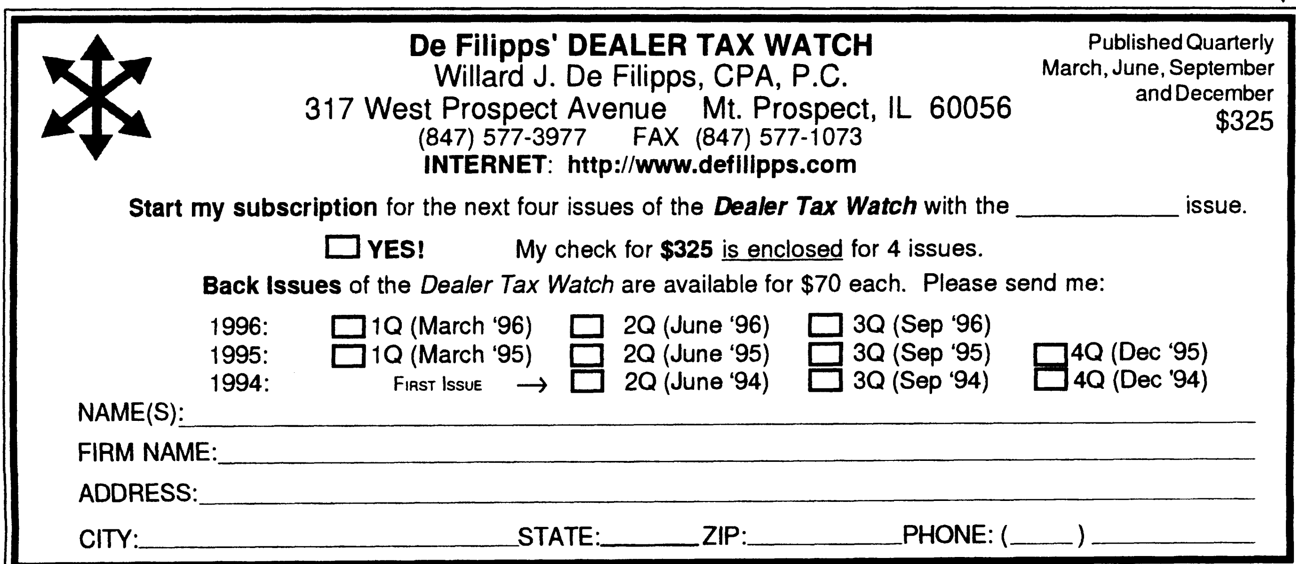
PORC ISSUES

1. Has the PORC actually been formed?
2. Are commissions reduced after the PORC has been formed?
   This is a major red flag and it gives the connotation of the shifting of income to someone else and that that income may never come back to the dealership.
3. Oversubmits.
4. Loans lacking proper documentation and/or performance.
5. "Touching the money,"...don't touch that money!
6. Investment in personal use assets such as condos, boats, etc.
7. Excise tax issues ... there may be some lurking in the background.
8. Insurance issues including (a) related party insurance income, (b) policy acquisition costs and (c) reserves and deferred income.

In discussing vehicle service contracts, Mr. Zwiers analyzed the decisions in *Hinshaw's, Inc. v. Commissioner, D.F.M. Investment Co. v. Commissioner* citing *Schulde, Hansen, and Basye*. In discussing producer owned reinsurance companies, the three cases Zwiers discussed were: "How to create a sham corporation ala *William T. Wright et. al. v. Commissioner*," "How to create a sham corporation ala *Malone & Hyde, Inc. & Subs. v. Commissioner*," and "How to interpret IRC Section 845(b) ala *Trans City Life Insurance Company v. Commissioner*." The holdings in the latter, *Trans City Life*, case were that (1) the IRS may apply Section 845(b) even though there are no written regulations interpreting that Code Section and (2) that the reinsurance agreements in question did have economic substance and they did not have a significant tax avoidance effect. The IRS decided not to appeal the *Trans City Life* decision.

Clearly, this is the best PORC to go with your *BEANS!*

I strongly recommend this Conference to anyone interested in, or involved with, VSCs or PORCs. ⁎



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ONE MAN'S GAME PLAN: A STUDY IN DEALER ENTITY STRUCTURING

PLAN AHEAD

The case of *E. W. Richardson* is interesting beyond the use of the airplane and LIFO computation questions that the Tax Court addressed...and even beyond the issues both sides conceded before going to trial.

If we look more deeply at the entire frame of reference for the litigation, we find E. W. Richardson's organizational setup or arrangement for his extensive activities in multiple corporations and other entities. Obviously, the ownership arrangements and separate corporate/entity selection evolved over time, taking into consideration Mr. Richardson's special needs and circumstances. In fact, several changes in shareholder percentages occurred over the 2-year period, and only the shareholder ownership percentages at year-end of 1989 are shown in the diagram. Mr. Richardson's overall structure is not shown here as something for you to copy. Rather, it illustrates one pattern against which you might consider comparing some of your own activities.

Mr. Richardson owned and operated several automobile dealerships and his investment company (an S Corporation) provided management consulting services to operating divisions and to many other controlled entities. These other entities included other dealerships and other incorporated activities selling credit life insurance, extended warranty service insurance, and other after sale products. The facts established before the Court and included in the Court's decision are very general as to the ownership of these entities. But, further analysis of the briefs filed with the Tax Court shows that some key employees and members of his family—including children—were shareholders in many of the other entities. See accompanying chart.

DIFFERENT ENTITIES, ACTIVITIES AND OWNERSHIP AMOUNTS

Obviously, where dealership activities are extensive, the use of multiple entities with different shareholder ownership percentages affords the opportunity for the dealer to legitimately shift income, future income, appreciation, etc. to other entities and to other shareholders.

Another significant element to notice in the "overall game plan" is the use of different stock ownership percentages in different entities by different selected key employees. For key employees, stock ownership in (selected) entities is a very good way of providing them with financial incentives and rewards for successful job performance. It is not uncommon for key employees in a management company or management entity to have an appropriate ownership stake in each of the dealerships or other entities supporting the dealerships. With different members of the management team, different ownership percentages may be appropriate and the opportunity to purchase additional shares from either the controlling shareholder/dealer...or from other employees...constitutes further incentive. All of this is an excellent way to reward and continue to develop business succession lines. It also fits well into the dealer's overall retirement and estate planning strategies. Different key employees, or employees who are "key" to different degrees in different stores or activities can be either rewarded or given incentive through either current or future stock ownership.

HOW ABOUT YOU?

1. Do you have a plan somewhat similar to this in terms of separating some activities from others, and having different ownership arrangements?
2. If you do, can or should it be carried further?
3. If you don't, why not?
4. Have you considered something more elaborate along the lines suggested by this?
5. What type of entities are involved: C Corps, S Corps, partnerships, LLCs or LLPs, etc.?
6. What are the ownership percentages? ...Should some consideration be given to shifting some ownership through gifts, sales, compensation incentives to key employees, or by other means?
7. For each separate entity, what are its prospects for growth? ...For stagnation?
8. For each entity, what are its prospects for short term and/or long term profit or loss?
9. What are each entity's prospects for either providing cash flow or draining away cash flow?
10. When was the last time you really reviewed your own "one of a kind" planning structure?

With different stockholder percentages in different entities, you always want to be sure that properly drawn and enforceable shareholder purchase agreements (i.e., buy-sell agreements) are in effect. In this regard Dave Duryee's words of wisdom on buy-sell agreements should not be forgotten:

Have one...	**Be sure it has been prepared by an experienced lawyer...**
Read it...	**Know where it is, and**
Understand every word...	**Review it every year.**

ONE MAN'S

E. W. RICHARDSON

STOCK OWNERSHIP AT THE END OF 1989

80% | 50% | 30% | 50% | 100% | SPECIAL TRUSTEE | 100%

AUTOMOBILE DEALERSHIPS

PIONEER
PHOENIX, AZ
R 80% | B.T. 20%

FIESTA LINCOLN
SAN ANTONIO, TX
R 50% | K.B. 25% | B.T. 25%

HERITAGE
KIRKLAND, WA
R 30% | K.B. 25% | W.Z. 20% | B.T. 25%

FIESTA DODGE
SAN ANTONIO, TX
R 50% | K.B. 25% | B.T. 25%

IMPORTS OF
ALBUQUERQUE
MAZDA - SUBARU
R 100%

SUNLAND FORD
APPLE VALLEY, CA
TRUSTEE
TRUST FBO
BARBARA HILL

INVESTMENTS, INC.
S Corp. Divisions
FORD SALES | LEASING & FLEET | R/E INVESTMENT PROPERTIES

50% | 50%

RANCH, PP
PARTNERSHIP

STOCK OWNERSHIP

R = E.W. RICHARDSON
R (C) = CHILDREN OF E. W. RICHARDSON
B. T. = KEY EMPLOYEE #1
K. B. = KEY EMPLOYEE #2
W.Z. = KEY EMPLOYEE #3
OTHERS...

GAME PLAN

STOCK OWNERSHIP AT THE END OF 1989

67% | 75% | 42% *25% Children | 49% | 51% | 15% *60% Children

SALES OF AFTERMARKET PRODUCTS AND FINANCIAL SERVICES

- **DEEP SEAL** — R 67% | B.T. 33%
  - PAINT SEALANT APPLIED TO NEW VEHICLES AT TIME OF SALE
- **HORIZON LIFE** — R 75% | B.T. 25%
  - CREDIT LIFE INSURANCE SALES
- **ARIZONA AFTERMARKET** — R 42% | R (C) 25% | B.T. 33% *
  - ACCESSORY PARTS FOR NEW VEHICLES AT TIME OF SALE
- **VALLEY FORD** — R 49% | OTHER 18% | B.T. 33%
  - ACCESSORY PARTS FOR NEW VEHICLES AT TIME OF SALE
- **THEFT SHIELD** — R 51% | B.T. 49%
  - ETCHING VIN #S ON WINDSHIELDS AT TIME OF SALE
- **WARRANTY PROTECTION CO.** — R 15% | R (C) 60% | B.T. 25% *
  - EXTENDED SERVICE WARRANTIES FOR NEW VEHICLES

CERTAIN USED CAR SALESPERSONS ARE NOT EMPLOYEES... THEY ARE INDEPENDENT CONTRACTORS *MARTIN L. SPRINGFIELD...D/B/A DOUGLAS MOTORS*

The March, 1995 *Dealer Tax Watch* analyzed a decision in the U.S. District Court, Southern District of California, in which the used car salespersons for an independent used car dealer (...*Martin L. Springfield...d/b/a Douglas Motors...*) were held to be employees—and not independent contractors. This decision was reversed by the Ninth Circuit Court of Appeals in a decision filed July 3, 1996 allowing the workers not to be treated as employees.

Our prior coverage in March, 1995 laid out the dealer's fact pattern, the worker classification dispute with the IRS, the issues and the District Court holdings and its analysis of Section 530 denying "safe harbor" relief. That coverage also included several analyses and practice guides related to worker classification, Section 530 safe harbor relief and Revenue Ruling 87-41. The prior articles are, as they say, "incorporated by reference" into our current analysis.

THE TWO ISSUES INVOLVED

FIRST: Was the IRS prevented or barred from making (pre-1988) assessments because of the statute of limitations? The taxpayer had filed Forms 1096 and 1099...and the IRS' contention and the District Court opinion was that the filing of Forms 1099 was not sufficient to start the statute of limitations where the proper forms that should have been filed were Forms 940 and 941. The Ninth Circuit agreed with the IRS and with the District Court on this issue.

SECOND: Was Martin L. Springfield entitled to the relief provided by Section 530 (of the Revenue Act of 1978)? If so, this would justify his treatment of his salespersons as independent contractors...and not as employees. On this issue, the Court of Appeals reversed the IRS and the District Court and concluded that pursuant to Section 530, Springfield was entitled to safe harbor treatment and his salesmen were not employees.

Most taxpayers will have great affection for the opening paragraph in Judge Hawkins' opinion:

> "When the government ignores a taxpayer's contentions as to the real world conditions of the marketplace, despite the requirements of Congress that it consider them, it invites the result reached here."

Although these remarks were made by the Court in the context of the *Martin L. Springfield* worker classification issue, see Update Comments 1 through 4 for some thoughts on their possible application elsewhere.

WHICH FORM STARTS THE STATUTE OF LIMITATIONS?

Section 6501(a) provides that any tax imposed by the Code shall be assessed within three years of the filing of the return. Mr. Springfield had contended that the IRS' pre-1988 assessments were untimely because they were made more than three years after he filed Forms 1099 for his salesmen, which he contended were "returns" within the meaning of Section 6501(a). The Government contended that the filing of Forms 1099 did not start the three years running because the "returns" Springfield was required to file were Forms 940 and 941.

The resolution of this issue is governed by the United States Supreme Court's holding in *Commissioner v. Lane-Wells Co.* In this case the Supreme Court held that a taxpayer does not start the statute of limitations running by filing one return when a different return is required if the return filed is insufficient to advise the Commissioner that any liability exists for the tax that should have been disclosed on the other return. The Supreme Court explained that the relevant inquiry is whether the return filed sets forth the facts establishing liability.

Ginter v. United States (W.D. Mo. 1993) also held that the statute of limitations did not run until the filing of Forms 940 and 941 even though the taxpayer classified the workers as independent contractors and filed Forms 1099.

Judge Hawkins in the Appeals Court observed that "Although the information provided on Form 1099 is similar to the information provided on Form 941, Form 1099 requests information about non-employee compensation while Form 941 requests information about employee compensation. Thus, an IRS official reviewing a Form 1099 is led to believe that the recipient is not an employee and has no way of knowing from the information provided that the taxpayer is liable for employment taxes for the individual named on the form."

→

He continued... "Assuming an individual should be treated as an employee, the filing of Form 1099 would not necessarily alert the IRS that the employer/ taxpayer is liable for additional taxes resulting from the individual's employment status. Thus, the filing of Form 1099 cannot start the statute of limitations running." Consequently, the District Court was correct in holding that, assuming Springfield's salesmen should be treated as employees, the pre-1988 assessments are not barred by the statute of limitations.

As an expression of sympathy...but in no way diluting its holding as to the 3 year statute of limitations, the Court stated that "While the rule set forth by the Supreme Court may be harsh in its applicability in at least some instances and while the result may be that individuals or corporations may never know with certainty that they are free from tax liability for periods long past, any charge in the rule must be made by Congress and not this court."

WORKERS WERE *NOT* EMPLOYEES... SECTION 530 RELIEF *WAS* AVAILABLE

The opening sentence in the portion of the Ninth Circuit's discussion of the Section 530 relief issue contains another gem: It states... "Through language that gives new definition to the word *arcane*, Section 530 provides that if... ." *ARCANE*...indeed; and laced with multiple negatives, too. See page 17 for a flowchart to guide you through Section 530 safe harbor relief.

Section 530 provides that if a taxpayer does not treat an individual as an employee for employment tax purposes for any period and files all of the required federal tax returns on a basis consistent with the taxpayer's treatment of the individual, that individual "shall be deemed not to be an employee unless the taxpayer had no reasonable basis for not treating such individual as an employee."

The real "heart of the matter" involved whether or not Martin Springfield had accomplished or satisfied his burden of showing "by a preponderance of the evidence" that he was entitled to Section 530 relief. The Appeals Court observed that the preponderance of the evidence standard applies because there is nothing in the language of Section 530 or its legislative history that suggests that Congress intended to reduce the taxpayer's *usual* burden of proof. Accordingly, a taxpayer's burden in Section 530 relief disputes with the IRS is greater than the taxpayer's "usual" burden of proof in other tax matters.

The Government had conceded that Springfield had met the first two requirements of Section 530: (1) The taxpayer had not treated the individual or any other individuals holding a substantially similar position as an employee during the period under examination or a prior period, and (2) All federal tax returns (including information returns, Form 1099) required to be filed for the period under examination with respect to those individuals had been filed on a basis consistent with treating them as not being employees.

Accordingly, having these two tests out of the way, the Ninth Circuit zeroed in on whether or not Springfield had basis for reasonable reliance on any one of the conditions (listed as numbers 3, 4, 5, 6, 7 or 8 in the "relief flowchart") on page 17, including:

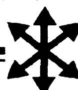
SAFE HARBORS

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

The Court observed that this is not a case where it was asked to review the trial court's interpretation of conflicting evidence. At oral argument, counsel for the United States did not dispute that the evidence established that...(1) at all relevant times (2) independent used car dealerships constituted a significant segment of the San Diego used car industry...and that (3) these dealerships generally treated their salesmen as independent contractors. Rather, it was the responsibility of the Appeals Court to review the District Court's conclusion that because the evidence *also* demonstrated that franchised dealerships that sell used cars treated their salesmen as employees, (therefore) the independent dealerships' practice of treating their salesmen as independent contractors could not logically constitute or be a 'long-standing...practice of a significant segment of (the used car) industry' under Section 530.

The Appeals Court observed that the plain language of Section 530 was unambiguous: A taxpayer need only prove that a *significant* segment of the industry follows a particular practice— not that *every* segment of the industry follows that practice. The Court supported its observation by emphasizing that the legislative history of Section 530 specifically provides that the practice in a given industry need not be uniform in order for a taxpayer to demonstrate that certain individuals should not be deemed employees.

see **CERTAIN USED CAR SALESPERSONS ARE INDEPENDENT CONTRACTORS,** page 16



WITNESS TESTIMONY AND EVIDENCE

At the trial in District Court, Mr. Springfield himself testified that the individual from whom he purchased Douglas Motors treated the salesmen as independent contractors and that he continued this practice after buying the business.

Mr. Springfield testified that he had the opportunity to talk to between 50 and 100 independent used car dealers who sold retail, and all of those dealers treated their salesmen as independent contractors.

Mr. Springfield also testified that he talked with a Mr. Hoffman, who owned a used car business and who said he used independent contractors from 1978 to 1988.

Springfield Witness #1: Had been a car salesman for forty years. He testified that he knew of other independent used car dealers whose salesmen were independent contractors.

Springfield Witness #2: Testified that prior to working for Springfield he worked at another place where they had independent contractor salesmen. This witness also testified that "unless there was a new car franchise, all the other guys that I knew that were doing what I did were independent contractors."

Springfield Witness #3: Testified that after working at Douglas Motors, he went to Valley Auto Sales, where he worked as an independent contractor. He also testified that, in all, he had worked as an independent contractor at four different places. When asked whether he knew of any other independent used car dealers who had salespeople who were independent contractors, he explained that the use of independent contractors was "widespread."

One of the IRS's witnesses testified that prior to opening his own dealership, he worked for franchise dealerships and was treated as an employee rather than as an independent contractor. Although he also testified that upon opening his own used car dealership in 1988 he treated his salesmen as employees, he did not testify as to the practice in the independent used car industry.

Another IRS witness simply testified that it was *his opinion* that a car salesman should be treated as an employee.

THE DISTRICT COURT'S DECISION

From the evidence and witness testimony, the District Court had concluded that the evidence demonstrated that Springfield was not entitled to Section 530 relief because he had failed to prove it was the long-standing, recognized practice of a significant segment of the used automobile sales industry in the metropolitan San Diego area to treat retail salesmen as independent contractors during the periods in issue. The District Court was persuaded that the evidence demonstrated that retail salespersons have, for the most part, traditionally been treated as employees in the San Diego metropolitan area. However, it did conclude that there was some contradictory practice in that community.

Said the District Court...Although the plaintiff presented evidence that some used car businesses treated salesmen as independent contractors, that evidence does not allow the plaintiff to qualify for the "industry practice" safe haven since Section 530 only protects individuals who follow the "long-standing practice of a significant segment of an industry."

Moreover...Where various segments of an industry are using contradictory practices, logic and the law dictates that there is no "long-standing recognized practice." Thus, in this case the fact that different members of the industry were treating salesmen differently mandates a finding that the "industry practice" safe haven relief of Section 530 is unavailable.

Finally, the District Court had concluded that Mr. Springfield failed to demonstrate he had a "reasonable basis" for treating the salespersons as independent contractors for federal employment tax purposes. Mr. Springfield had claimed that he had a reasonable basis for characterizing his salesmen as independent contractors because there was confusion regarding the characterization of such workers. However, misunderstanding or confusion about the law is not a defense for failing to properly characterize employees or pay employment taxes. It was also insufficient to qualify him for Section 530 relief given his testimony that he never consulted with attorneys, certified public accountants, representatives of the Internal Revenue Service, or of the Employment Development Department concerning the applicable standards and requirements with regard to the characterization of salespeople also makes his reasonableness argument difficult to accept. He relied simply on things he had heard from others in the business rather than making his own inquiry.

So the District Court ruled for the IRS, holding that the salespersons were employees.

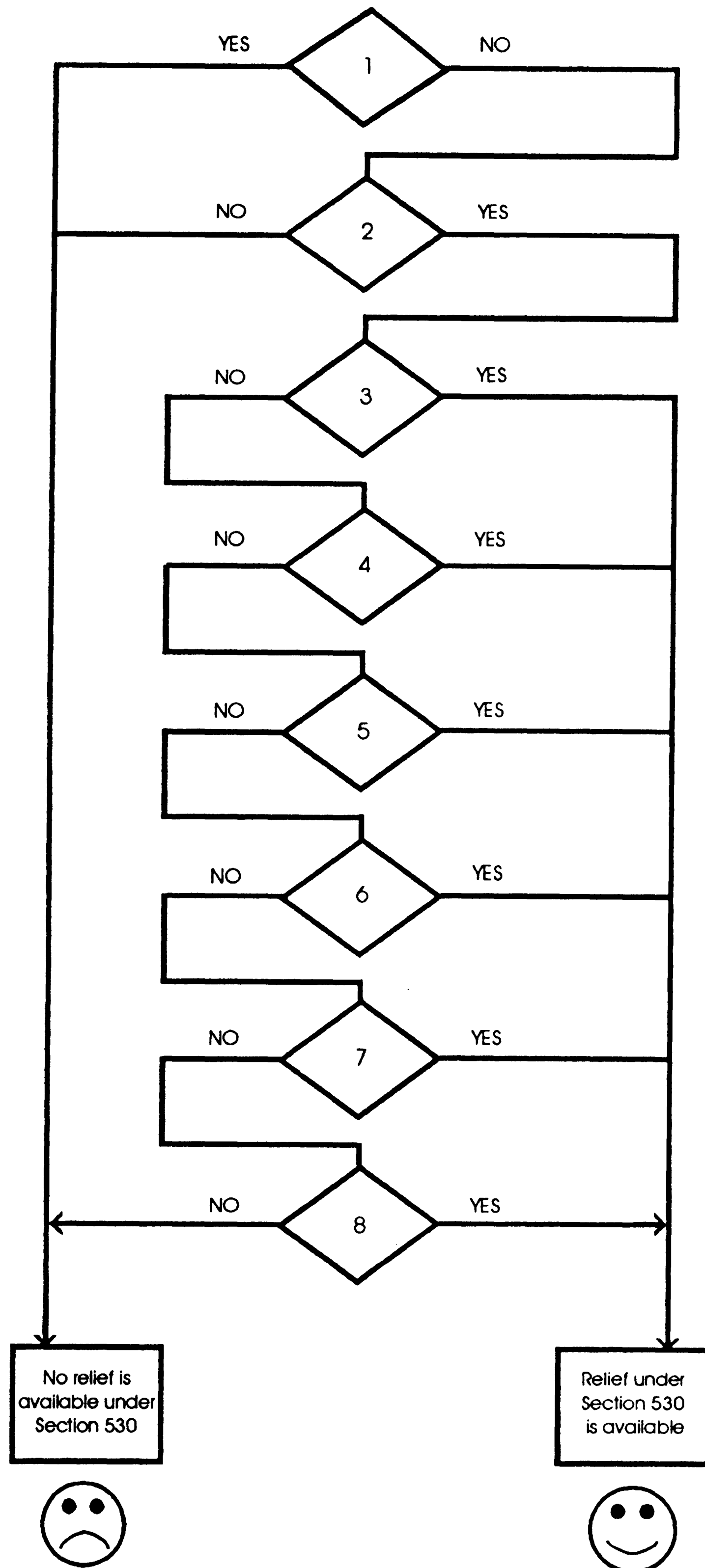
THE APPEALS COURT'S REVERSAL

The Court of Appeals observed that the government did nothing more than establish that another segment of the used car industry (i.e., franchise automobile dealerships) treated their salesmen as employees.

Springfield presented considerable ("an abundance of") evidence establishing that it was the practice of San Diego's independent used car deal-

see **CERTAIN USED CAR SALESPERSONS ARE INDEPENDENT CONTRACTORS,** page 28

Section 530 Safe Harbor Relief Flowchart *



Answer the 8 questions:

1. Has the taxpayer "treated" the individual or any other individual holding a substantially similar position as an employee during the period under examination or a prior period?

2. Were all Federal tax returns (including information returns, Form 1099) required to be filed for the period under examination by the taxpayer with respect to the individual filed on a basis consistent with treating the individual as not being an employee?

3. Is there a judicial precedent or published ruling under which the individual may reasonably be considered as not being an employee?

4. Has technical advice or other determination been issued with respect to the taxpayer indicating the individual (or a class of individuals) should not be treated as employees?

5. Does the taxpayer have a letter ruling indicating the individual (or a class of individuals) should not be treated as employees?

6. Was there a prior IRS examination for a period in which the taxpayer employed the individual (or the class of employees) in question and employment taxes were not an issue?

7. Is it a long standing recognized practice of a significant segment of the industry to treat such individuals as not being employees?

8. Did the taxpayer have any other reasonable basis for treating the individual as not being an employee?

* Source: Internal Revenue Manual

IRS USED CAR DEALERS AUDIT GUIDE

IRS GUIDE

One year ago, we reviewed a version dated April, 1995 of the *IRS/MSSP Manual or Audit Technique Guide for Independent Used Car Dealers*. That *Guide* was recently finalized as Training Document 3147-106, dated April, 1996. As revised, it contains an even greater store of information, reflecting many completely new or significantly expanded discussions, as well as some general fine tuning. In many instances, the additions to the 1995 version clearly signal those areas the IRS is now emphasizing in **both** new and used dealer audit situations.

MANUAL CHAPTERS	
1. Industry Background	5. Balance Sheet
2. Accounting Methods	6. Expense Issues
3. Gross Receipts	7. Required Filing Checks
4. Cost of Goods Sold/Inventory	8. Related Finance Companies (RFCs)

Significant new or expanded discussions have been added for inventory valuation, LIFO valuations, changes in accounting methods, credit life and disability insurance, warranty contracts, year-end writedowns, customer deposits, deferred income, related finance companies (RFCs), amortization of intangibles, corporate-owned life insurance (of the "split dollar" kind), rental expenses and many others. We have discussed many of these topics directly or indirectly in the *Dealer Tax Watch* over the last two years.

We will be pleased to provide any new subscriber with a copy of the September, 1995 review of the *IRS Used Car Dealers Audit Guide* so that this discussion of the finalized *Guide* can be read in the context of our prior review.

This IRS training guide cautions that "under no circumstances should the contents be used or cited as authority to setting or sustaining a technical position." The full text of this Training Guide is readily available under the Freedom of Information Act for a small charge from a variety of sources.

INDUSTRY BACKGROUND

This chapter consists of three sections: (1) a narrative overview of the industry, (2) general questions the agent should ask the taxpayer during the initial interview and (3) a dictionary of industry jargon. The general narrative is expanded (from the original) to explain that dealers recently have begun to establish separate related companies to sell service or warranty contracts at or close to the time of the sale of a vehicle. These service/warranty contracts are most often third-party contracts, with the dealer receiving a commission from the sale. There are several business reasons for establishing a separate company to sell the contracts. Liability can be isolated in a separate entity, ownership of the separate entity can be spread among key employees and/or family members, and any problems associated with the sale of these service or warranty contracts can be handled without jeopardizing the car sales business. Furthermore, there are no inherent prohibitions against using a separate company for this business ... and there are normally no significant additional costs other than the normal costs of creating a separate entity. (This is generally true of separate entities for other purposes, such as BHPHs and RFCs.)

The listing of "General Questions" includes a set of questions revolving around whether the dealer has a minimum deal gross profit percentage or dollar amount (such as a $100 minimum profit, etc. per car). Another question asks if the dealer has any dealer reserve accounts at a financial institution and references that question to the gross receipts section. In the Inventory related questions, the taxpayer is to be asked whether one official valuation guide is used <u>consistently</u> or whether more than one is consulted. Dealers are also to be asked to explain whether any vehicle is valued below cost and if so, how the asking price at any point in time differs from the value recorded on the books at year-end. This is intended to reinforce to the agent that the propriety of a write-down may be determined—or evaluated—by the actual sales price.

Dealers using LIFO for their used car vehicle inventory are to be asked: In determining the yearly LIFO index, what is the vehicle in ending inventory compared to in the ending inventory of the preceding year (that is, the taxpayer's own cost for the same type of vehicle or a "reconstructed" cost from an official valuation guide for the same type of vehicle at the beginning of the year)? ... and then: "Explain how these vehicles are comparable." This suggests the IRS' current thinking on, and broad inquiry for, used car LIFO.

The "industry jargon" guide includes the term "guide book" and references *NADA, Kelley* (now correctly spelled), *Black Book, Red Book, Gold Book,* and a host of other books, the popularity of which vary by region.

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ACCOUNTING METHODS

In observing that dealers may have more than one business operating at the same location, this chapter states: Provided various requirements are met, those other businesses may be eligible to use the cash method of accounting ... and this method may be acceptable as long as it clearly reflects the dealer's income from the business and conforms to the Regulations. The used car dealership activities and the other businesses should be on separate returns or Schedules C.

This chapter also contains a significantly expanded discussion of accounting methods and of procedures for changing accounting methods in accordance with Revenue Procedure 92-20. This section now includes discussions of Section 481(a) adjustments, Category A and B methods, 90-day windows for requesting changes during an audit and how the year of change is affected by whether the Section 481(a) adjustment is positive or negative. It also contains the statement that *consistent* treatment is established by: ...Using an *improper* method for two (2) or more tax years,...or Using a *proper* method for one (1) year.

GROSS RECEIPTS

The chapter on Gross Receipts includes a number of new discussions and observations on fee income, rebate income, warranty contracts, dealer financing and rate spreads.

The discussion on fee income includes the observation that many states have licensing requirements that make it illegal for some of the dealers to purchase a particular vehicle for a customer at auction and that dealers caught in such activities will not only lose auction privileges, but they may also have their dealer license revoked. Warning: This then triggers the non-deductibility aspect of expenses incurred in the conduct of illegal activities.

The discussion on credit life and disability insurance warns examining agents that although most states allow dealers to sell credit life insurance and earn commission income on each policy sold, some states—Michigan, for example—specifically prohibit car dealers and their employees from receiving any portion of the insurance premium attributable to the retail sale of a motor vehicle. Therefore, in such states, it is a common practice for the dealer to establish a "dealer-related" insurance agency with a family member as the officer and/or owner of the dealer-related agency. Michigan law is violated if it can be shown that the dealer controls or manages the insurance company. A very "Michigan-specific" discussion is included relative to what expenses auto dealerships may or may not deduct in the credit life insurance scenario.

The discussion of rebate income has been expanded to include reference to the Supreme Court decision in *Commissioner v. Hansen* in which the Court held that an amount retained as a finance company reserve was a sale of installment paper and the amount of the purchase price retained and reported as a liability to each dealer, in the dealer reserve account, must be accrued as income to the dealer since the dealer has a fixed right to such sums. In other words, for an accrual basis taxpayer it is the right to receive ... and not the actual receipt ... that determines the inclusion of the amount in gross income. Even though money is held back in a reserve account, the taxpayer has the right to receive it in the future. Agents are reminded to ask dealers to provide account statements showing the reserve account transactions, along with a listing of contracts financed and the amounts financed and withheld.

The discussion of warranty contracts has been clarified and expanded. When a used car dealer sells an extended service contract which is a contract between the customer and the dealer, the dealer may buy insurance covering the repair risk or remain "self-insured." If the dealer buys insurance, the income and expenses should be reported according to Revenue Procedure 92-97 and 92-98. If the dealer is "self-insured," with respect to these warranty contracts, then the sales price of the contract should be reported as income in the year the contract is sold and expenses should be deducted under Section 461(h).

TIDBIT in the discussion relating to State Departments of Transportation/Motor Vehicles: If the dealer is doing business in a state in which dealer plates are dependent on gross receipts, then the number of dealer plates issued by the state can give the IRS agent an idea of the overall range or reasonableness or correctness of the gross receipts amount reported in the tax return. The discussion on "repossessed vehicles," observes that where the dealer has substantial repos, state law should be reviewed because "if the repossessed car is sold with an overage (sales price exceeds the amount owed to the dealer), the overage may be required to be repaid to the owner of the vehicle ... and such requirements may vary from state to state and may be shown on the contract."

The long list of audit techniques for getting a handle on gross receipts is summarized on page 20.

see **IRS USED CAR DEALERS AUDIT GUIDE**, page 22

IS IT *ALL* THERE? ...WHERE? ...HOW CAN WE BE SURE?
TECHNIQUES TO SEE IF GROSS RECEIPTS ARE PROPERLY REPORTED

1. Pre-audit planning should include the following steps:
   A. **Look into the owner's/shareholder's standard of living prior to starting the audit. This may indicate he or she is living beyond the means shown on the return.**
   B. Analyze prior and subsequent return information as percentages of Gross Profit. Large changes in percentage of Gross Profit may indicate need for examination of a particular issue.
   C. Run a cash transaction record (Form 8300) check to determine if large amounts of cash are being received and/or deposited. This should be done before starting the examination.
   D. **Perform quick Cash-T on shareholder/owner based on return information.**
   E. Check with your state's corporate charter division for a listing of all corporations the owners are involved in as officers or directors.
2. Visit the business location, checking for additional income sources such as a body shop or garage for mechanical work, or other on site businesses such as related finance companies (RFCs).
3. Reconcile the gross receipts shown on the return with the amount per books.
4. Scan General Ledger for unusual entries such as:
   ...Debits to Sales ... Credits to Expense Accounts ... Cash Over/Under Accounts.
5. Carefully review internal controls, particularly for who receives cash, makes the deposits and records income. This is an important part of the **initial interview**.
6. If the dealership has poor internal controls or if there are indications of significant gross receipts, the use of indirect methods are appropriate. This holds true for all types of business entities.
7. If records are poor, ask for all of the dealsheets for the year and total them up. The total should be the sales for the year shown on the return. ...For medium and large dealers, test this for a month's sales prior to taking the time necessary to do this for the entire year.
8. Trace a few vehicles through the dealer's accounting system as they impact inventory, cost of sales, expenses and sales. This should be done for each category or type of sales transactions.
9. Determine if the dealer engages in bartering, and if so, how actions are handled on the books for income reporting purposes. This should be determined during the **initial interview**.
10. Determine if sales taxes and registration/licensing fees are included in income ...**initial interview**.
11. Determine if the dealer has received any prizes from auctions or other dealers ...**initial interview**.
12. A comparison of the financing file with the customer file is one way to verify the sales price and terms of the deal.
13. Determine whether the dealer is offering in-house financing and how these sales are recorded. There should be an accounts receivable set up to reflect the amount due and the full amount should be shown as a sale.
14. If in-house financing is provided ...Refer to the Related Finance Company section of this *Guide* and
    A. Sample financing agreements for proper income reporting of the sale.
    B. Determine whether interest and other customer charges are properly included as income.
15. Determine if the dealer has arrangements with insurance or finance companies to provide customer financing or credit life insurance for the dealer's customers.
    A. If so, how much commission or fee does the dealer receive from the insurance or finance company?
    B. Are the fees or commissions included in the dealer's income? If so, where are they included?
    C. Scan the cash receipts journal or ledger for recurring receipts from insurance and finance companies.
    D. Be aware of the proper timing for inclusion into income any amounts held as finance reserves.
16. Review statements for all checking, savings and other investment accounts for the period under examination, and for the period under audit. If necessary, obtain personal account info, as well as the business accounts.
17. Compare sample of entries in used car log to dealsheets; Assure all cars sold were included in gross receipts.
18. Review cash receipts journal for unusual and small recurring entries. Recurring entries may indicate the dealer is reporting income under the installment method or receiving commissions from insurance or finance companies. Such entries may also indicate the dealer is leasing vehicles.

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19. Review State Sales Tax returns to see if what is reported for sales tax is "in line with" what is on the income tax returns.
20. Ask to see all Forms 8300 filed—these may provide leads to additional audits. Do as part of the package audit.
21. Scan deposit slips for recurring deposits from individuals that may be on an installment sale plan or commissions from insurance and finance companies. Receipt of large amounts of cash from one individual may indicate an attempt to circumvent the large cash transaction reporting requirements by leasing out vehicles and then selling at the end of the lease for a minimal amount.
22. Trace auto jacket and dealsheets to accounts receivable and sales. If there are a large number of sales, use a sample to check the accounts receivable and sales.
23. Sample dealsheets for other sources of income such as fees, warranty plans, finance charges, etc.
24. Sample dealsheets for items such as boats, camper trailers, RVs, and snowmobiles that may have been taken as a trade-in. Look for personal use and eventual sales of these items. *(Yarbrough!)*
25. Review other documents in the car jacket and customer file for financing, warranty, agreements, service tickets, and other possible sources of income.
26. Obtain the number of title transfers from your state Dept. of Motor Vehicles to cross check records. Use this technique when there is evidence of unreported income. In most states, this info should be easy to obtain.
27. Determine whether the dealership is selling notes receivable to a related finance company (RFC). See Chapter 8 for details on transactions between the dealer and the related finance company.
28. Inquire about any previous state and local examinations the dealer may have had in the past, including Department of Motor Vehicle examinations of used car records.
29. Obtain a listing of title transfers from the State Department of Transportation/Motor Vehicles for a selected period of time (week or month). Use this to verify that these sales were recorded. Do this when records are incomplete or the examiner suspects unreported sales.
30. When there is a firm indication of unreported sales, consider issuing a summons—for records not provided by the taxpayer. Include bank records, invoices, purchase contracts, and other source documents from auto auctions.

... Note: See also "Income Recognition & Reporting Issues" (September, 1995 *DTW*, page 16).

LOANS TO ...AND.... FROM SHAREHOLDERS

Factors the courts consider in deciding whether withdrawals are constructive dividends or loans:
Most criteria also apply to evaluate whether advances from the shareholder to the corporation are loans (repayable, with interest) or contributions to capital.

CONSTRUCTIVE DIVIDENDS
CONTRIBUTIONS TO CAPITAL

1. The extent the shareholder controls the corporation.
2. The corporation's history of paying dividends.
3. The existence of earnings and profits. Note: The nonexistence of earnings or retained earnings determines whether withdrawals are dividends.
4. The magnitude of the advances and whether a ceiling existed to limit the amounts advanced to the shareholder(s).
5. How the parties record the advances/withdrawals on the books and records.
6. Whether the parties executed notes:
   - Are there written notes, maturity dates, interest charged?
   - Was security or collateral provided for the advances? If so, was it adequate?
7. Was there a fixed schedule of repayment?
8. Evidence of the shareholder's intent to repay the loan.
9. Are there regular payments made toward reducing the loan balance?
10. Was interest paid or accrued? If interest was charged, was it at the market rate?
11. The shareholder's position to repay the loan/advances.
12. Were the withdrawals or payments made in proportion to stock holdings?

 (Continued from page 19)

INVENTORY & COST OF GOODS SOLD

Lo and behold! Even remanufactured cores are discussed as a new area for auditors to check out to be sure that if the dealer has any (cores on hand at year-end), they should be inventoried.

More significantly, this chapter contains expanded discussions on year-end writedowns, culminating with the suggestion that auditors should review the sales of vehicles that have been written down that do not show unusually large profits.

A discussion on demonstrator vehicles has been added, even though demos may be less an issue for used car dealers than for new car dealers. This discussion indicates that demos are inventory, rather than depreciable assets. Also added are comments relative to a dealer who may be leasing vehicles, indicating that the leased vehicles are capital items subject to depreciation. Agents are warned that "dual purpose" property, that is, property offered for lease or for sale, is properly includable in inventory. Revenue Ruling 55-540 is cited as a reference for the tax treatment of leases of equipment.

Under "specific audit techniques" for inventory and cost of goods sold computations, the revised Guide has been expanded to indicate that if the lower of cost or market method is used, the agent should be satisfied as to whether the method used to determine inventory values is at the acceptable industry market values. The Manual acknowledges that an accepted industry guide book may be used in arriving at this valuation, listing two of the most common industry valuation guides as the *NADA Official Used Car Guide* and the *Kelley Blue Book*. However, the Manual points out that the agent should assure that the valuation guides are used properly and consistently. "The dealer should be using (the) same guide for valuing all inventory items, and not using a different guide for different cars because of a lower value shown in one guide for a certain car." Agents are reminded to "compare the subsequent sale of inventory items to the year-end inventory value. If the sales price is more than the inventory value, the writedown would appear to be improper. (Cost was lower than market.)"

BALANCE SHEET

The chapter on balance sheet-related audit reminds agents that with respect to accounts receivable, there should be none arising out of the installment sale method because Section 453 does not permit the deferral of income from an installment sale for a dealer who regularly sells or otherwise disposes of personal property.

With respect to other current liabilities, agents are advised that customer deposits may pose an income issue when they are associated with leasing. They may, in fact, be a disguised advance payment. The Manual observes that it is common for customers to make an up-front payment called a "capital cost reduction" to lower their monthly lease rate. The Supreme Court decision in *Indianapolis Power and Light* is mentioned as providing good insight into the difference between a deposit used as security collateral and an advance payment.

Finally, the accumulated earnings tax under Section 531 is further highlighted in the revised Guide through the inclusion of a reminder that if a dealership is financially successful, it may decide to retain earnings at the corporate level, after paying the corporate tax, as a means of avoiding individual income tax at the shareholder level.

EXPENSE ISSUES

This chapter contains a greatly expanded discussion relating to amortization deductions where a dealership has acquired another dealership. In addition to going into the different rules before and after August 10, 1993, because of the enactment of Section 197, agents are now warned to "be alert to the potential overvaluation of inventory and/or short-lived depreciable tangible assets in which taxpayers may seek an even shorter period to recover their investment." Reference is also made to the February 9, 1994 Service Settlement Initiative for most intangible issues pending in years not affected by new Code Section 197.

It is specifically stated that "the Service is not bound by prior accounting methods merely because the tax returns may have been examined and no deficiency was asserted" with respect to the write-off in prior years of various amounts allocated to acquired intangible assets. (Note: This is evident from the Tax Court Petition mentioned in Update Comment #6 on page 3 involving *Mealey-Serra Chevrolet, Inc.*)

Under the "Commissions and Fees" section, the statement is made that agents should determine whether an employer-employee relationship exists for any payments made to individuals that are not treated as wages. Commissions paid to salesmen (employees) are to be included on Forms W-2 along with their salaries. In this regard, see the discussions in this issue of the *DTW* of the *Martin L. Springfield* case, as reversed July, 1996 in the 9th Circuit Court of Appeals.

see **IRS USED CAR DEALERS AUDIT GUIDE**, page 24

YEAR-END USED CAR INVENTORIES | WRITEDOWNS & LIFO

WRITEDOWNS FOR USED VEHICLES

Year-end write-downs on used vehicles are allowable when certain requirements are met. Revenue Ruling 67-107 allows a car dealer to value used cars for inventory purposes at valuations comparable to those listed in an official used car guide adjusted to conform to the average wholesale price listed at that time. (See also *Brooks-Massey Dodge, Inc.*, 60 T.C. 884 (1973).) Although this is a practice recommended by the industry and used by nearly all car dealers, there are some additional requirements.

Reg. Section 1.446-l(a)(2) states in part that a method of accounting which reflects the **consistent** application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflecting income. Treas. Reg. Section 1.471-2(d) provides that the method must be applied with reasonable consistency to the entire inventory of the taxpayer's trade or business. According to the IRS, **there is a "lack of consistency" if more than one official valuation guide is used simultaneously.**

IRC Section 471 provides that inventories must conform as nearly as may be to the best accounting practice in the trade or business and must clearly reflect income. These regulations under IRC Section 471 prescribe two instances where inventory may be written down below cost to market. The first instance allows a taxpayer to write down purchased goods to replacement cost (Reg. Section 1.471-4(a)).

The second instance is described in Reg. Section 1.471- 4(b) which states in part that inventory may be valued at lower than replacement cost with correctness determined by actual sales for a reasonable period before and after the date of inventory. Prices which vary materially from the actual market prices during this period will not be accepted as reflecting market. (See also *Thor Power Tool Co. v. Commissioner*, 439, U.S. 522 (1979) and *Saul S. Pearl v. Commissioner*, T.C. Memo 1977-262.)

"Review the sales of vehicles that have been written down and not unusually large profits."

LIFO PROCEDURES FOR USED VEHICLES

The Inventory chapter also contains a new discussion stating that the Service holds that a taxpayer may use an official used car guide such as the *Kelley Blue Book* in determining its LIFO cost of trade-in vehicles. The taxpayer must make the determination of value at the time of trade-in and no future write-downs are permitted.

With respect to the taxpayer's LIFO index computation method, the Manual states that "the proper method for computing the (inflation) index for used vehicles is:

1. To use the taxpayer's own cost (actual for vehicles purchased and *Blue Book* value as of the trade-in date for vehicles obtained in a trade-in); and
2. To use the taxpayer's own cost (as described in #1) for the same type vehicle in the ending inventory of the preceding year, or, if there was no such vehicle in the ending inventory of the preceding year, use the "reconstruction" techniques contained in Reg. Section 1.472-8(e)(2)(iii) for items not in existence and items not stocked in the prior year—that is, the *Blue Book* value for the same type of vehicle at the beginning of the year.

Dealers using LIFO for their used car vehicle inventory are to be asked: In determining the yearly LIFO index, what is the vehicle in ending inventory compared to in the ending inventory of the preceding year (that is, the taxpayer's own cost for the same type of vehicle or a "reconstructed" cost from an official valuation guide for the same type of vehicle at the beginning of the year)? ... and then: "Explain how these vehicles are comparable." This suggests the IRS' current thinking on, and broad inquiry for, used car LIFO.

...PROBLEM AREAS: The IRS *Guide* explains: "As with any method, (unforseen) problems can and do arise... Included among these are program cars with a much higher value than 'book' and there is no requirement to increase trade-in value to equal 'book' value. In addition, the costs of improvements are expensed and there is difficulty with objectively defining a comparable vehicle. If you find a LIFO inventory case, request assistance from a resource person."

SOURCE: IRS/MSSP *Audit Guide for Independent Used Car Dealers.*

This chapter also contains new and/or expanded discussions relative to vehicle service contracts (extended service warranty), corporate-owned life insurance and rent expense where leases are "net leases."

Material added on Vehicle Service Contracts reminds agents that they may have to read the actual contracts to determine who is the obligor.

SPLIT DOLLAR CORPORATE OWNED LIFE INSURANCE

With respect to deductions related to corporate-owned life insurance—more particularly, interest expense related thereto—the Guide explains: "The emerging issue of 'leveraged corporate owned life insurance' has been identified. The issue has been found in both large corporate examinations and small corporations that employ the primary shareholders. The small corporation cases typically involve a life insurance product known as a 'split dollar' life insurance policy owned by the employer or a key person life insurance policy owned by the corporation.

"In the split dollar cases, the corporation may be claiming interest deductions on debt from the insurance company used to pay a premium to the insurance company. In reality, however, these interest payments may be more properly characterized as premium paid on behalf of the employer (...employee?...), thereby producing taxable income to the employee. See *Young v. Commissioner,* T.C. Memo. 1995-379. Any adjustments for this type of insurance would be a disallowance of interest deduction to the corporation and an increase of income to the shareholder(s). The interest paid on debt used to purchase key person insurance may be generated by the same 'loan premium' transaction that might also be non-deductible under a similar sham loan analysis.

"When examining the issue, it is necessary to determine the nature of all interest payments deducted on the return. If any interest is attributable to a loan from an insurance company, further inquiries should be made concerning the transaction to determine if the interest payment is actually a disguised insurance premium payment. If this type of issue is found or suspected, the examiner should contact the issue specialist for corporate owned life insurance ('COLI')."

RENT EXPENSE

Examining agents are cautioned about net leases which "may require the lessee to pay specified expenses of the lessor. Such leases, commonly referred to as 'net leases' or 'care-free leases,' may require the lessee to pay expenses including the lessor's real estate taxes or insurance premiums. Treas. Reg. Section 1.61-8(c) treats these payments as additional 'constructive' rent payments between the lessee and the lessor. Treas. Reg. Section 1.162-11(a) provides: 'Taxes paid by a tenant to or for a landlord for business property are additional *** income to the landlord, the amount of tax being deductible by the latter.' The same treatment is accorded insurance premiums and other deductible expenses of the landlord that are paid by the tenant. The treatment accorded the landlord depends on the landlord's method of accounting and whether the expenses are paid directly by the tenant/lessee or paid to the landlord/lessor.

"If the lessor is a related party owning more than 50 percent of the lessee by attribution, IRC Section 267(a)(2) must be considered. This section applies when the lessee is on the accrual basis and the lessor is on the cash basis of accounting. It requires a matching of income and expense, thus the lessor and the lessee are treated as if both are on the cash basis. In this case, no expense deduction in advance of payment, is allowable. IRC Section 267 overrides IRC Section 461. **Remember the expense is rent even though the lessee may deduct it as taxes, insurance, etc.**"

This raises an additional issue: Are real estate taxes accrued by a lessee relating to a "net lease" deductible?

REQUIRED FILING CHECKS

This chapter was titled "Package Audit Requirements" in the earlier version. It included substantial discussions relative to checking up on cash reporting using Forms 8300 and employee/independent contractor issues. The latter discussion on worker classification is substantially expanded in the April, 1996 revision. For a more thorough discussion, see *Martin L. Springfield,* recently reversed in favor of the taxpayer.

RELATED FINANCE COMPANIES (RFCs)...

See pages 25-27 for additional materials.

RELATED FINANCE COMPANIES

This chapter is significantly different from the chapter in the 1995 version in which considerable attention was focused on a RFC scheme promoted in the Jacksonville District. The prior version of the *Guide* contained exhibits and sample/proforma IRS reports and schedules to combat this ploy. The April, 1996 version of the *Guide* simply provides an overview of RFCs so agents can contact the district ISP for further guidance.

The original version had stated that the related finance company issue does not appear to apply to all "buy here, pay here" plans if the dealer discounts its receivables to its related finance company for (1) legitimate business reasons, (2) at their fair market value, and (3) perfected the form of the transactions including title transfer, legal incorporation under the State law by the RFC, etc. If these three conditions are satisfied, it would appear the IRS would not have a strong incentive to challenge the dealer's discount transactions.

7 GOOD BUSINESS AND ECONOMIC REASONS TO SET UP RFCs

1. PROVIDING CREDIT TO ENABLE THE CUSTOMER TO BUY A CAR.

Many marginal credit purchasers who resort to BHPH do so because of their inability to get credit elsewhere. The RFC serves a useful purpose in providing credit to individuals with little, no, or bad credit. A properly operating RFC focuses the collection function outside of the dealership itself, relieving sales personnel from this time consuming task. Payment schedules are generally on a weekly basis.

2. IMPROVING THE COLLECTION OF ACCOUNTS RECEIVABLE.

RFCs usually require the borrower/buyer to remit payments to a third party, even though the third party is related to the dealer. Industry experience is that when payment is made directly to the dealer, a bad experience with the car often leads to a default on the note for the car. (I.E., payments usually continue only as long as the car keeps running.) This, in turn, creates a collection problem, and possibly adverse publicity for the dealership.

If a RFC is involved, the customer may be less likely to default. Given the general credit worthiness of the customers, this is significant. Some dealers, through effective management and controls, have RFC discount rates lower than what they can obtain from third parties and still make a profit on their RFC financing operations.

3. AVOIDING LICENSING AND OTHER REGULATORY REQUIREMENTS ON THE DEALER ENTITY.

Many states have licensing requirements for finance companies. Establishing a RFC permits the dealer to isolate liability for violation of any requirements in a separate entity, without jeopardizing the status of the dealership. In addition, some states have capital requirements for finance companies that may interfere with the normal operations of a dealership.

4. PREVENTING ADVERSE PUBLICITY ON REPOSSESSIONS AND OTHER COLLECTION ACTIONS.

Repossession and collection problems are not unusual for BHPH dealers. Creation of a RFC permits an entity other than the dealership to undertake these actions and insulate the dealer from any adverse publicity. Even in states requiring greater disclosure, the resulting publicity is comparably less adverse when an RFC is used.

5. INSULATING THE DEALERSHIP FROM THE FINANCIAL RISK OF DEFAULT ON THE NOTES.

The industry deals with a customer base that generally has poor or non-existent credit. The default rate on BHPH notes is substantially higher than on general bank loans. This economic fact is recognized both by the interest rates charged by the dealer or finance company and the reserves that independent finance companies generally maintain. A separate RFC removes the financial risk from the dealership entity.

6. DIVERSIFICATION OF OWNERSHIP.

Since the financing of used cars is not inherently part of a dealership's operation, a separate RFC permits the dealer to provide ownership in that specific business to both family and non-family members without diluting the existing ownership in the dealership. This allows the dealer to separate the two businesses and reward certain employees or other individuals with an ownership interest in a segment of the business.

7. FLEXIBILITY TO EXPAND RFC TO *ALSO* FINANCE UNRELATED RECEIVABLES.

A good reason, but not frequently used.

TAX ISSUES CREATED BY RFCs

RFCs

The economic substance of the discounting transactions usually presents the most critical tax issues. The sale of receivables must have economic substance to be recognized for tax purposes ... valid business reasons alone are not sufficient. Determining the fair market value (FMV) of a receivable ... or a group of receivables ... is not an exact science. The FMV will depend on a number of subjective factors, listed below, and the facts and circumstances underlying each receivable will determine the importance of each factor.

1. Credit history ...Terrible...Bad...Marginal...No prior history...Other,
2. History of payments on the note ...Regular...Sporadic or inconsistent,
3. Amount of time remaining until the note is fully paid off, and
4. Age and condition of the vehicle collateralizing the note.

DISCOUNTS: HOW BIG? The industry's position is that a deep discount is warranted in nearly all transfers of receivables. Reviews of some third-party finance company documents indicate that these companies can offer to acquire receivables from dealers at up to a 50% (up-front) discount. These discounts apply whether or not the finance company buys in bulk or "cherry picks" the best receivables for purchase. Will the IRS agree?

The IRS has ruled, in specific situations, that a related finance entity can be used by a dealer to discount its receivables and to have the transaction accepted for tax purposes.

LTR 9534023

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

Typically, where the RFC is set up as a corporation, that corporation usually makes an S election to avoid double taxation and other tax problems and to provide greater all-around flexibility.

IRS CONCERNS AND ISSUES

- The discounting transactions must have economic substance, considering all relevant facts and circumstances. The primary reasons for selling receivables are to obtain cash (i.e., improve cash flow) or to shift risk. If both are absent, that suggests the "sale" transaction lacks economic substance.
- The form of the transactions and the form of the related finance entity must be perfected.
- The receivables must be sold for fair market value. The seller and the purchaser must base the discount on some reasonable, objective factors—not on an arbitrary determination of the discount rate.
- Whether there has been a change in method of accounting where a RFC is used to defer income.
- Whether the loss incurred by the dealership from the purported sale of notes receivable to the RFC should be disallowed because the RFC existed only in form and the transaction between the dealer and the RFC lacks economic substance.
- Whether Section 482 (reallocation of income) applies to the loss claimed by the dealer on the sale of notes receivable to the RFC because the notes were sold for less than their fair market value.
- Whether Section 267 disallows the loss from the sale of notes receivable by the dealer to the RFC.
- Whether the dealer and the RFC are members of a controlled group for the purposes of Section 267, and thereby eligible for the special loss recognition rules of Reg. Section 1.267(f)-1T(e) ... and 1.267(f)-1(f) which provide that ... If S has income or gain from a receivable acquired as a result of selling goods or services to a nonmember, and S sells the receivable at fair market value to B, any loss or deduction of S from its sale to B is not deferred under this section to the extent it does not exceed S's income or gain from the sale to the nonmember.

CHECKLIST OF SUBSTANCE vs. FORM FACTORS RELATED FINANCE COMPANIES THE "VALIDITY" ASPECT OF RFCs

PRACTICE GUIDE

	YES	NO
1. Is the RFC a separate legal entity?		
2. Does the RFC meet all licensing requirements of the jurisdiction(s) in which it operates?		
3. Is the RFC adequately capitalized in order to pay for the contracts?		
4. Does the RFC have its own employees?		
5. Does the RFC compensate its own employees directly? Note: The fact that the RFC and the related dealership or other related entities may elect to use a common paymaster does not indicate, in any way, that the RFC does not have its own employees.		
6. Has the RFC obtained and maintained all appropriate local business and similar licenses?		
7. Does the RFC have a separate telephone number?		
8. Does the RFC have a separate business address (which may be a Post Office Box)? Note: Even if a separate business address is maintained, it is common for the RFC to have an office at the dealership.		
9. Does the RFC maintain a separate set of books and records?		
10. Has the RFC complied with all title, lien and recordation rules in the jurisdiction(s) in which it operates?		
11. Does the RFC make it a practice to notify customers of the purchase of their notes?		
12. Does the contract between the RFC and the dealership for the purchase of the receivables:		
• Comply with the appropriate state law?		
• Provide evidence of ...or show... how the fair market value (FMV) of the receivables was determined?		
13. Is the RFC operated in a businesslike manner?		
14. Is the RFC the entity making any necessary vehicle repossessions? Note: Often this repossession activity is subcontracted out by the RFC.		
15. Does the RFC pay the dealership for the receivables at the time of purchase? Note: The RFC can generate the cash to make the payment from any combination of capitalization of the RFC, bank and/or third party borrowings or borrowings from related entities or shareholders. However, borrowings from related entities or shareholders can diminish the validity of this factor.		
16. Other(s) ____________		
____________		

ADDITIONAL COMMENTS & EXPLANATIONS

____

____

The purpose of the RFC is to protect the dealership by isolating liability or to segregate transactions in a separate entity. As more of the factors listed above are satisfied, the case for the separate validity of the RFC becomes stronger... See Letter Ruling 9534023 (discussed in the September, 1995 *DTW*) for more specifics on the operational setup of that related finance entity, which happened to be a partnership.

SOURCE: IRS/MSSP *Audit Guide for Independent Used Car Dealers.*

 (Continued from page 14)

ers at all relevant times to treat their employees as independent contractors, and the government had failed to rebut this evidence.

The Appeals Court concluded that Springfield had put on substantial proof that a significant segment of the used car industry treated its salesmen as independent contractors, thus demonstrating a reasonable basis for treating his salesmen as such. It stated that the Government had put on evidence of the practices of a *different* portion of the industry, but that the Government had not put on anything to contradict Springfield's evidence of the practices followed by independent used car dealers.

Consequently, pursuant to Section 530, Springfield was deemed to be entitled to safe harbor treatment and his salesmen should be deemed to be independent contractors.

ASK THE IRS ??

Recall that, in upholding the IRS, the District Court had emphasized the fact the taxpayer failed to demonstrate that it had a "reasonable basis" for treating salespersons as independent contractors. The District Court stated that "misunderstanding or confusion about the law is not a defense for failing to properly characterize employees or pay employment taxes." It further observed that Mr. Springfield had testified that he had never consulted with attorneys, CPAs, representatives of the IRS or the Employment Development Department (EDD) concerning the applicable standards and requirements. The District Court stated that Mr. Springfield "simply" relied on things he had heard from others, rather than making his own inquiry."

Was the District Court's inference that a taxpayer should always consult with CPAs, lawyers, the IRS, etc.? Mr. Springfield seems like many other auto dealers: competent to make many investigations on his own behalf, sometimes more thoroughly and more cost effectively than their paid representatives.

As far as relying on information provided by "representatives of the IRS" as to how Mr. Springfield should have handled his debatable tax question...Perish the thought! Every reader can recall his or her own experiences where information provided by "representatives of the IRS" was simply shortsighted, short-circuited or based upon how the IRS *preferred* something, rather than how it *might* be done. And case law is replete with examples of the IRS disavowing and backing away from incorrect or erroneous advice supplied by its own agents and employees.

CONCLUSION

The good news, then, for Mr. Springfield and possibly for many others similarly situated in the San Diego area was that his salespersons were independent contractors and that he was not liable for the employment/FICA taxes and income tax withholding on their compensation. You too can be a winner...if your facts fit and you are willing (and financially able) to fight the IRS all the way through "the system". ✱

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