De Filipps' DEALER TAX WATCH

A Quarterly Update of Essential Tax Information

Volume 4, Number 1 | Publisher: Willard J. De Filipps, C.P.A. | June 1997

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 ... HOT & EMERGING ISSUES. There are lots of new and interesting things to report, but still nothing specific on our three "hottest" topics: **Demonstrators** (how far does the salesman's exemption extend and how should income from demo use be computed?), **Factory incentive payments** (who pays the "employer's portion" of the FICA taxes?) and **LIFO conformity** for dealership financial statements (what is allowable and what is not, and what if "it" wasn't done "right" in the past?).

One reader recently said his experience in the Chicago area is that the IRS policy on demos is to treat 80% of any computed demo expense as personal and to treat 20% as business-related and deductible ... and often that's a bargain. Also, F & I managers are not being considered as salespersons eligible for the $3-a-day special rule.

As to dealer financial statement LIFO conformity, based on another recent meeting with the IRS, Peter Kitzmiller of NADA said he is hopeful that the IRS may issue something by the end of the summer ... or at least before the AICPA Auto Dealership Conference in late October. Only time will tell.

#2. CURRENT CONFUSION RE: CONFORMITY. Lately, some dealers have come back from 20 Group meetings with bogus or vague notions about the release of a conformity document by the IRS. Many CPAs have also called under similar spells. *Wards Dealer Business* may have contributed to this confusion by recently reporting that "at last, according to the IRS' chief officer on auto dealer tax matters, a policy for determination of LIFO conformity issues is near the publication point." This could have been said a year ago, ...just before the only person who could have engineered a resolution left the IRS and the whole thing fell into its current catatonic state ... and it would have been accurate then, too.

WATCHING OUT FOR

Quite possibly, the confusion has been generated by the release of Revenue Procedure 97-27 which revises some of the terms and conditions involved in changing accounting methods. These procedural changes affect all requests for permission to change methods. While this includes LIFO methods, it has absolutely nothing to do with dealer "conformity" issues (which involve LIFO eligibility requirements).

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So don't be confused: There is still nothing "official" out at this time on dealer conformity. And when it comes out, it will assail us in the form of a Revenue Procedure and/or as a Revenue Ruling - or both - issued by the IRS National Office. It will not come out as a position paper issued by IRS' Motor Vehicle Industry Group in Grand Rapids. Anything less will be a mess, and let's hope that what's issued by National ... will be rational.

#3. IRS EASES RULES FOR CHANGING ACCOUNTING METHODS. Revenue Procedure 97-27 issued in May simplifies many rules, terms and conditions involved when taxpayers have to request IRS permission to change accounting methods ... including LIFO accounting methods. The IRS has dropped the requirement that the Form 3115 request must be filed within the first 180 days of the year of change. Also, several difficult technical definitions have been eliminated along with the 90-day window for filing 3115s by taxpayers coming under IRS audit. The now-familiar 6-year spread period for reporting positive Section 481(a) adjustments in income has been shortened to four (4) years. These changes and other details are discussed thoroughly in the June 1997 issue of the *LIFO Lookout.*

#4. USED CAR LIFO AUDITS. We have received several calls indicating that some IRS agents are looking into the specifics of used car LIFO computations. At the present time, the IRS has issued nothing "official" on how used vehicle LIFO computations should be made. No one (except the IRS ...or the Tax Court) can say for sure what the IRS will accept.

CPAs should emphasize to their dealer clients that the Alternative LIFO Method for new vehicles in Revenue Procedure 92-79 does not apply to used vehicles.

#5. THE *STRONG* CASE SHOWS JUST HOW HUNGRY THE IRS CAN BE FOR MEAL EXPENSE SUBSTANTIATION. Like spoiled meat, a business manager's "meal and entertainment" diary didn't pass the IRS smell test. Mind you, this case just came out of the Tax Court ... 10 years after the taxable year - 1987 - in which an F & I manager attempted to claim $50,000 as deductible meal and entertainment expenses in his personal return on Form 2106. Five years later (1992) the case actually went to trial. And now (1997), another five years later, the Tax Court threw out every single penny claimed in the salesman's diary that, among other things, purported to document meals eaten in a restaurant over a year before it ever opened and where the restaurant meal receipts would remind you of a Damon Runyon story about betting tickets

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picked up off the race track floor after the races had been run.

Not only were receipt serial numbers and other similarities put under the inspector's microscope, but many of the taxpayer's meal companions were called to the stand to testify in a trial 5 years after the fact. Often, they couldn't remember either the restaurants or the other diners with whom they supposedly shared that (partially) tax-deductible meal 5 years earlier.

The *Raymond Strong* case (T.C. Memo 1997-105) presents almost a humorous contrast to some of the other cases recently making their way through the Courts. But it does stand *strongly* for this simple proposition: Unless a taxpayer can satisfy the demanding substantiation requirements of Section 274, the IRS will not allow ersatz diaries and claims ... and the Courts are specifically prohibited from applying the *Cohan* approximation rule that might give more credible taxpayers at least some benefit of the doubt under other circumstances.

Fat-free diaries and artificially sweetened receipts will be returned to the kitchen for the real thing.

#6. DEALER'S ARABIAN SHOW HORSES ... A *NO SHOW* IN TAX COURT. We recently mentioned a petition in the Tax Court in which the IRS was disputing what it thought was some horsing around going on with Arabian show horses in a dealership's "Equine Assets" department. Some aggressive tax planners were chomping at the bit after reading about this.

The IRS had ignored the sale transaction which the CPA had suggested and charged the dealer with a constructive dividend to the extent of the "horse" expenses paid. Obviously, the dealer didn't want to "pony up" the tax! We all know how exciting a photo finish can be. Whoa ... boy! ... that won't happen here. The taxpayer and the IRS agreed by stipulation in Docket No. 19447-96 to settle the case with only nominal adjustments to the taxpayers for the years in question. Can it be said that the dealer bet on a long shot and won?

#7. EFTPS ELECTRONIC FILING UPDATE: PENALTIES POSTPONED 'TILL JANUARY 1. The May 1, 1997 enrollment deadline has come and gone for all "mandated taxpayers" required to enroll to cease non-electronic/paper payments after July 1. With some second thoughts on how "smoothly" things might go ...not to mention the unpleasant idea of Congress' looking over its shoulder and anxious to avoid unfavorable publicity... the IRS said that it will not impose penalties right away on taxpayers who enroll

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and attempt to make electronic deposits by computer or telephone.

Wait-till-the-last-minute habits and concern over what might happen when more taxpayers actually start using the new procedures have resulted in a temporary moratorium on penalties. Nevertheless, taxpayers still may have to cope with attempts to track down errant payments that have "electronically" gone astray.

Friendly advice: Enroll sooner - rather than later - if you haven't already. Get used to making deposits electronically well in advance of the December 31, 1997 penalty-free deadline. Relax ... a bit... there's still time to figure out the difference between the debit and the credit option ... or to hire a "kid" who's not afraid of making e-payments to do it for you.

P.S. On page 27 of the March 1997 *DTW*, we suggested that you select the debit method.

#8. COMPENSATION (REASONABLE OR NOT?) FOR A DEALER ABOUT TO BUY OUT. *Twin City Dodge-Chrysler, Inc.* provides an example of how not to do things in a hurry just before a buy-out. In this case, the dealership tried to justify a last minute bonus to the dealer as reasonable compensation for his being undercompensated in prior years. The IRS didn't think so, neither did the Court ... and for whatever reason, the dealer didn't present any defense for his position! The IRS and the Court had no trouble in putting "two and two together" using the *step transaction doctrine* to disallow the entire compensation deduction. See page 4.

#9. MORE ON FORM 709 DISCOUNTS FOR GIFTS OF DEALERSHIP STOCK. Recently issued Letter Ruling 9718004 gives us the opportunity to look at some of the intricacies involved with the interplay between present gifts and later gift and estate tax computations and consequences.

In the March 1997 *Dealer Tax Watch*, we pointed out the higher profile disclosure rules for gift tax returns reporting gifts of dealership stock reduced by lack of marketability and minority interest discounts. We also observed: Valuation discounts - where appropriate - are as good as a repeal of the estate tax! Think about that!

In Letter Ruling 9718004, the IRS held that a taxpayer could, by timely filing an amended return or claim for refund, go back and adjust (i.e., lower) the value of prior gifts where discounts had not been claimed in connection with valuing property given away to family members. Discussion of this letter ruling explores the workings of Section 2504(c) which permits such revaluations in connection with subsequent **gifting** activity ... and - depending on which court you're in - may or may not permit similar revaluations in connection with the computation of the subsequent **estate** tax liability for the donor. For more, see page 11.

#10. IRS AUDIT ALPHABET: BHPH, RFCs & VSCs. The IRS' strong interest in the activities of used car dealers, Buy-Here, Pay-Here (BHPH) operations and Related Finance Companies (RFCs) comes through in another recent letter ruling. This one held that the real business of a buy-here, pay-here operation was that of being an automobile dealer ... and not a securities dealer. The dealership had claimed it was just breaking even selling used cars as a loss leader for *its real business* which was financing customers' paper. Letter Ruling 9723004 is discussed on page 18, as is the context in which it suggests far more "beneath the surface."

In another recent Tax Court decision involving RFCs, *Cordes Finance Corp.* (T.C. Memo 1997-162), the IRS was upheld in throwing out the "method of accounting" for interest income that a dealer's finance company had been using since 1964. Prior to the IRS audit, the deferred interest income account had not been reconciled with the customer ledger cards for about 20 years. Was it coincidence that *Cordes* was issued on April Fools Day? There are at least two lessons in this case on page 22.

As to VSCs (Vehicle Service Contracts), the IRS recently was successful in requiring a dealer to report all of his warranty/service contract income up front. In *Johnson et. al. v. Comm.* (108 T.C. No. 22, filed June 16, 1997), the IRS and the Tax Court adjusted vehicle service contract income in the years 1989 through 1992 by a Section 481(a) adjustment which required the dealership(s) to include in income currently the entire amount of the contract price deposited in escrow. We plan to analyze this pre-*SWIM* accounting method case in an upcoming issue of the *DTW*.

#11. FOOD FOR THOUGHT: SHOULD A DEALER EVEN BOTHER WITH AN RFC?

$2,000,000 DE MINIMIS? One CPA recently suggested his rule of thumb: Unless a used car dealer has at least $2 million in Buy-Here, Pay-Here type receivables, setting up a related finance company may not really be worth the effort. For more, see page 21.

BIG *"BONUS"* JUST BEFORE BUY-OUT WASN'T *"REASONABLE"*... HOW (NOT) TO DO IT

Somehow or other, the idea of paying out a third of a dealership's retained earnings the day before a buy-out and treating that payment as deductible (reasonable) compensation just didn't seem reasonable to the IRS ... even though the amount was relatively small. In a case decided in May, 1997, Twin City Dodge-Chrysler, Inc., was not able to convince the U.S. District Court (for the Western District of Michigan, Case #2:95-CV-317) that a $210,000 payment made right before a buy-out was reasonable compensation to the dealer for services in prior years.

The dealer had worked long hours (55 to 65 hours a week) but only paid himself a "meager salary in order to keep as much capital in the business as possible." This had been going on since 1981 when he became the sole shareholder, Chief Executive Officer, President and sole director of the dealership. In 1987, three employees approached him about buying the dealership, and he agreed to sell it to them ...but not until the net worth of the company increased from $500,000 to $750,000.

An option to purchase was signed in January, 1990 giving the three individuals the right to purchase all the dealership stock for $500,000, and the parties verbally agreed that the option could not be exercised until the net worth reached somewhere between $700,000 and $750,000. The dealer testified that they knew that $500,000 was the net worth, but "the hinge on the whole situation was the net worth in two years - basically January 1, 1992 - because I knew I needed at least $200,000 more so that I could maintain my lifestyle for the rest of my life because this was my *investment*."

"DIRECTOR'S FEE" VS. "BONUS" VS. DEFERRED COMP

On January 1, 1992 the dealership Board of Directors authorized a payment of $210,000 to the dealer as a *director's fee* "for his years of diligent and loyal service to the corporation." The next day, the purchasers and the dealer signed a contract of sale which stated that ... "if the total net worth exceeds $500,000, then the excess shall be converted to cash and distributed to the Seller in the following manner:

(A) $25,000 to be paid as a dividend prior to or at closing;

(B) the remaining amount to be paid as a *bonus*, one half at the time of closing and the other half 180 days later."

The Dealer Net Worth Statement as of January 1, 1992 showed net worth of $735,059. The bonus paid to the dealer was computed as $735,059 minus $500,000 (the stock price) and minus the $25,000 dividend. When the dealership filed its income tax return for its fiscal year ended April 30, 1992, it deducted the $210,059 paid to the dealer as *salary*. However, it had reported that payment on a Form 1099-MISC rather than on a Form W-2. Therefore, the dealership did not withhold FICA or income taxes on the payment, and that payment was not included on the annual and quarterly payroll tax returns Forms 940 and 941.

The corporate income tax return claimed a deduction for the $210,059 as salary ... but it did not show that payment to the dealer in Schedule E Officers Compensation because the seller was no longer an officer on the last day of the taxable year. The dealership conceded that the $210,059 "director's fee" was mistakenly reported on Form 1099-MISC rather than on Form W-2. The dealership "speculated" that this mistake - as well as the failure to pay payroll taxes on that amount - may have been due to the fact that the person responsible for proper treatment was receiving chemotherapy treatments for cancer and died shortly thereafter.

INCONSISTENCIES

These facts contain many inconsistencies and warrant further discussion. When the dealer's deposition was taken, he had indicated that he needed at least $200,000 more so that he could maintain his lifestyle for the rest of his life because "this was my *investment*." The dealer indicated in an affidavit after his deposition that he had used the word "investment" to refer to the thousands of hours of service he gave to the dealership for which he was **not** compensated from 1977 until 1992. Although that might have been the basis for introducing considerable supporting detail and documentation, no such evidence or information was ever introduced.

Another inconsistency related to the different references to the same payment. Was is a director's fee, a bonus or deferred compensation? The inconsistent treatment of the same payment on various tax reporting forms is also evident: The payment was treated differently on the corporation's federal income tax return, its quarterly and annual payroll tax forms and the information reporting forms (Form 1099-MISC). Furthermore, the tax return classifica-

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tion of the payment was inconsistent with the filing of a Form 1099-MISC, since payments reported on a Form 1099-MISC would not ordinarily be deductible as "wages or salaries." Still further inconsistency existed with the omission of the payment from the "Officer's Compensation" schedule in the tax return.

Most significantly ... and surprisingly ... neither the IRS nor the Court mentioned the fact that the terms of the contract for the sale of the stock provided that the "bonus" was to be paid "one half at the time of closing and the other half 180 days later." That would have split the payment over two different taxable years. In fact, the payment was made in a lump sum. The dealership's fiscal tax reporting year ended April 30, 1992 and the contract of sale was signed on January 2, 1992. Had the bonus payment been paid in accordance with the contract terms for the sale of the stock, only one half of the bonus or slightly more than $100,000 would have been paid before the end of the fiscal year and the other one half would have been paid after the close of the fiscal year. Had that timetable been followed, that would have raised an issue over the deductibility of the full amount of the compensation paid in the tax return filed for the year ended April 30, 1992. No mention was made of this discrepancy or inconsistency.

IRS POSITION

The IRS position was that the $210,000 claimed as a deduction in the corporate tax return was nondeductible either (1) as part of the purchase price of the stock or (2) as a dividend. It reached this conclusion in assessing the tax consequences of the payment to the dealer by giving greater weight to the substance of the transaction, and not simply by looking at the form. Under this approach, the origin and nature of the payment controls whether or not the payment is deductible.

The IRS position was that the $210,000 payment was "part and parcel of (the dealer's) termination of his 100% stock interest and is, therefore, a redemption that is nondeductible under IRC Section 162(k)." This section does not allow a deduction for any amount paid or incurred by a corporation in connection with the reacquisition of its stock. Using the *step transaction doctrine*, the IRS argued that the $500,000 payment to the dealer by the purchasers, in conjunction with the simultaneous payment by the dealership of its excess net worth, comprised two steps in a single integrated transaction. "The substance of the transaction was that before the (purchase) transaction (the dealer) owned 100% of the stock of the corporation and after the $735,059 was exchanged with (him) for his stock, the three individuals ended up with 100% of the Twin City's stock and (he) terminated his stock interest in Twin City."

PROCEDURAL MATTERS

This case was before a United States District Court and not before the Tax Court. Twin City Dodge-Chrysler had decided to pay the tax assessed by the IRS when it disallowed the deduction and file a claim for refund. The IRS denied the claim for refund and the taxpayer sought relief in the U.S. District Court. The matter was before the Court as a result of the IRS moving for a motion of Summary Judgment. A motion for Summary Judgment is appropriate if there is no genuine issue as to any material fact and the moving party (in this case, the U.S./IRS) is entitled to a judgment as a matter of law. Without going into all the details, a Summary Judgment is made based on documentary evidence before trial and, during such proceedings, the Court must draw all inferences in a light most favorable to the non-moving party (i.e., the taxpayer in this case). The Court may grant Summary Judgment when "the record taken as a whole could not lead a rational trier of fact to find for the non-moving party (i.e., the taxpayer)."

The Court agreed with the IRS disallowance of the dealership's deduction for the payment. The Court reasoned that the total amount paid to the dealer was tied to the value of the stock and to the net worth of the dealership. The Court observed that there was nothing in the record to suggest any analysis of the value or extent of the dealer's past services in the dealership's decision to pay him the $210,059. In addition, the dealership did not take any steps, other than by its own resolution, to confirm that the $210,059 was payment for past services. Accordingly, the Court upheld the disallowance of the deduction.

OBSERVATIONS

If the dealer were undercompensated for prior years of service, wouldn't it have been better to start paying him more salary during the years before the buy-out, rather than attempting to pay a lump sum settlement the day before his stock was transferred? The case is brief and the facts are relatively uncomplicated. One is struck by the absence of any information supporting the dealer's claim that he had been undercompensated in prior years. Other cases where reasonable compensation is in dispute often include in the record lengthy statistical analyses, expert witness testimony, charts, diagrams and all fashion of relevant (and, sometimes irrelevant) other information. Cases involving reasonable compensation and automobile dealerships, such as *A.I.D., Inc.*

see **REASONABLE COMP & BUY-OUTS...**, page 6

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(Automotive Investment Development, Inc.), as reported in the September 1994 *Dealer Tax Watch,* present tremendous operating detail, results of performance and other criteria which everyone knows the Tax Court, at least, is looking for when the issue of reasonable compensation is raised.

This case illustrates how not to approach the situation where the dealer wants to make it easier for the purchasers to come up with the purchase price by "bailing out" some of the retained earnings right before the purchase date. But assume, for example, that a dealer in similar circumstances might want to do some longer range planning. He could have set up a deferred compensation contract with the corporation, providing for the payment of adequate compensation but, given the limited cash position of the corporation, deferring the payment of part of the compensation until retirement age or some later date when funds were available. Although this would result in the dealership not being able to deduct any of the liability until it was actually paid, it might provide a much stronger basis for the deductibility of the payment(s) when eventually paid.

In this case, the dealer referred to "thousands of hours of service" from 1977 until 1992 that he gave to the dealership for which he was not compensated. Note: the dealer said he was not even compensated for thousands of hours of work ... he was not saying that he was undercompensated. For discussion purposes, assume that as little as 10 hours per week had been worked but not compensated for the period "from 1977 until 1992." Simple math, without any compounding, would show that 10 hours per week multiplied by 50 weeks in a year would result in 500 hours per year for which no compensation had been paid. Fifteen years times 500 hours per year equals 7,500 hours over the 15 year period. At, say, $30 per hour, 7,500 hours times $30 per hour equals $225,000 ... far in excess of the $210,000 paid out at the last minute to the dealer in this case.

It wouldn't take a rocket scientist to come up with a host of combinations of hourly rates multiplied by hours worked per year - whether compensated or not, or undercompensated - to come pretty close to the desired dollar pay-out objective. By factoring interest into (or discounting) these calculations, one might easily have started out at much lower hourly rates in the earlier years, and which rates could be increased significantly and justified by inflation and the complexity of the business in the later or more recent years.

Furthermore, if the dealer personally guaranteed the floor plan, wouldn't that be worth something in the nature of a guarantor's fee every year? There's no point in speculating why some arguments ... or some variations, at least, weren't raised in the current case. The point of the preceding discussion is that if a dealer is considering selling his dealership in a reasonably similar fact pattern, it would be helpful to do the math up front, and to consider paying out some of the deferred compensation (or guarantor fees) over some of the years before the year in which the buy-out actually occurs.

In the current case, since there was quite a bit of build up in retained earnings (and, possibly in cash), if the dealer had paid out as little as $20,000 or $25,000 each year, from the time that he was first approached by the ultimate purchasers (which was back in 1987), more than half of the "big payment" would have been paid out before the buy-out. Some of it would even have been paid in closed years at that point ... thus mitigating exposure to the "all or none" risk inherent in deducting a lump sum.

DEFENSE STRATEGIES

In short, it might have been better ... and, in a planning context, it might usually be better ... to start drawing out more compensation sooner, rather than later, to make up for prior lack of - or less than adequate - compensation for services. When a buy-out is on the horizon, it becomes difficult to manage and successfully defend the deductibility of larger payments over a short period of time.

SIX STRATEGIES

1. Plan extensively in advance for the (ultimate) confrontation.
2. Develop information over a period of years by collecting as much information as possible while events are happening.
3. Evaluate your situation realistically. Determine whether the dealer fits in with the "industry norm", and if (s)he doesn't, why not.
4. Be consistent in the terminology used in all contracts and documents to describe the (compensation) payments being made. Treat the payments consistently in all tax returns filed.
5. Consider guarantors fees, where applicable.
6. Build a compensation defense file by investing time in this specialized planning effort.

See our extensive coverage in the June 1994 and September 1994 issues of the *Dealer Tax Watch* for information on what the IRS and the Tax Court look for and on documenting and defending dealer compensation. *

MEALS AND ENTERTAINMENT SUBSTANTIATION SALESMAN'S "DIARY" GIVES EVERYBODY A *STRONG* CASE OF INDIGESTION

T & E 274(d)

Never underestimate just how far the IRS will go in reading and checking out a taxpayer's diary supporting meals and entertainment deductions. The recent case of *Raymond Strong*, Tax Court Memo 1997-105 (March 3, 1997), is striking in showing just how hungry for detail the IRS appetite can be. In the end, everybody had indigestion: the IRS, the Tax Court, diners who ate the meals and 5 years later were called into the Tax Court to remember them, the CPA return preparer ... and the taxpayer who, after the IRS' Heimlich maneuver, ultimately had to cough up more than $20,000 in tax, and significant penalties as well.

This case spans a decade from the 1987 income tax return, through the Tax Court trial 5 years later in 1992, to the ultimate filing of the decision by the Tax Court in March, 1997. It shows how the IRS scrutinizes diaries, receipts and check stubs, and even calls diners to the stand in Tax Court to check up on - make that "corroborate" - the diary details.

The taxpayer was the F & I manager for a group of dealerships in New Rochelle, New York. He had two college degrees, including a Masters in Business Administration, and he principally worked for a Toyota dealership. Business was so good in 1987 that he earned over $160,000, and customers often had to stand in line with a number waiting to see him. As the F & I manager for the Toyota dealership, he was required to be in the showroom from 50 to 70 hours each week attending to responsibilities that included arranging financing, selling insurance and warranties, assisting customers with vehicle registrations and making leasing arrangements. It was fairly well established that he was hardworking and successful, and his compensation consisted solely of commission income.

The dealership's informal policy was to reimburse employees for business meal expenses only if the employee was asked to incur the expense. Otherwise, the dealership had no formal meal reimbursement policy. This meant the employee would have to claim any unreimbursed business expenses in his or her individual income tax return as an itemized deduction in Schedule A.

In the Form 2106 attached to his 1987 personal return, Strong claimed a deduction for meals and entertainment in the amount of exactly $50,000. This was the net amount after subtracting the 20% ($12,500) disallowed by Section 274(n) from gross "Meals and Entertainment" expenditures of $62,500. In addition to this $50,000 net deduction, vehicle expenses of $4,016 and other lesser expenses were also claimed. These amounts were aggregated and then reduced by the 2% of adjusted gross income cut-back applicable to miscellaneous itemized deductions in Schedule A.

Upon audit, Strong submitted his 1987 diary in which he claimed 388 business meals, 274 of them dinners. Each entry in his diary for meals listed the name of a restaurant, the names of the people present, the type of meal (i.e., breakfast, lunch or dinner) and the cost of the meal. His diary did not show the business purpose of any of these meals, nor did it show the business relationship of Strong to any of the other diners present. The diary reflected a total for meals and entertainment expense of $65,777 which was more than the gross amount of $62,500 claimed on Form 2106. Mr. Strong had testified that he did not claim the full amount in his diary "in order to allow a *cushion* (of $3,277 or approximately 5% of the total) because some of the meetings in the diary *could* have been of a personal nature." Although Strong claimed that during 1987 he entertained customers, prospective purchasers, bank officials, other salespeople, insurance representatives and other specialists, no identification was made in the diary as to what category any person "supposedly entertained" was in.

The diary showed entries for every day of 1987, except Sundays, six holidays and one 3-day vacation. Most of the restaurants listed in the diary, including those shown as lunch sites, were located within a few miles of his home on Long Island, a little more than 30 miles from the location of the dealership where he worked. Others were located in The Bronx, Manhattan, Westchester and in Connecticut.

In its brief, the IRS contended that Strong's diary was "so riddled with inaccuracies, ... that it cannot stand as credible evidence to substantiate that any of the claimed expenses were incurred." Since Section 162(a) allows a deduction only for ordinary and necessary employee business expenses, the IRS contended that in the very healthy ("exploding") auto sales market of 1987 - when business was so good that at times customers had to line up with tickets because the dealership was so busy and banks were competing with each other to try to

see **SALESMAN'S "DIARY"...**, page 8

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get the finance business of the dealerships where Mr. Strong worked - it was inconceivable (to the IRS) that it would have been "ordinary and necessary" for Strong to incur such "grandiose" business expenses as an employee in order to fulfill his duties.

According to the IRS, "it is clear that the diary produced by (Strong) was not prepared at or near the time of the events supposedly recorded." Furthermore, many of the restaurant receipts or stubs offered by Strong were considered by the IRS to be ..."highly suspicious, at best. The majority of the stubs did not have the name of the restaurant printed on them. None of the stubs contained the year in which the meal supposedly took place. Petitioner filled out the dates and the amounts as well as the name of the restaurant on most of the stubs. The amounts for entertainment expenses, parking and tolls and mileage ... do not match up with the amounts claimed for these items ... and petitioner can offer no reasonable explanation for the difference."

The IRS contended that "according to the diary, petitioner was regularly entertaining at lunch and dinner at restaurants near his home on Long Island when he was supposedly working 40 to 70 hours a week at the ... dealership located 34 miles away in Westchester County. According to the diary, he entertained 11 times during 1987 at a restaurant known as ***FRANK'S STEAKS***, a restaurant which ***WAS NOT EVEN IN EXISTENCE DURING THE YEAR IN ISSUE.*** Moreover, two of (his) own witnesses ... could not recall having been entertained by him with the other persons listed by him in his diary and one of them had no recollection of several of the restaurants at which he was supposedly entertained."

The position of the IRS was that "the irregularities, inconsistencies and improbabilities contained within the purported diary make it highly unlikely that petitioner maintained the diary in such a way so that the entries were made at or near the time of the expenditure." Accordingly, the IRS said that the diary could not be considered to be an adequate record for purposes of Section 274(d). In its Reply Brief filed January 4, 1993, the IRS almost categorically objected to the taxpayer's proposed findings of facts on the grounds that they were "misleading, self-serving, incredible and uncorroborated testimony, and not supported by any credible evidence in the record." Elsewhere, in its Brief filed earlier, the IRS had stated that the taxpayer was "not able to identify all the people whose names are listed in the diary"... and that... "when questioned on just a small portion of the diary entries, petitioner testified several times that he had no recollection of the name or the purpose of the meeting recorded in the diary."

APPLICABLE LAW

The technical challenges mounted by the IRS were:

1. *FIRST*, under Section 162(a), the taxpayer failed to prove that the expenses claimed (1) were incurred and (2) were ordinary and necessary expenditures of his being in the trade or business of being a business (i.e., F & I) manager.
2. *SECOND*, the taxpayer failed to meet the strict recordkeeping requirements of Section 274(d).

Section 274(d) provides that no deduction is allowable under Section 162 for meals and entertainment expenses - as well as certain other types of expenses - unless the taxpayer substantiates certain matters by "adequate records" or by "sufficient evidence" corroborating the taxpayer's own statements. The elements required to be substantiated in any expenditure are:

- The amount of such expense,
- The time and place,
- The business purpose of the expense or other item, and
- The business relationship to the taxpayer of the person or persons entertained.

Section 274(d) requires that in order to meet the "adequate records" requirement, a taxpayer shall maintain an account, diary, statement of expense or similar record or documentary evidence which, in combination, is sufficient to establish each element of an expenditure. These records also must be prepared or maintained in such a manner that each recording of an element of the expenditure is made <u>at or near the time of the expenditure</u>.

The regulations further provide that if a taxpayer fails to establish that he has substantially complied with the "adequate records" requirement with respect to an element of an expenditure, then the taxpayer must establish such element (i) by his own statement, whether written or oral, containing specific information in detail as to such element ***<u>and</u>*** (ii) by other corroborative evidence sufficient to establish such element. If the element is the cost, time, place or date of the expenditure, the corroborative evidence shall be <u>direct</u> <u>evidence</u>, such as a statement

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in writing or the oral testimony of the persons entertained or other witnesses setting forth detailed information about such element or documentary evidence.

Where Section 274(d) applies, it specifically overrules the *Cohan* rule. The Committee Reports specifically state ... "It is reemphasized that ... the Internal Revenue Service and the Courts are not to apply the *Cohan* approximation rule to allow deductibility of any food or beverage expense, other entertainment expense, or other expenditures subject to substantiation pursuant to Section 274(d) if the expenditure is not substantiated in accordance with Section 274(d) and the regulations thereunder." Under the *Cohan* rule, the Tax Court would be permitted to approximate the allowable expenses in circumstances where the taxpayer kept no records or poor records if the taxpayer were able to establish that it had incurred business-related expenses. Such *Cohan*-type approximations are clearly not to be made in situations involving Section 274(d) meal and entertainment expenses.

Finally, two other principles apply in this area: First, deductions are a matter of legislative grace; second, the taxpayer seeking the deduction has the burden of overcoming the presumption of correctness that attaches to the IRS' factual determinations in its Notice of Deficiency.

HOW THE TAX COURT DIGESTED THINGS

The Tax Court dug into the 274(d) part of the IRS' argument first and found it so persuasive that it wasn't necessary to examine any of the Section 162(a) "ordinary and necessary" part of the IRS attack.

The Tax Court observed that Strong's diary "paints a picture of an indefatigable worker ... who was, if anything, overly cautious on his tax return." The Court noted that the diary showed he had business meals on 304 days, even though his tax return showed he worked only 250 days during 1987. As to Strong's "cautious" approach to his tax return, the Court cited the fact that his diary showed the meals cost him $65,777 but that he had deducted "only" $62,500. The Court also observed that his bill stubs "present an ostensibly plausible backup, in a bewildering variety of styles, sizes and colors." The Court didn't overlook the fact that Strong's diary showed eleven dinners at *Frank's Steaks* in 1987, nine of which were purportedly substantiated by stubs, and that at these 11 dinners 32 different people consumed meals costing more than $50 per person per meal. However, *Frank's Steaks* did not open until July, 1988 and the predecessor restaurant, named "The Peculiar Pelican," had closed in January of 1987. Also, the stubs that Strong presented to substantiate his claims to have eaten at *Frank's Steaks*, were of a style that had never been used either by *Frank's Steaks* after it opened or by the "Peculiar Pelican" before it closed.

The Tax Court concluded that Strong really had no plausible explanation or rebuttal when he was informed by the IRS "some nine months before the trial that *Frank's Steaks* did not open until (July) 1988, and so was not open on the relevant 1987 dates shown in (his) diary and on the stubs." Other inconsistencies were found as matters of fact and the Court commented that Strong had not helped his own cause by testifying that he relied on stubs that he filled in, even where he had credit card receipts. Furthermore, Strong had said the stubs he filled in were just as trustworthy as his credit card receipts. Note, the IRS even called on the owner of a restaurant known as "*Frank's Steaks*" to testify, and he was unable to identify the receipts that Strong had provided.

The Court stated all the evidence and testimony "strongly suggests that petitioner's diary and stubs (1) are materially false and (2) were not substantially contemporaneous in 1987, but were constructed well after August, 1988 when the restaurant first opened as *Frank's Steaks*."

And, in digging deeper (or, you might say, going back for a second helping), on the "corroborating evidence" entree, the Tax Court concluded that the witnesses who testified about sharing meals with Strong were "unable to support the specifics of (his) testimony or diary." "Not only was there a total failure of direct evidence to corroborate (his) statement as to cost, time, place and date, but some of the witnesses' testimony directly contradicted at least some of (Strong's own) statements." Accordingly, "the record does not include "sufficient evidence" of corroboration for purposes of Section 274(d) ..."

Pass the Rolaids, please!

LOOKING FOR A LOOPHOLE

One of Strong's arguments was that he should not be held to strict compliance with the requirements of Section 274(d) because important records relating to the identities of actual customers of the dealerships whom he had entertained became unavailable through no fault of his own when the dealership was sold sometime after

see **SALESMAN'S "DIARY"...**, page 10

 (Continued from page 9)

RELIEF FOR RECEIPT RETENTION

UPDATE NOTES

RECEIPT LIMIT INCREASED FROM $25 TO $75

In March 1997, following up on Notice 95-20, the IRS issued regulations under Section 274(d) raising the substantiation threshold for saving documentary evidence such as receipts from $25 to $75. This increased threshold is effective for expenses incurred on or after October 1, 1995. (*Reg. 209785-95; T.D. 8715*)

This change is applicable to both deductions and reimbursement arrangements. But, before you go throwing out (or stop asking for) receipts, keep in mind that this change does not apply to lodging expenses. Also, it may still be advisable to obtain and save meal and entertainment receipts anyway since often the date, time, exact name and address of the establishment providing the meal or entertainment is printed out and this information may be very helpful - if not indispensable - in completing a diary or other summary of expenses.

Starting in 1994, the 20% disallowance by Section 274(n) was increased to 50%.

1987. The regulations do provide that if records have become unavailable through no fault of a taxpayer, then the taxpayer is permitted "to substantiate a deduction by reasonable reconstruction of his expenditures."

However, in order to qualify for relief under this provision, a taxpayer must establish that (1) at one time he had possessed adequate records and (2) his present lack of records was due to fire, flood or other casualty beyond his control (*Gizzi v. Commissioner*, 65 T.C. 342 (1975)). The Tax Court concluded there was not any evidence that (1) Strong ever possessed the records in question or (2) if the records were available, that the records would contain sufficient evidence to satisfy the requirements of Section 274(d). "Even if the records of who bought automobiles from the ... dealerships in 1987 were available, then petitioner's records would still have all the problems discussed (above), that caused us to conclude that petitioner's diary and the stubs are materially false and were not substantially contemporaneous." Accordingly, Strong was denied relief under the waiver allowed where records are destroyed by casualty.

AUTO EXPENSES

By Strong's own calculations, his vehicle expenses totaled $4,016, covering 28,867 miles and various maintenance-related expenses. There was no evidence as to the locations of many of the restaurants named in Strong's diary or on the meal stubs. There was also no record of the location of any of the non-meal business meetings for which business use was claimed.

His diary indicated business meals on 304 days of the year, yet his tax return claimed that he used his auto for business purposes on only 250 days, thus giving the Tax Court "qualms" about the credibility of his testimony. Also, he could not provide a satisfactory explanation for why he claimed that his "average daily round trip commuting distance" was only 10 miles in light of the stipulation that the distance from his home to his workplace was about 34 miles.

The Court decided that even if it were to allow $1,000 in vehicle expenses, Strong would not be entitled to any net miscellaneous deductions in his Schedule A because this amount was below the 2-percent of AGI floor on itemized deductions which amounted to $3,350.

NEGLIGENCE AND PENALTIES

Negligence is the "lack of due care or failure to do what a reasonable and ordinarily prudent person would do under the circumstances" (*Neely v. Commissioner*, 85 TC 934 (1985)). Strong contended that he had relied on his tax preparer, a CPA, to prepare the 1987 return and that he personally was neither negligent nor guilty of acting in intentional disregard of the rules or regulations. However, he testified that he did **not** turn over his diary or the stubs to the CPA for the preparation of his tax return. The Court observed that an "ordinarily prudent person" who contends that he spent more than $60,000 ... (about 40% of his $163,289 gross receipts from that trade or business) would (1) keep such records and (2) present them to his or her tax return preparer.

The Court observed that, as a general rule, the duty of filing accurate tax returns cannot be avoided by placing responsibility on an agent. Both Strong and his CPA testified in Court as to what information was provided to the CPA, but the record did not include evidence that Strong had turned over complete and accurate information to his CPA. Ironically, 1987 was the first year that Strong had his tax return prepared by this CPA.

see **SALESMAN'S "DIARY"...**, page 24

AMENDING PRIOR GIFT TAX RETURNS TO CLAIM LARGER DISCOUNTS AND LOWER VALUATIONS

FORM 709 (AMENDED)

The March 1997 *Dealer Tax Watch* reported on the IRS changes in reporting valuation discounts on gift tax returns (Forms 709). These were discussed in the context of "Gifts Are Good." Typical, traditional estate planning benefits are significantly enhanced by claiming appropriate discounts in valuing dealership stock and other assets. That article summarized the advantages of lifetime gifts and provoked some thought on what the upper reaches or range for valuation discounts might be.

Recently released Letter Ruling 9718004 focuses on an interesting related aspect integral to gifting, discount, business valuation and estate planning scenarios. This ruling holds that prior year gift tax returns can be amended to adjust the value of past **gifts** for purposes of determining future **gift** tax liabilities.

BACKGROUND

In 1982 and 1989, a donor had made gifts of fractional interests in developed real property directly to family members and to trusts for their benefit. These gifts were reported on gift tax returns for those years. In valuing the gifts, the donor did not claim any discount to reflect the fact that fractional interests in real estate had been transferred. Instead, each fractional interest was valued at its proportionate share of the value of the entire property.

In 1991, the same donor made additional gifts of fractional interests in other developed real property to family members and trusts for family members. As with the prior gifted interests, on Form 709 no fractional interest discounts were claimed against the 1991 gifts. The underlying real estate property that was the subject of the 1991 gifts was different from the real estate property involved in the 1982 and 1989 gifts.

The total taxable gifts made in 1982 and 1989 equaled $565,424. Because of the availability of the donor's $600,000 unified credit (which offsets $192,800 worth of transfer tax liability), no gift tax was due or payable with either the 1982 or the 1989 gift tax returns. The valuation of the taxable gifts in 1991 totaled $468,750.

Since gift taxes are determined by adding all prior taxable gifts to the current year's taxable gifts in order to compute cumulative or aggregate taxable gift amounts, the combined valuation in the 1991 return of the three years' gifts totaled $1,034,174. This produced a total tax of $359,811 which, after subtracting the $192,800 unified credit, became a net gift tax of $167,011 due and payable with the gift tax return filed for 1991.

The donor died after the filing of the gift tax return. The personal representative of the donor's estate filed a claim for refund relating to the 1991 gifts on April 13, 1995 ... just two days before the expiration of the 3-year statute of limitations. In this claim for refund, the donor's estate applied a fractional interest discount in valuing the real property interests transferred in 1991. That refund claim did not refer to ... or mention ... either the 1982 or the 1989 gifts. At a meeting with the IRS about six months later, the estate's representatives told the IRS that fractional interest discounts should also be allowed for the gifts made in 1982 and 1989. These discounts would result in further adjustments affecting the amount of the unified credit available in 1991 and the rate of tax applicable to the 1991 gifts. In other words, the estate claimed that in computing the gift tax liability for 1991, the value of the donor's taxable gifts in the preceding years when gifts were made should be decreased by similar fractional interest discounts, thus (1) lowering the valuations of the gifts, (2) lowering the resulting taxable gifts and (3) increasing the amount of the unified credit that would be unused and carried forward from the 1982 and 1989 gift years to 1991.

THE ISSUES AND HOLDINGS

The facts relative to 1982, 1989 and 1991 raised two issues.

1. In determining the donor's gift tax liability for 1991, can the value of the donor's 1982 and 1989 gifts be adjusted?

2. Assuming the value of the gifts made in 1982 and 1989 may be adjusted, is an oral amendment to claim the refund filed by the donor's estate barred by the statute of limitations? (For general planning purposes, this second issue is less important assuming donors file timely and complete amended returns.)

In Letter Ruling 9718004, the IRS held that Section 2504(c) does not preclude adjusting the value of the donor's 1982 and 1989 gifts for purposes of determining the aggregate sum of the donor's taxable gifts for preceding calendar periods. However, the estate's oral amendment of its claim for refund was, in effect, treated as a new claim that was barred or prevented by the statute of limitations.

see **AMENDING GIFT TAX RETURNS,** page 12

Amending Gift Tax Returns

GIFTS & GIFT TAXES ARE CUMULATIVE

The gift tax rules are found in Chapter 12 of the Internal Revenue Code. Section 2501 imposes a tax on all transfers of property by gift during any calendar year. The tax imposed by Section 2501 for each calendar year is an amount equal to the excess of

1. a tentative tax, computed on the aggregate sum of the taxable gifts for the calendar year and for each of the preceding calendar periods, over

2. a tentative tax, computed on the aggregate sum of the taxable gifts for each of the preceding calendar years.

In other words, the current year taxable gifts plus the sum of all prior years/periods' taxable gifts are added and the resulting total is subject to the graduated tax rates shown in the accompanying table. From this computed amount of tax, subtract the tax computed on the aggregate of the sum of all of the taxable gifts in the preceding calendar years/periods. This remainder is the tax on the current year's gifts. The effect of all of this is simply that the amount of gift tax computed on the taxable gifts for the current year is computed at a higher graduated rate than if the tax computation for taxable gifts each year were to start at the bottom of the table as if the taxable gifts were non-cumulative.

(Continued from page 11)

SECTION 2504(c): THE EYE OF THE NEEDLE

The code section controlling the issues in LTR 9718004 is Section 2504(c). This section provides that if the time has expired within which a tax may be assessed on the transfer of property by gift made during a preceding calendar period, *and if a tax has been assessed or paid for the preceding calendar period*, the value of the gift made in the preceding calendar period shall ... be the value of the gift that was used in computing the tax for the last preceding calendar period for which a tax under Chapter 12 was assessed or paid.

Section 2504(c) was added to the Internal Revenue Code in 1954. Before then, the value of a gift made in a closed year could be adjusted to determine the gift tax liability for open years. The revaluation of a prior gift at the time of a later gift obviously created a high degree of uncertainty, and Section 2504(c) was enacted to remove that uncertainty.

The legislative history of Section 2504(c) includes the following statements:

"Due to the cumulative nature of the gift tax and the progression in gift tax rates, the tax liability for gifts in a particular year is dependent on the correct valuation of gifts in prior years. Therefore, a taxpayer's gift tax liability for 1953, for example, might be

NOTES TO UNIFIED TRANSFER TAX TABLE

1. The transfer tax rates are integrated for lifetime gifts and these rates apply to the value of what is left in one's estate at one's death. Total taxable gifts during one's lifetime are added to the value of the net taxable estate to determine the Taxable Amount in Column A for estate tax purposes.

2. The $600,000 unified credit is not obvious at first glance. But it is easily located a little past the midpoint in the $500,000 to $750,000 "Taxable Amount" bracket. The tax computed ... using columns (C) and (D) ... on a Taxable Amount of exactly $600,000 equals exactly $192,800 ($155,800 + 37% of $100,000).

3. Once the unified credit has been used against prior taxable gifts, or against a combination of prior taxable gifts (if any) plus a portion of the taxable estate, the tax rate applicable to the first taxable dollar being transferred is 37% ...From there, the rates just get bigger.

4. The rates are progressive and reach fairly deep into one's (heirs') pocket book.

The $167,011 paid by the donor in LTR 9718004 with the 1991 gift tax return consisted of three elements (representing the amount of taxable gifts *in excess of $600,000*):

First:	$150,000	@ 37%	=	$55,500
Second:	$250,000	@ 39%	=	$97,500
Last:	$34,174	@ 41%	=	$14,011
	$434,174			
Total tax				$167,011

5. To the extent that stock (and other property interest) valuation discounts are claimed and are allowable, those amounts never even come into the picture.

6. The benefit of the unified credit "$600,000 freebie" is phased out for larger estates. See the $10,000,000 taxable amount line which reflects a 60% rate of tax on taxable transfers by gifts or at death or by any combination thereof between the amounts of $10,000,000 and $21,040,000. The tax in Column (C) on a taxable amount of exactly $21,040,000 is simply the sum of 55% of $21,040,000 (or $11,572,000) plus $192,800 (the tax dollar amount of the unified credit exemption freebie of $600,000).

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UNIFIED TRANSFER TAX FOR TAXABLE GIFTS AND ESTATES

FORM 709
FORM 706

COLUMN A TAXABLE AMOUNT OVER-	COLUMN B TAXABLE AMOUNT NOT OVER-	COLUMN C TAX ON AMOUNT IN COLUMN A	COLUMN D RATE OF TAX ON EXCESS OVER AMOUNT IN COLUMN A
------	$ 10,000	------	18%
$ 10,000	20,000	$ 1,800	20%
20,000	40,000	3,800	22%
40,000	60,000	8,200	24%
60,000	80,000	13,000	26%
80,000	100,000	18,200	28%
100,000	150,000	23,800	30%
150,000	250,000	38,800	32%
250,000	500,000	70,800	34%
500,000	750,000	155,800	37%
750,000	1,000,000	248,300	39%
1,000,000	1,250,000	345,800	41%
1,250,000	1,500,000	448,300	43%
1,500,000	2,000,000	555,800	45%
2,000,000	2,500,000	780,800	49%
2,500,000	3,000,000	1,025,800	53%
3,000,000	10,000,000	1,290,800	55%
10,000,000	21,040,000	5,140,800	60%
21,040,000	------	11,764,800	55%

dependent on whether the valuation of a gift made in 1935 (is) larger, smaller, or the same as previously reported, although that statute of limitations has run on the tax paid on the 1935 transfer.

"It is believed that once the value of a gift has been accepted for purposes of the (gift) tax BY BOTH THE GOVERNMENT AND THE TAXPAYER, this value should be acceptable to both in measuring the tax to be applied to subsequent gifts. For that reason the bill provides that the value of a gift as reported on a taxable gift tax return for a prior year is to be conclusive as the value of the gift (after the statute of limitations has run) in determining the tax rate to be applied to subsequent gifts. <u>This substantially increases certainty in the gift tax area.</u>"

Elsewhere, the legislative intent of Section 2504(c) is amplified to clarify that ... "This ... will prevent the value of a gift from being adjusted under such circumstances in cases where a tax was paid for the prior year in question. (It), however, will not prevent such an adjustment if no tax was paid for the prior year...."

see **AMENDING GIFT TAX RETURNS**, page 14

Amending Gift Tax Returns

Note: That explains why many gift tax returns were filed in the days of the $3,000 annual exclusion reporting gifts of slightly more than $3,000 per donee so that corresponding gift tax liabilities of a few dollars resulted. These started the statute of limitations running on the valuations used on the gifts when payment of the small tax was made with the filing of the gift tax return.

REVENUE RULING 84-11

Revenue Ruling 84-11 (1984-1 C.B. 201) directly addresses the question of whether a donor's use of the unified credit under Section 2505 results in a "payment or assessment" of gift tax that would preclude an adjustment to the value of the gift under Section 2504(c). Rev. Rul. 84-11 holds that a donor's use of the unified credit to reduce his gift tax payable does not result in a payment or assessment of gift tax that would prevent an adjustment to the value of the gift under Section 2504(c).

In other words, at a later date, the IRS might challenge the valuation of the gifted property in a return where no gift tax was paid because the unified credit (i.e., some part of the statutory $192,800 credit allowed) was used. The $600,000 unified credit was provided as a substitute for both the "old" $30,000 lifetime gift tax exemption and the $60,000 estate tax exemption which, prior to 1977, were allowed in connection with the respective gift and estate tax tables for computing gift and estate tax liabilities. The new unified credit was phased into the law to its full $192,800 amount over a period of years.

In reasoning that a donor's "use" of the unified credit - even though that use was mandatory - did not result in a payment or assessment of gift tax, the IRS reasoned that only taxes, net of credits, can be the subject of assessment and that (gift) taxes that are entirely offset by a correctly claimed credit are not "assessed or paid" within the meaning of Section 2504(c). The Service rationalized its conclusion as conforming with Congressional intent which was to prevent the valuation of a past transfer from being placed in doubt after the Service had previously been satisfied as to the correctness of the taxpayer's valuation. The Service added that an undervaluation of a gift that fell within the limits of the unified credit might have little or no current tax consequence, and it should not acquire any finality from the fact that it went unchallenged at the time the gift tax return was filed.

The donor in Revenue Ruling 84-11 had made a gift of stock in 1977 having a reported fair market value of $123,000. In 1982, the donor made another gift of $230,000 and, upon audit of the gift tax return

(Continued from page 12)

filed for 1982, the IRS increased the value of the 1977 gift to reflect a corrected higher fair market value of the stock. When the gift tax return for 1977 was prepared, the return showed a tentative gift tax liability of $29,800 which was fully offset by the available unified credit so that no gift tax was paid with the filing of that return. When the IRS examined the 1982 gift tax return, it was too late for the Service to go back and assess any additional gift tax relative to the gift made in 1977 because the period of limitations for any assessment against 1977 had expired. However, the adjustment by the IRS to the valuation of the gift made in 1977 did increase the aggregate sum of the donor's taxable gifts, and this did result in increasing the rate of tax applicable to 1982. In other words, the gift in 1982 was pushed up into higher brackets because the valuation of the 1977 gift had been increased, even though no additional 1977 gift tax had been paid.

The donor/taxpayer's objection (in Rev. Rul. 84-11) to the IRS' adjustment in 1982 to increase the 1977 gift valuation was that since the unified credit had been "used", a tax had been assessed or paid for the 1977 gift. However, consistent with its own logic, the IRS held that there was no bar to adjusting the donor's available unified credit to reflect the credit that would have been used had the donor correctly valued the 1977 gift. Consequently, the unified credit available to the donor for the 1982 gift could be adjusted (reduced) to reflect the greater amount of credit that would have been used had the donor correctly valued the 1977 gift, even though no tax could be assessed against that 1977 gift because the statute of limitations had expired. Accordingly, the donor's available unified credit in 1982 was decreased to reflect the larger amount of credit that would have been used if the 1977 gifts had been reported correctly.

PROBLEMS CAUSED BY NOT TIMELY FILING CLAIMS AGAINST 1982 & 1989 GIFTS

LTR 9718004 is consistent in applying the reasoning in Rev. Rul. 84-11. It concludes that because the donor's unified credit offset the gift tax liability fully for gifts made in 1982 and in 1989, the donor had incurred no gift tax on these gifts, and the use of the unified credit did not result in the payment or assessment of gift tax for purposes of Section 2504(c). Therefore, the donor in LTR 9718004 was not prevented from adjusting the values of the 1982 and the 1989 gifts in determining the aggregate sum of the donor's taxable gifts for the preceding calendar years. Had the gifts in 1982 and 1989 been valued/reduced by a fractional interest discount factor, the amount of taxable gifts would have been smaller and a corre-

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spondingly larger amount of unified credit would have been available for carryover against later gifts.

Although the IRS National Office held that an adjustment to the valuation of the 1982 and 1989 gifts was not precluded by Section 2504(c), that did not automatically mean that the taxpayer could go ahead and make the adjustment ... unless the taxpayer had raised its refund claim "in a timely fashion." This second issue or condition created a problem for the taxpayer that prevented it from being able to go back and make the adjustments.

In its claim for refund for 1991, filed on April 13, 1995, the Estate applied a fractional interest discount in valuing the property that was transferred in 1991. No mention was made of the 1982 or 1989 gifts in the 1991 claim. After the period for filing a refund claim had expired, the Estate asserted a right to an additional amount for 1991. This amount was attributable to its reduction in value of the 1982 and 1989 gifts, and this would have increased the amount of the unified credit available in 1991 and also affected the rate of tax on the 1991 gifts.

However, Section 6511(a) provides that a claim for credit or refund of an overpayment must be filed within three years from the time the return was filed or two years from the time the tax was paid. The claim must set forth in detail each ground upon which a credit or refund is claimed and facts sufficient to apprise the Commissioner of the exact basis thereof. A claim that does not comply with these requirements will not be considered as a claim for refund or credit. The IRS held that the donor's estate failed to satisfy these requirements.

The Estate's original claim for refund did not specifically include as grounds for its claim the assertions that fractional discounts should have been applied in determining the value of the gifts made in 1982 and 1989. The Estate's position was that by raising (i.e., mentioning to the IRS) the issue of a minority discount with respect to the gift of an interest in one property in 1991, it necessarily raised the issue with respect to prior gifts of interests <u>in different properties</u>, the valuation of which had an indirect effect on its 1991 liability.

The IRS stated that the valuation of property, including the valuation of fractional interests in property, is a factual determination and a taxpayer must do more than merely assert that a fractional interest has a value that is less than a proportionate part of the entire value of the property. And it is necessary for the lower value to be supported by evidence *(Estate of Fitti v. Comm.* (T.C. Memo. 1986-452)). In the absence of evidence that a partial interest in a tract of land would sell for less than its proportionate share of the entire value of the tract, a fractional interest discount may not be appropriate. Furthermore, even if a fractional interest discount were appropriate, the same discount may not be appropriate for different properties. For example, see *Estate of McCormick v. Comm.* (T.C. Memo. 1995-371), in which varying fractional discounts were applied to several properties held by the taxpayer.

The National Office pointed out that the availability and amount of any discount depends on the particular facts and circumstances pertaining to a specific interest. Also, it said that it believed that the Estate's original claim, seeking a fractional interest discount for specific gifts, did not include an implicit claim with respect to the effect on the unified credit and tax rate of other gifts of interests in other properties in other years. It reasoned that even if discounts were appropriate with respect to the donor's gifts in 1991, it does not follow that the same discount or, indeed, **ANY** discount, would automatically apply to the value of other fractional interests. Accordingly, a claim that raises the valuation issue with respect to only one gift of a fractional interest does not apprise the IRS that the taxpayer is also claiming a refund on the ground that a fractional interest discount should also have been applied in valuing prior gifts.

The IRS held that the Estate's amendment of its claim after the expiration of the statute of limitations was, in effect, a new claim. When the Estate's representatives met with the IRS in October 1995, the statute of limitations for filing a claim for refund had expired and Section 6511(a) barred the Estate from asserting a new claim. Similarly, an amendment to an existing claim raising a new ground is not permitted after the statute of limitations has expired.

WHAT DOES 9718004 REALLY MEAN?

When all the smoke clears, it appears that the taxpayer's estate/donor: (1) was successful in filing a timely amended return to claim a discount against the valuation of the fractional interests in real property gifted in 1991, and (2) the donor would have been able to reduce the valuations of the gifts reported in 1982 and 1989 - against which only portions of the unified credit were applied - if proper and timely claims had been filed and adequate factual basis existed to support the discounts claimed in valuing the 1982 and 1989 gifts.

Recall that the property gifted in 1991 - i.e., the underlying real estate - was not the same property as the underlying real estate gifted in the earlier years. Also, the IRS cited the *McCormick* case for the

see **AMENDING GIFT TAX RETURNS**, page 16

proposition that different or varying fractional discounts might be applicable to different properties. Query: Might the result have been different if in all 3 years gifts had been made in the same underlying property ...or (common) stock of the same company?

DOES THE SAME LOGIC APPLY TO SUBSEQUENT *ESTATE* TAXES?

LTR 9718004 deals with going back and adjusting valuations in prior gift tax returns in the context of computing the gift tax liabilities of subsequent years. Is there a similar interplay involving the possibility of adjustments to prior year gifts in the context of arriving at later estate tax determinations? As discussed previously, under the unified gift and estate tax system, the adjusted taxable gifts during a person's lifetime are added to the value of his net taxable estate at death to determine the tentative estate tax. This amount of tentative estate tax is then reduced by a tax computed on the total of all lifetime taxable gifts.

ANSWER: Unfortunately, the courts are divided on whether or not Section 2504(c) prevents the revaluation of prior taxable gifts for the computation of estate tax liabilities. The first time this issue was raised, it became apparent that the estate and gift tax provisions are not (yet?) as fully or perfectly "integrated" with each other as taxpayers hoped. This is because the explicit language of Section 2504(c) - ... a gift tax provision - ... does not refer to a comparable result for estate tax purposes. Estate taxes are computed under Chapter 11 of the Internal Revenue Code - not under Chapter 12.

In *Boatmen's First National Bank of Kansas City v. US* (89-1 USTC ¶ 13,795), the US District Court held in 1988 that Section 2504(c) was applicable to estate tax computations and that the IRS could not go back and revalue the taxable gifts in prior years in the context of a subsequent estate tax calculation. In the *Boatmen's* case, the IRS was not even giving the estate credit for the gift taxes "payable" - as required by statute - to reflect the change in the valuation of the gifts. The result of the IRS' calculations, if upheld, would have been to add the tax impact of the revaluation of the prior gifts entirely to the estate tax to be paid by the donor's estate.

To keep things in perspective: the issue is - or should only be - whether or not the additional (or fewer) dollars of valuation of the gifts in prior years result in transfers at a later date being taxed at higher (or lower) graduated transfer tax rates. Essentially the same principles as those discussed in Letter Ruling 9718004 are involved, except for the fact that, if Congress had intended for there to be identical results for both (1) subsequent gift tax determinations and (2) estate tax determinations, it failed to say so or to include the necessary corresponding language in the statute to achieve that result when it changed the law in 1976.

(Continued from page 15)

Although the IRS was prevented in the 1988 *Boatmen's* case from going back and adjusting or revaluing prior gifts for estate tax computation purposes in the case, its efforts to accomplish the same results have been upheld in several more recent cases. These include, but are not limited to, *Carrol Evanston v. US*, 94-2 USTC ¶ 60,174 (1994), and *Estate of Frederick R. Smith v. Commissioner*, 94 TC 872 (1990). See the accompanying selected bibliography of articles which discuss the controversy over revaluation of prior gifts in the context of subsequent estate tax liability determinations.

The status of this long-standing debate is summarized well by Ellwanger in his article in the January, 1994 *Journal of Taxation*:

"**The battle over revaluation of adjusted taxable gifts for estate tax purposes is being lost. Total defeat seems inevitable unless Congress can somehow be brought into the struggle.** For now, it must be assumed that Section 2504(c) does not apply to estate taxes. Even if it did, of course, there still would be many gifts that the Service could redetermine, and even revalue, in computing estate taxes. Many clients make gifts, but relatively few pay gift tax ...

"The prudent practitioner will supervise a client's gifts with the thought that values may not be carved in stone ... Executors should be advised to exercise due diligence in reviewing gift tax returns and in seeking out other gifts. There should be more than a transfer of numbers from one return to another.

"Finally, redetermination of adjusted taxable gifts is not always a bad thing from the taxpayer's perspective. Appraisers are not infallible, and hindsight should not be solely the province of the Service."

CONCLUSION

It seems an oversimplification to state that the intended net result of the unified transfer tax system is (simply) that the rate of tax ultimately applied against any property in an estate will be the same rate that would have been applied if the decedent had never made any taxable gifts during life and kept possession of everything until the very end. However, that may be the result where only nominal gifts are (infrequently) made, gifting programs are started very late in life, or discounts are not aggressively pursued.

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Amending Gift Tax Returns (Continued)

The split of authority in the courts over whether estate tax liabilities can be affected by the revaluation of prior gifts creates a major element of uncertainty which is not likely to be resolved soon. On the other hand, Letter Ruling 9718004 appears to offer encouragement to those willing to be more aggressive in their discounts by permitting timely filed adjustments/amendments of prior gift returns and valuations for subsequent gift tax purposes.

Taxpayers may wish to postpone filing such amended gift tax returns until just (a few days) before the expiration of the statute of limitations. Note, that's what the taxpayer did in LTR 9718004. This strategy might increase the chances of success if the IRS can't possibly process and audit all the gift tax returns with discount issues, including last minute amended returns and refund claims.

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BUY-HERE, PAY-HERE DEALER MUST INVENTORY USED VEHICLES *SECURITIES* OR *AUTO* DEALER ... OR BOTH?

BHPH
RFC
§ 475

The accelerating interest of the IRS in used car dealers, Buy-Here, Pay-Here (BHPH) operations and Related Finance Companies (RFCs) is evidenced in another recent letter ruling involving, in part, the question of whether a used car operation was really an automobile dealer ... or a securities dealer. In this situation, the taxpayer claimed to be more in the business of being a securities dealer than in the business of being an auto (used car) dealer. The dealer claimed that the *real money* was in financing the customers' paper and that buying used cars at the auction or from other dealers was simply what had to be done as a means to its real source of income ... financing the customers' paper.

In Letter Ruling 9723004, the IRS held that the dealer was required to maintain an inventory of used vehicles at year-end, and the Service denied the dealer permission to change its method of accounting.

If this seems like a no-brainer, ... Think again ... Still waters run deep.

BACKGROUND

The taxpayer is an accrual basis S Corp operating in Florida. Its activities consist of selling used automobiles that it has acquired from other dealers or at auctions. After purchasing a used vehicle and making whatever repairs are needed to clean up the vehicle, the dealer insures the auto immediately and begins its reselling efforts. The taxpayer acquires legal title to the vehicles, although it may take as long as one or two months after the initial purchase before it receives the certificate of title. Usually, the vehicle is sold before the dealership receives the certificate of title. Out of this scenario, the taxpayer claims that the used vehicles are "entrusted" to it while it is attempting to locate purchasers and that this "entrusting" permits it to resell the automobiles, even though it should not be treated as the owner of the vehicles.

In some instances, the vehicles are sold for cash and when this occurs, the purchaser receives title to the automobile. However, the taxpayer primarily sells its used vehicles on credit and provides the financing. In the course of providing this financing, the taxpayer requires the buyer to sign a note for the purchase price of the auto (net of any cash paid) and the buyer pledges the purchased auto as collateral. The dealership retains legal title to the vehicle until the note is paid in full. The dealership usually holds and collects on a purchaser's note for about two or three months, then sells the note to an unrelated finance company at a price that is less than the aggregate payments required on the note. When the dealership sells a purchaser's note to the finance companies, the dealership transfers title to the vehicle securing the note to the finance companies. The price at which the notes are sold to the unrelated finance company is a material fact in dispute in the IRS audit of the taxpayer's 1991 and 1992 tax returns.

The dealership was incorporated in 1990 and in its original tax return, it reported installment notes as accounts receivable. On its 1991 tax return, it treated installment notes in the same fashion. The taxpayer filed an amended return for 1991 (after the due date of the return) and subsequently filed its Federal income tax return for 1992 reporting the outstanding customer notes as ending inventory valued under the lower or cost or market method of accounting. The Federal income tax returns for 1991 and for 1992 showed that the dealership held an inventory of automobiles. This inventory consisted of unsold autos at year-end. Autos that the dealership had sold to customers on credit were not included in its ending inventory even though the taxpayer held legal title to these automobiles as collateral.

"WE DON'T MAKE MONEY SELLING USED CARS ... WE MAKE IT ON THE FINANCING"

The Ruling states that the taxpayer claims that the selling price of the used vehicles is about equal to its cost of acquiring the vehicles and, therefore, it realizes little or no profit from the sale of used vehicles. It claims that it earns substantially all of its net income from its customer financing activities and the discounting of customer notes. The taxpayer further represents that its ability to function as a going concern is due to its financing activities.

The taxpayer claims that it is a dealer in securities. As such, Regulation § 1.471-5 permits it to inventory its customer notes using the lower of cost or market method of accounting because its notes are securities within the meaning of § 1236(c). On both its 1991 amended return and its 1992 return, as filed, the dealership inventoried the notes using the lower of cost or market method for valuing the inventory. The dealership argued that since it is a securities dealer - and not an automobile dealer - it should not have inventoried its automobiles, →

and it should be allowed to deduct the cost of its automobiles currently. As an alternative argument, it argued that it should not be required to maintain an inventory of vehicles because it rarely receives title to the automobiles before it sells them to customers.

IRS HOLDINGS

The National Office pointed out that the taxpayer did not file Form 3115 requesting IRS permission to change accounting methods either (1) to change to the lower of cost or market method of accounting for its installment notes or (2) to discontinue inventorying its used automobiles. Instead, it tried to make these changes in methods by filing an amended return for 1991 and then continuing these methods in 1992.

The National Office held that the dealership must continue to use the same method it had been using to account for its used vehicle inventory. Revenue Ruling 90-38 requires that a taxpayer must obtain the Commissioner's consent before making a retroactive change in method by amending prior tax returns.

The IRS said that the fact that the taxpayer may earn little or no profit on the sale of its used automobiles does not mean that the automobiles are not inventory ... "(Taxpayer's) business is selling automobiles." Although the taxpayer argued that it rarely receives a certificate of title to a vehicle before it was sold to a purchaser, the facts were that the dealership acquired legal and equitable ownership of the automobiles it bought at auction or from other automobile dealers and that its purchases of the vehicles were unconditional. The dealership insured the autos and bore all risk of loss. The fact that the dealership was able to resell the automobiles before it received the certificate of title merely attested to the fact that it was able to resell the vehicles relatively quickly.

The National Office distinguished Revenue Ruling 75-538 which the taxpayer cited in support of its position that its automobiles were not held for sale but, rather, are *"used or consumed* in the securities business." Revenue Ruling 75-538 involved whether autos *used or consumed* by a dealer were "held for sale" to customers, and it held that when the cost of an auto is recovered *through the use of* an automobile, the auto was not "held for sale." The IRS concluded that the dealership in the instant letter ruling situation recovered the cost of its automobiles through the sale of the automobiles, notwithstanding the fact that these vehicles were sold at little profit (i.e., approximately at cost). Under these circumstances, Revenue Ruling 75-538 was not applicable.

Based on the foregoing, the National Office held that the dealership must continue to maintain an inventory of automobiles at year-end, and it denied the taxpayer permission to retroactively change from its accounting method of inventorying them. Although one might not be too surprised at the National Office holding in this ruling, it does indirectly shed light on certain avenues of approach some BHPH dealers are taking in connection with the potential application of the mark-to-market rules under Section 475.

BENEATH THE SURFACE ... DEEPER WATERS ... GREATER OPPORTUNITIES?

QUICK: Name a few "dealers in securities." What names come to mind? Merrill Lynch, E.F. Hutton, Prudential, Smith Barney, Charles Schwab... ? How about *Joe's Used Car Buy-Here, Pay-Here*? Do used car dealer BHPH operations fall into this elite category?

Throughout Letter Ruling 9723004, the IRS carefully dances around the real question: Is the taxpayer a dealer in securities? In fact, the issue is introduced by a double question: "*If* T is a dealer in securities for purposes of Reg. Sec. 1.471-5, must it maintain an inventory of unsold automobiles it holds at year-end?" Note that the Service did not acknowledge or state as a fact that the taxpayer was a dealer in securities. The letter ruling consistently refers to the taxpayer "*taking the position that* it is a dealer in securities" or "*claiming that* it is a dealer in securities ..." or "*arguing that* it is a dealer in securities." Why the fancy footwork around the "dealer in securities" status?

Are sub-prime purchasers' notes and receivables the same thing as securities for these tax purposes? The "dealer" in Letter Ruling 9723004 also tried to make a change in accounting method for its inventory of customer notes. It had started out in 1990 reporting its installment notes as accounts receivable (i.e., face value, dollar-for-dollar). It continued to do so in its 1991 income tax return. Then it filed an amended return for 1991 (and it filed its 1992 return consistent therewith) reporting the customer notes as ending inventory under the lower of cost or market method of accounting. Presumably, the LCM method resulted in a valuation of these notes at less than face value to reflect real market considerations.

Reg. Sec. 1.471-5 provides that a dealer in securities may use either (a) cost, (b) cost or market, whichever is lower, or (c) market value as a method of accounting for valuing unsold securities on hand at year-end if that is how they are accounted for in the "books of account." Note: Whether the dealer could use the lower of cost or market method for its customer notes (securities) is not answered by LTR 9723004.

see **BUY-HERE, PAY-HERE DEALER...**, page 20

Buy-Here, Pay-Here Dealer Must Inventory Used Vehicles... (Continued from page 19)

LTR 9723004 could have - but didn't - say anything about the possibility that the taxpayer might be in two trades or businesses (one involving the sale of used automobiles; the other involving financing customer paper). The sole issue as framed in the letter ruling was narrowed down to whether unsold automobiles should be inventoried. The more interesting questions involve the taxpayer's position that it was a "dealer in securities" and its (unsuccessful) attempt - (because it did not proceed in the proper procedural manner? ...or because it was not a "dealer in securities?") - to use the lower of cost or market inventory valuation method provided by Reg. Sec. 1.471-5 for valuing its inventory of customer notes.

The IRS did not discuss the "separate trade or business" possibility. And it didn't discuss the "principal trade or business" ramifications either. *"Principal"* becomes very important under Section 475.

Since 1991 and 1992 were involved in the LTR 9723004 IRS audit, Reg. Sec. 1.471-5 ...which allows (1) cost, (2) lower of cost or market or (3) market possibilities... would apply. However, for tax years ending after December 31, 1993, Code Section 475 repeals Reg. Sec. 1.471-5 and now requires dealers to inventory securities *at market.* The real, interesting question is how does Section 475, which contains the mark-to-market accounting method rules for dealers in securities, apply to used car dealers after 1993?

DO THE MARK-TO-MARKET RULES OF SECTION 475 APPLY TO BHPH OPERATIONS?

There's lots beneath the surface here ... and the IRS has only recently issued regulations. Section 475(c) contains very broad definitions which should be and are likely to be tested by aggressive dealers seeking to benefit from the new rules which require that "any security which is inventory in the hands of the dealer shall be included in inventory at its fair market value."

The definitions found in Section 475(c) define a "dealer in securities" as a taxpayer who ... regularly purchases securities from or sells securities to customers in the ordinary course of a trade or business. A "security" is defined to mean ***ANY***..."evidence of indebtedness." Special rules and exotic definitions attempt to exclude used car buy-here, pay-here type operations from the application of the Section 475 rules. However, aggressive dealer advisors seem to believe that Section 475(c) has such broad definitions for the terms *"dealers"* and *"securities,"* that they ought to be able to fit certain buy-here, pay-here type operations within them so that accounts receivable or customer notes might be characterized as securities that can be written down to market.

The Section 475 regulations contain language intended to exclude from dealer status taxpayers who acquire or purchase instruments that are purchaser-originated or "customer paper." The regulations also define "customer paper" as debt that has been issued to a taxpayer ... "whose principal business is nonfinancial" ... by a purchaser to finance a purchase of goods or services. Doesn't this open the door for the argument the taxpayer in LTR 9723004 was making: that its principal activity was not "selling nonfinancial goods" (i.e., selling used vehicles was not its principal activity - that was its secondary activity) so that the *dealer in securities* provisions might apply? Is that argument too shallow? Recall that although the letter ruling deals with years before the Section 475 mark-to-market rule applies, after 1993 dealers in securities (eventually) come under Section 475.

Since Section 475 applies to taxable years ending on or after December 31, 1993, a taxpayer that is required to change its method of accounting to comply with Section 475 is treated as having initiated the change in method of accounting and as having received consent of the IRS to make such change. The net amount of the Section 481(a) adjustment is to be taken into account ratably over a 5-taxable year period beginning with the first taxable year ending on or after December 31, 1993. This comes from the legislative history in the Committee Reports on the Omnibus Budget Reconciliation Act of 1993 which added Section 475 to the Internal Revenue Code.

Section 475(e) provides that such regulations as may be necessary or appropriate may be written to prevent the use of year-end transfers, related parties or other arrangements to avoid the provisions of this section. Does this mandate operate in reverse? May regulations be written to prevent taxpayers from attempting to come under the provisions of this section, where to do so would be beneficial?

Hearings on proposed regulations under Section 475 were held in October 1996. The potential applications of Section 475 to used car buy-here, pay-here type operations and related finance companies were certainly not overlooked. Some of the Big 6 accounting firms were present and participated in those hearings commenting on these dealer implications. So, where there's smoke, there's (usually) fire, and the potential favorable applications to BHPHs should not be overlooked.

RETROACTIVE BENEFITS, TOO?

There are special rules that may even allow the application of the mark-to-market rules retroactively to tax years ending before December 24, 1996. There was an original deadline of June 23, 1997 to allow this retroactive →

result; however, the IRS in Notice 97-37 extended the date for making this retroactive election. Agreeing that taxpayers needed additional guidance to decide whether to make such an election, the Service extended the deadline to at least 45 days after the guidance is released.

This election may be limited to the context of consolidated returns, captive finance companies and the ability to recognize losses on the transfer of receivables between members of a consolidated group. Some accounting firms have sent out letters to dealerships suggesting that they can assist in evaluating the application of the 1996 proposed regulations, valuing the portfolios of customer notes in order to quantify the benefits of making an election, preparing the election forms for the appropriate years, where appropriate, and preparing refund claims.

CONCLUSIONS

There's a huge difference between "securities" which more often are thought of as being publicly traded and readily priced (like shares of IBM stock or U.S. Treasury Notes) and the nearly usurious notes signed by some *credit-challenged* purchasers of used cars whose payments are likely to stop when the car stops running or other credit difficulties overtake them.

Congress may never have intended Section 475 to apply to used car dealers. Whether that's the case or not, the IRS may strongly try to prevent its application to BHPH-type operations. That's why the regulations are complex and formidable. However, the application of Section 475 to used car BHPH dealers could provide a real ... though unintended ... benefit for used car operators who fight for membership into the elite club limited to "dealers in securities." Right now, how - or if - all this fits together is unclear.

OTHER COVERAGE ON BHPH's IN THE *DEALER TAX WATCH*

SHOULD A DEALER EVEN BOTHER WITH AN RFC? $2 MILLION DE MINIMIS?

One CPA recently suggested his rule of thumb: Unless a used car dealer has at least $2 million in Buy-Here, Pay-Here receivables, setting up a related finance company (RFC) may not really be worth the effort.

For example, assume $2 million of receivables at the end of the first full year. Further assume that 25% will be uncollectible before the end of the **next** year. If the dealer is paying tax on $500,000 of income at a 40% tax rate, the dealer is, in effect, making a one year loan to the IRS of $200,000.

If the dealer went to a bank and borrowed $200,000 at 10% interest, the dealer would pay roughly $20,000 to finance the tax that he has to pay up-front or in advance on the earlier payment of the tax (due to the full realization of income on the BHPH receivables in the year of sale).

Contrast this with the up-front costs of setting up a separate entity (which should be capitalized and amortized) and the on-going extra accounting and bookkeeping costs and fees to prepare tax returns and to keep other necessary records. Even more significant are the applicable State regulations and supervision to which the RFC must submit.

Is an RFC really worth all the *trouble?* Does this "oversimplify" the case? What if the RFC also shifts significant amounts of income and wealth to other family members? Bottom line: What do you think?

IRS CHANGES DEALER FINANCE COMPANY'S METHOD OF ACCOUNTING FOR INTEREST INCOME

Cordes Finance Corporation v. Comm., T.C. Memo 1997-162 is a classic case of the IRS coming in and finding an improper method which it then adjusts under its authority provided in Section 446. There really was no good argument that could have been raised in defense of the method used by the taxpayer: it accrued interest only when a loan was fully paid or when it repossessed the vehicle securing the loan.

As a result of the IRS change, the Company had to accrue interest over the life of each loan, resulting in an adjustment of almost $3.1 million. The Service also found that the Company had understated interest income by another $1.6 million which was the difference between the interest reported on individual customer note cards and the total of the control account which had not been reconciled to the detail for 20 years. Here's a summary.

Mr. Cordes owned and controlled three Oklahoma automobile dealerships. These dealerships referred their customers to the related finance company to provide financing for the customers' purchases of automobiles. If the customer credit was acceptable, the finance company would issue a check to the dealership for the purchase price of the car, and the customer would issue a promissory note to the finance company under which the customer would agree to pay the principal amount of the note plus interest. Payment of the customer's promissory note was secured by a mortgage on the automobile that was being financed.

Every lending transaction was supported by a ledger card which contained the customer's name, the vehicle identification number (VIN) of the vehicle being financed, the principal amount of the loan and the total interest that would accrue during the life of the loan. During the life of the loan, the date and amount of each payment would be recorded on the respective ledger card. The Company did not maintain a list of all loans outstanding, and it had no way of knowing if a ledger card had been lost or misplaced ... unless the borrower subsequently made a payment on the loan.

Since 1964, the Company had used the same method of accounting to record loan transactions. When a loan was made, the "Loan Receivable" account was debited for an amount equal to the sum of the principal amount of the loan plus the total interest income that would accrue over the life of the loan. The "Cash" account was credited for an amount equal to the principal of the loan (since that reflected the payment of the purchase price of the car back to the dealership by the finance company for the purchaser) and the "Deferred Interest Income" account was credited in an amount equal to the interest to be paid by the customer over the term of the loan.

Interest income was not accrued while the loan was outstanding and the customer was making payments. After the loan was initially recorded, only the date and amount of each payment made by the customer was entered on the ledger card for the loan. Interest was not accrued until the principal amount of the loan was fully paid or the vehicle was repossessed. At that time, the Company recognized for book and for income tax purposes all of the interest that had been paid on the loan.

At the end of 1990, there were about 1,300 loans outstanding representing $17.3 million in loans receivable with a corresponding credit of $7.8 million in the deferred interest income account. Thus, at that date, the deferred interest income account on the balance sheet reflected interest of $7.8 million to be realized after 1990 on the portfolio of outstanding loans. This account had not reconciled with the customer ledger cards for approximately 20 years.

The IRS recomputed the interest income by working from the customer ledger cards for all loans outstanding at the end of 1990. From the ledger cards and other loan documents prepared at the time when loans were made, the agent computed (1) the amount of deferred interest on each outstanding loan, (2) the interest that should have been reported on that loan using the accrual method of accounting, and (3) the amount of deferred interest with respect to each loan at the end of 1990. The taxpayer refused to cooperate with the agent's requests for certain bank information.

ERRONEOUS METHOD ISSUE

The major issue involved the Company's method of accounting for the interest earned on its portfolio of car loans under which the Company (1) did not accrue interest on any loan that was outstanding at the end of the year and (2) treated interest as having been earned only when a loan was fully paid off or after the vehicle securing the loan was repossessed. The taxpayer offered little defense in connection with this $3.1 million part of the IRS' adjustment.

The Tax Court upheld the IRS, stating that neither the purpose nor the necessary effect of the IRS adjustment was to include in gross income for

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1990 interest that will accrue after 1990. The change of accounting method that was made by the IRS was to require interest to be ratably included in income over the life of the loan. Based upon taxpayer's records of loans outstanding at the end of 1990, the IRS found that almost $3.1 million interest had been earned through the end of 1990, and that was not challenged by the taxpayer. The Court said that under the taxpayer's method of accounting, the amount of interest earned during the year was reflected as a decrease (debit) in the balance of the deferred interest account. That meant that the ending balance of the deferred interest account was nothing more than the interest that potentially would be earned on the portfolio of loans in the future. Therefore, it was necessary for the IRS to decrease the ending balance of the deferred interest account by the additional earned interest that the IRS had computed for the year.

The Company had made a halfhearted attempt at trial to argue that it had consistently used its method for over 30 years, and that historically it had suffered an "unusually high incidence of repossessions". However, the Company did not prove the allegation of a high incidence of repossessions, and it apparently abandoned the argument that its method of accounting was appropriate. The Court stated that it was evident that the taxpayer's method of accounting for interest income did not clearly reflect income and that it was well within the Commissioner's discretion under Section 446(b) to change a taxpayer's method which, although consistently used over a period of years, was erroneous and did not clearly reflect income.

DISCREPANCY BETWEEN CONTROL ACCOUNT BALANCE AND INDIVIDUAL LOAN CARDS

This second issue was based upon the discrepancy between the deferred interest control account balance and the total from the underlying customers individual loan activity cards. Although the 1990 tax return balance sheet reported $7.8 million as the balance of the deferred interest account at the end of 1990, the aggregate deferred interest recorded on the ledger cards for all of the loans outstanding at the end of 1990 was $6.2 million.

To reconcile this discrepancy and bring the balance of the deferred interest account into agreement with the ending balance computed by the IRS from the loan ledger cards, the IRS further increased income by $1.6 million.

The taxpayer resisted this adjustment claiming that:

"The Commissioner's proposed method of accounting requires that any interest which has not already been recognized and which could possibly be earned at any time in the future on any contract outstanding at the end of 1990 be recognized as income in 1990. (Taxpayer) object(s)... because it required the inclusion in income in 1990 of interest on installment note payments that are not due at the end of 1990 and won't be due for months or even years in the future."

The taxpayer claimed that the IRS was, in effect, placing it on an erroneous method of accounting to the extent that the IRS computed income by reference to unearned interest. The taxpayer said that this exceeded the Commissioner's authority to change a method of accounting under Section 446(b).

TAXPAYER BEARS BURDEN OF PROOF

With respect to this adjustment, the Court said that to overcome the IRS determination as to this accounting adjustment, the taxpayer bears a heavy burden of proof in that it must show that the IRS determination is arbitrary and unsupported by any basis in law.

The Court said that the taxpayer's objections were based upon the premise that the $1.6 million difference is interest that did not accrue in 1990 or in any prior year. However, the taxpayer had not introduced any evidence to rebut the IRS determination or to explain the difference. "Contrary to the premise of petitioner's argument, the ledger cards for loans outstanding at the end of 1990 substantiate deferred interest of $1,596,968 (i.e., $1.6 million) less than the ending balance of the deferred interest account as shown on (the) balance sheet.

"We find that petitioner has not proven that respondent abused her discretion by determining that the difference described above is interest that accrued prior to 1991."

The burden of proof was on the taxpayer, not the IRS, in this matter. Accordingly, the IRS was upheld on this issue, and the taxpayer had to take this $1.6 million into income also.

CONCLUSION

Based on the facts, the Court's decision hardly seems surprising. Good accounting controls, not to mention common sense, suggest that control accounts should be frequently reconciled to their underlying details. This case suggests that adjustments to agree control accounts to supporting subsidiary records should be made at least at the end of each year. This should avoid the unpleasant consequences of having to take a very large "unlocated difference" adjustment entirely into income in one year.

Salesman's "Diary"... (Continued from page 10)

The Court concluded that "it is more likely than not that petitioner's diary and the stubs were created (by him) well after the events they purport to describe" and that he "failed to keep contemporaneous records, and his efforts to create *contemporaneous-appearing* records have succeeded in destroying what modicum of credibility his testimony might otherwise have had." Accordingly, due to his negligence, Strong had to pay all of the additions to tax under Sections 6653 and 6661.

LEGISLATIVE "GRACE" BEFORE A MEAL: THE MORAL OF THE STORY

Travel and entertainment expense substantiation requirements, including those for meals, may seem overly detailed, harsh or even unrealistic and difficult to meet. However, because the Internal Revenue Code contains these requirements, the Courts are required to administer them to the letter of the law. The *Cohan* approximation rule cannot be applied in these circumstances.

It is not safe to assume that just because IRS agents in the past were satisfied with less explanation or documentation, other IRS agents in the future won't demand more. Nor is it safe to assume that the compliance requirements can be slighted because no change - or examination - was made by the IRS in prior year audits. *Strong* and other decisions consistently uphold the IRS where the taxpayer has failed to comply with these strict requirements. Although *Strong* may involve an extreme situation where an individual was claiming the deductions, all of the substantiation elements discussed in it apply to employers or corporations seeking to deduct meal and entertainment expenses under reimbursement arrangements with their employees. Furthermore, where employees have received "excess" reimbursements or where reimbursements are not appropriately documented, the IRS tends to treat those amounts as nondeductible dividends where the employees are shareholders.

The moral should be obvious ... Don't underestimate the IRS' powerful appetite for detail in support of your substantiation diary... crumbs and leftovers won't do. Expense records and diaries should be kept up-to-date; receipts should be obtained at the time payment is made. And, before leaving the restaurant, don't forget to stab an "official" receipt with a toothpick if you haven't already picked one up ... if you're the one who really paid the bill.

BON APPETIT!

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