De Filipps' DEALER TAX WATCH

A Quarterly Update of Essential Tax Information

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DEALER TAX WATCH *OUT*

If you had called me personally to ask, "What's happening lately with IRS audits of dealers and dealerships that I need to know about?" ... Here's what I'd say:

#1. IRS AUDIT UPDATE ...

HOT & EMERGING TAX ISSUES. Last quarter, the "big news" was the IRS release of Revenue Procedure 97-44 and Revenue Ruling 97-42 providing special relief **only** for automobile dealers with **certain** financial statement LIFO conformity violations.

This quarter, the "big news" is the IRS National Office Technical Advice Memo on demonstrator vehicles. It covers taxation, valuation, and related employer payroll tax liabilities. This is likely to cause many dealers to reconsider providing demonstrator vehicles to their employees ... if they have not already given up that practice.

Demonstrator vehicles: In Letter Ruling 9801002, the IRS held that sales and nonsales employees of a dealership under audit were not entitled to exclude the value of the use of the vehicles from gross income as a working condition fringe. The reason was because the substantiation requirements of Section 274(d) were not satisfied. The Service held further that the more favorable lease valuation rule and tables could not be used. Finally, with every form of compensation, whether indirect or fringe, there are related employment tax obligations. The liability of the dealership for "employment taxes" on the employee use of demo vehicles was not overlooked either. The IRS held that the dealership was liable for applicable employment taxes on ***all*** demo vehicles, including those for which no particular employee could be identified. For more on this, see page 15.

LIFO conformity for dealership financial statements: Since the publication of the IRS' relief for auto dealers with LIFO conformity violations, more problem areas and unanswered questions are emerging. Also, NADA recently released its "*Dealer Guide to the LIFO Conformity Settlement.*"

Some dealers and CPAs are just beginning to realize the mess they're in ... unless, of course, they're willing to fork over 4.7% of their LIFO reserves to buy their way out of trouble. Can anyone offer advice on what to do? We've included a *Practice Guide* for your consideration and reprints from the *LIFO Lookout* on pages 28-31.

Used vehicle LIFO computations. We have received many calls during the last quarter regarding questions the IRS is raising on used vehicle LIFO calculations. Some of these questions may be resolved through a Technical Advice proceeding in 1998. If you're computing used vehicle LIFO indexes for 1997 and come up with *inflation* indexes, you may

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WATCHING OUT FOR

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want to seriously question the underlying assumptions or calculation approach. Are you sure you can justify showing price *inflation* while the rest of the industry is showing price *deflation?*

Factory incentive payments: (who pays the "employer's portion" of the FICA taxes?) ... *Still* nothing new to report at this time, not even a rumor.

Replacement Cost for Parts Inventories: This IRS challenge of the dealer inventory practice of valuing parts and accessories inventories using replacement cost (and not actual cost) went to trial in the Tax Court in Denver in October, 1997. It may be at least mid-summer before the Court issues its opinion in *Mountain State Ford Truck Sales v. Commissioner* (Docket 16350-95).

#2. TAX COURT ACTION. A recent Tax Court Memo decision held that two dealerships in Michigan could deduct commissions paid to salesmen for selling credit life insurance. State law prevented the dealership from directly collecting commission income from the sale of credit life policies. In *Berger Chevrolet* (TCM 1997-499), the Tax Court discussed how important finance and insurance activities are to a dealership. This discussion may have some weight in arguments with the IRS over whether F&I personnel can be considered to be "salesmen" for the special demonstrator fringe benefit treatment allowed by the Code.

Also, in the last issue of the *Dealer Tax Watch*, we discussed the *Howard Pontiac-GMC Inc.* case where the IRS disagreed that the $490,000 allocated by a dealer to the purchase of a non-compete agreement. The Tax Court reduced the taxpayer's allocation to $300,000 but that was far more than the $125,000 that the IRS would have allowed. Although this case involved a pre-1993 buy-out, the IRS brief provides some interesting insights into arguments that it may advance in looking at open years which have amortization deductions in them. See page 11.

#3. WALL STREET DEALERS CONFERENCE. This November Conference provided an in-depth look at dealers going public ... or considering other alternatives. For a report on the Conference, see page 3.

#4. USED VEHICLE LIFO ELECTIONS FOR 1997... STUCK IN REVERSE? With the year-end 1997 information now available, many dealers with used car LIFO elections are finding that what may have been small increases or decreases in used car prices in 1996 are being followed by greater price decreases for 1997. For some, this combination is undoing the prior benefits from used car LIFO elections made in 1995 and 1996. Furthermore, used car price decreases are being forecast for 1998. In this regard, the December, 1997 issue of *Auto Remarketing* interviewed several used vehicle industry experts who forecast the continuation of pressures felt during 1997. With near term price *deflation* experienced by many in 1997 and expected to continue over the next year or so, dealers contemplating used vehicle LIFO elections for 1997 surely ought to think twice about giving up their used car writedowns ... even though they flip-flop or reverse every year.

#5. REVISED FORM 3115. The current Form 3115 now bears a revision date of November, 1997. It reflects the changes made by Revenue Procedures 97-27 and 97-37. These include allowing the filing of Form 3115 at any time during the year of change (97-27) and an expansion of the "automatic consent" provisions regarding method changes which allow the filing of Form 3115 for certain changes well after the end of the year.

#6. "RETROACTIVE" TAX PLANNING. Under Revenue Procedure 97-37, Forms 3115 filed to reflect "automatic" consent changes are not required to be filed until the filing of the tax return for the year of change. The original must be attached to the taxpayer's timely filed (including extensions) original federal income tax return for the year of change.

At that time, a copy of Form 3115 is required to be furnished to the IRS National Office in Washington, D.C. The NTO copy must be filed no earlier than the first day of the year of change ... and no later than when the original is filed with the tax return for the year of change.

Accordingly, taxpayers now have added planning flexibility and more opportunities to use hindsight. The risk, of course, is that the longer one waits to file a Form 3115, the greater the possibility that during that "waiting period," the IRS may just start an audit.

With the elimination of the "90-day audit window" benefit that many LIFO taxpayers previously found quite favorable, this risk has to be carefully considered by those wishing to continue a questionable method of LIFO accounting for just one more year.

Similarly, for extended warranty/vehicle service contract sales, hindsight is available for dealer obligors. The republication of the Service Warranty Income Method (SWIM) in Rev. Proc. 97-38 now has automatic change status under Rev. Proc. 97-37.

DEALERS GOING PUBLIC
... OR CONSIDERING OTHER ALTERNATIVES
TAX CONCERNS & CONFERENCE HIGHLIGHTS

Car Dealer Insider/United Communications Group sponsored a "Wall Street Dealers" Conference on November 13-14, 1997 in Las Vegas. This conference featured an impressive roster of speakers representing the disciplines involved with Wall Street's embrace of auto dealers going public. Speakers included automotive financial analysts, CEOs of many of the public dealerships, attorneys, CPAs, Factory representatives and dealer consultants.

FINANCIAL ANALYSTS' COMMENTS

Since the "public market" values dealerships higher than does the private, non-public market, dealers are attracted to the idea of "going public". In 1997, public valuations were approaching eleven times 1998 earnings for some of the dealerships in publicly held groups.

As the retail automobile dealership industry continues to be consolidated, the arbitrage opportunities between public and private ownership cause successful and well-run dealerships to consider the opportunities of entering the IPO market. Although manufacturer approval is obviously necessary, it appears that, in most instances, the Factories will say "yes" notwithstanding the more highly publicized controversies between Republic Industries and Toyota and Honda. Two entrants in early November 1997 were Group I Motors out of Houston and the Sonic Motors Group out of Charlotte.

For dealers who are not able to go public on their own, "roll-ups" can provide market access to comparatively smaller sized dealer groups if they are able to overcome some of the practical obstacles which sometimes prevent their moving forward together.

DEALER OPTIONS

1. Sit tight, continue to operate the dealership reaping the rewards of hard work in developing a successful dealership,
2. Go public,
3. Sell the dealership to someone who is either looking to have the dealer stay on ...or take the cash and go somewhere to retire and "live the good life", or
4. Partner with another dealer or dealers in a "roll-up".

In the current buy-sell market, (1) multiples rise and fall with the stock market, (2) quality counts, (3) different profiles exist, especially in different parts of the country, and (4) "there's plenty of room for all."

Market analyst Jordan Hymowitz emphasized that Wall Street wants three "C's" ... Consistency ... Certainty ... and ... Credibility. Satisfaction of the three "C's" will result in the creation of stock value for the shareholders of public dealerships.

Consistency means achieving reasonable earnings projections every quarter. These earnings projections are the minimum results expected to be achieved. Dealerships that miss their earnings projections will suffer market loss of confidence and price drops in their stocks. Some of the market reactions produce sharp and significant overnight losses in values. After dealership groups have a track record, one may expect consistent upward revision of projection models. It is anticipated that stock prices for dealership stock will track the earnings growth over a period of time, as has been observed elsewhere in the stock market.

Wall Street hates uncertainty because uncertainty creates fear that earnings estimates previously announced by dealer groups will not be made ... or exceeded. In November, 1997, three elements creating uncertainty for public dealership groups are: (1) used car prices are down significantly during 1997, almost 10% (2) superstores are not selling, and (3) the litigation involving Toyota and Honda.

The best way for dealerships to create value for their shareholders is to achieve estimates and to come up with greater and unique improvements. Some of the anticipated profit improvements are already taken for granted. These include lower floor plan interest rates, reduced advertising expenses, and savings from all or massed purchasing.

Examples of "unique" improvements include (1) developing expertise through turning underperforming dealerships into very profitable dealerships, (2) the creation of a brand so that loyalty created with the brand name will result in more future sales, and (3) the successful operation of used car superstores.

Jordan Hymowitz provided each attendee with a copy of his Business Service Research Report, entitled "Auto Retailing–The Consolidation Shifts Into High Gear," dated November 10, 1997 (BancAmerica Robertson Stephens). This report contains a wealth of information and it belongs high on any list of "Must Reading" for CPA advisors to dealers. Mr. Hymowitz may be contacted at (415) 248-4610.

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FROM THE PUBLIC DEALERSHIP CEOs

Attendees heard from the CEOs of four publicly held dealer groups: Mike Maroone/Republic Industries, Bill Gilliland/Cross Continent, Brian Neill/Lithia Motors, and George Lowrance/United Auto Group.

George Lowrance of United Auto Group stated his beliefs that the market really is not anticipating a lot of dealership public offerings, and that there really is a "critical mass" or major size in terms of sales that a group needs to have before considering offering itself to the public. In addition to that "critical mass," he believes that there should be an excellent infrastructure–commitment, skills and stamina–so that if the dealership group successfully goes public, it has the skills to stay public and be public.

Lowrance emphasized that going public is <u>not</u> a good exit strategy and that it is <u>not</u> a cash cow. Even though a dealer might achieve the highest value for his dealership in the process, value does not equate with cash.

Each one of the existing public dealership groups has its own story and its own distinctive features separating it from the others. When United Auto Group looks at a "deal," it has to be sure that the cash is right ... and the "culture-fit" is right. UAG expects that the selling dealer will stay on, and it looks to place meaningful incentives in the dealership to reward employee loyalty and longevity. Typically, UAG structures its transactions to involve a large cash component. If a dealer does not want all cash, then it will allow a stock component, but that stock typically must be held for more than one year under SEC requirements before the dealer may dispose of it. Republic Industries, on the other hand, typically makes most of its acquisitions through stock issuance.

Brian Neill, in discussing Lithia Motors, emphasized that the major reason to go public is to have access to more capital so that the dealership(s) can grow. ***If the dealership doesn't want to grow, there's no reason to go public.*** He also indicated that he thought a prospective public dealership group should have a "story" so that the public would respond favorably to who "you" are, how "you" grew, and how "you" plan to grow in the future.

Neill pointed out that the reason most acquisitions fail is because of the inability to integrate the acquired business into the system, infrastructure, and culture. This suggests that controlled growth should be part of a dealership's overall plan. With many different types of dealerships, Lithia chose to put every store on the Toyota financial statement format so that the financial reporting by all dealerships would be uniform.

LEGAL ASPECTS TO BE CONSIDERED

Dan Myers made several significant observations on the legal aspects of going public. First, Factory approval is an absolute must, and Factory approval should never be assumed or taken for granted. Without Factory approval, the dealer cannot sell his dealership. Second, "market share is everything," and some of the concessions made by some of the dealer groups going public may, in the long run, be problematic where they have agreed to attempt to comply with the Factories' "Channel" strategies, Project 2000, and other objectives.

It is anticipated that any standard or criterion used by the Factory in allowing publicly held corporations to purchase dealerships will have to be applied consistently by the Factory in evaluating sales of dealerships involving non-public transactions.

Today, many of the Factories are imposing special conditions by which they eventually may be able to exert great control through vertical agreements involving exclusivity and/or site control in perpetuity. Myers observed that some dealers who are anxiously going public now are conceding exclusivity and/or site control. These dealers may, at some future time, find themselves unable to come up with any opposition to the Factory when it chooses to enforce these provisions. Under an "exclusivity" agreement, a dealer agrees to be only an exclusive dealer selling that brand. Currently, the Factory is permitting changes in dealer agreements only if the dealer agrees to such "exclusivity".

Myers also observed that it is important for a dealer to understand what "his Factory" considers important. This might be (1) sales, (2) segmented sales, and/or (3) consumer satisfaction/CSI requirements, by whatever name called: QCP, TSI, PDI, etc. These "hot spots" or "standards" should be given major emphasis so that the dealer can successfully defend itself if the Factory attempts later to terminate the franchise based on the dealer's failure to measure up to its "standards".

REITS, REAL ESTATE, & REALTY FINANCING ALTERNATIVES

Several speakers discussed approaches to help dealers separate and make more liquid an investment in the dealership realty by separating it from the overall dealership aggregation. By separating the real estate as an asset, the dealer has greater flexibility and ends up not having all, or as many, eggs in the same basket. One presentation by Falcon Financial outlined two distinct programs designed to help dealers out of the sometimes typical real estate quandary. Currently, most dealers are required to provide per- →

sonal guarantees in connection with dealership borrowings, and this simply increases overall risk and limits the dealership's ability to grow. Falcon attempts to impose on dealers as borrowers the same disciplines it applies to other businesses. Falcon Financial has plans designed to help a dealer capitalize on existing equity in the real estate facilities which are (1) long-term, (2) fixed interest rate, (3) flexible, (4) designed not to interfere with the operations of the dealership, and (5) structured to maximize proceeds based on cash flows.

Falcon offers two separate programs. The first is a franchise mortgage program pursuant to which Falcon Financial provides fixed rate, long-term loans to dealers secured by the dealership's land and buildings. Under Falcon's fixed or "franchise" mortgage program, the fixed rates are clearly higher than floating interest rates. However, the trade-off and consideration received by the dealer for paying the higher interest rate is the freedom from the personal guarantee (for which he is paying an extra one-half point). Under this arrangement, the dealer also is freed from the risks associated with interest rate fluctuations that would otherwise have to be dealt with when the shorter term financing matured and refinancing became necessary. Also, greater proceeds may be paid to the dealer for the real estate because of the recognition of blue sky value as part of the overall funds available under the program.

The second program Falcon offers is a separate sale/lease back program for dealers who do not wish to own dealership real estate, but who wish to utilize the proceeds either to acquire additional dealerships or to make further investment in their existing dealerships. This sale/lease back program is intended to allow the dealer to maintain control over the dealership through a long term lease with the "off-balance-sheet" additional financial advantage. More information on these programs can be obtained directly from Falcon Financial at (203) 967-0000.

Other speakers discussed the ability of dealers to use REITs ... or Upreits as the strategy currently receiving attention in the marketplace. A REIT or Real Estate Investment Trust is simply a corporation that satisfies various Internal Revenue Code requirements under which it must pay out almost all of its taxable income to its share holders. In so doing, the REIT not only complies with IRS requirements, but essentially avoids the double taxation consequences.

What is becoming attractive to many dealers is the opportunity to transfer their dealership realty into a REIT (as contributing partners) and to take back stock in the REIT while the dealership entity leases the real estate from the REIT, making rental payments to it. If the dealer takes REIT stock (instead of cash), he can defer taxes until he sells his stock in the REIT. However, to the extent that the dealer continues to hold the REIT stock, the dealer assumes the traditional market risk that the value of the REIT stock will go up and down over time.

The November 11, 1997 *Automotive News* reported that the Potampkin Companies, one of the largest groups, was planning to sell the real estate for eight of eleven of its dealerships to Kimco Auto Fund and then lease the properties back. The real estate involved was estimated at $50 million. More information is available on these REITs from filings with the SEC after the registration process is complete. Because the franchise is not transferred, the sale of the dealership real estate to a REIT does not require Factory approval.

The "Upreit" approach allows dealers to come as close as possible to having their cake and eating it, too. Typically, this is done by limiting the number of dealership rental parcels in an Upreit so that the dealer comes as close as possible to maintaining the equivalent control and cash flow ***after*** the REIT structure is set up as he enjoyed ***before*** the REIT was set up.

Under a sale-lease back arrangement, the dealer ***sells*** the real estate to the REIT and then leases it back to the dealership. This has the disadvantage in that, for the seller, the sale triggers the realization of taxable income and related income tax consequences. However, REIT ***transfers*** may be structured as non-taxable transactions in the initial transfer of the property to the REIT so long as only stock in the REIT is taken back.

MAKING DEALERSHIPS LOOK LIKE ATTRACTIVE, PROFITABLE, INVESTMENTS

Some say that a major part of the phenomenon of dealerships going public is based upon preoccupations over (1) this year's earnings, quarter-by-quarter, (2) next year's earnings, and (3) long-term projected growth in earnings.

Several speakers addressed the process by which dealership value is created ...or reflected... as a result of looking at prior dealership earnings and recasting them under a "new paradigm". This new paradigm (that's a fancy term for "approach") involves maximizing income and minimizing expense components. While working in their parents' dealerships as young children, many of today's dealers were brought up to appreciate the importance of minimizing income taxes as a way of life and dealership accounting. Today's dealers going public need to be *relobotomized.* Now,

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their alchemist auditors, by a process even Harry Houdini might admire, can transform their dealerships into glittering prospective investments for which multiples of four to six times projected earnings adjusted for add-backs can be obtained in the public market.

Adjustments previously adopted because of their favorable income tax consequence must now apparently be sacrificed at the altar of greater earnings ... and therefore, greater stock values or so the assumption goes!

All one has to do is think like an IRS agent and proceed with abandon to reverse all of the previously hallowed and tax motivated accounting methods and strategies that were adopted. Then, think like an accounting professor grading a CPA exam, and pick up even more income by uncovering all of the violations of GAAP (that's Generally Accepted Accounting Principles) that dealers have indulged in over the years as well.

"ADD BACKS" TO CREATE EARNINGS

1. If the dealership uses the Last-In, First-Out (LIFO) inventory method, switch back to specific identification and/or First-In, First-Out (FIFO) equivalence.

2. Reduce the number of demonstrator vehicles and all expenses associated with them. (See Letter Ruling 9801002 for a real incentive in this direction.)

3. Review the used car write-downs and track the major net adjustment back to a year before the first year of the earnings restatement. Often, the used car writedown may also be normalized so that margins are not distorted from quarter to quarter.

4. Eliminate the "unreasonable" or excessive part of the dealer's salary, as a pro forma benefit, if the dealer agrees to accept a reduced salary/compensation package in the future.

5. Eliminate "excessive" rentals on property leased from the dealer or dealer controlled or related entities.

6. Personal expenses of the dealer/shareholder previously paid for by the dealership can be pulled out of the projection (or treated as a pro-forma addition to earnings) if the shareholder agrees to discontinue running those expenses through the dealership and/or removes the unwanted assets from the dealership.

7. Instead of taking accelerated depreciation on the furniture, fixtures, and equipment, adopt the longest lives possible for depreciation purposes.

8. Add back any income streams from separate, after-market sale entities that might previously have been set up for income and/or estate planning purposes if these are conducted in a partnership or a separate corporation.

9. Add back any charges for non-recurring litigation or legal settlements that are not expected to reoccur.

10. In prior acquisitions where the dealership purchased goodwill or executed consulting agreements and/or non-compete agreements as substitutes therefor, some of the charges against income made in those years may be reversed. The SEC requires amortization of goodwill or blue sky value over a period not to exceed forty (40) years and the period for the automobile industry may be closer to thirty (30) years. Each industry apparently has its own range of life expectancy over which amounts paid for goodwill are to be charged against earnings.

11. In the interests of fair presentation of income, it may be necessary to reduce income (to some extent) by charging expenses against income for prior reserve liabilities in connection with finance contracts that were sold and/or Buy-Here, Pay-Here note lots.

Typically, these liabilities may not have been fully booked in prior years to reflect the dealership's recourse liability for either or both types of customer paper. The customer reserve liability in connection with finance contracts and Buy-Here, Pay-Here could not be deducted for tax purposes because of Section 461 and, accordingly, they were often left off of the books and financial statements as a matter of course. However, often the charges against income to record these reserve liabilities are pushed into prior years so that the charge against current income is minimized.

12. Transfer equity to key employees using stock options: Previously, if a dealer was inclined or required to transfer an ownership interest to a non-family, key employee, that transfer was often done by simply issuing additional stock. This diluted the dealer's previous ownership. Once a dealership goes public, the preferred way to provide employees with equity interests in the dealership entity is by using stock options. Stock options are attractive because as long as the options have an exercise price equal to the value of the stock on the date they are issued, there will not be any earnings impact resulting from the issuance of those options to the key employees. →

Observations on some "techniques" for "creating value": It is not really necessary to go off of LIFO ... although almost all of the public dealerships have done so. Under the regulations, a technicality permits the use of different LIFO methods for income tax reporting and for financial statement reporting purposes.

Ironically, United Auto Group seems to be the only publicly held group using LIFO, and it was United Auto Group that missed its earnings projection by "only" $240,000 and suffered a significant drop in market price of the stock. One wonders whether it might have created far more than $240,000 of income in that prophetic quarter by simply using different LIFO methods for reporting purposes.

Say, what if the IRS gets its hands on these numbers? To the extent these normalization adjustments are made–either in dealership valuations or pro-forma recastings of earnings–one must also ponder whether the IRS might see some of these adjustments as easy targets in open year tax return audits.

For many dealers with non-franchise and/or other unwanted assets, tax planning challenges may arise in attempting to structure ways to pull those unwanted assets out of an S corp. or a C corp. without incurring a significant tax liability on the transaction. The principal way to try to deal with these assets is through a tax-free spin-off. However, this a very technical area of the law and, recently, it has received significant attention from both the IRS and Congress.

The case of *Yarbrough Oldsmobile Cadillac* provides a sobering example of a situation that could be troublesome to a dealer. For discussion of the *Yarbrough* case, see the December, 1995 *Dealer Tax Watch*.

Different levels of materiality and lookback periods: There are different levels of materiality that determine back audit requirements for dealerships that want to go public. If a dealership is acquired, for example, in a merger transaction by Republic and the deal constitutes less than 10% of their assets–which almost all would–and less than 10% of their operating earnings–then there would be no audit requirement because the acquired dealership would be considered an immaterial or insignificant subsidiary.

On the other hand, if a dealership is taking itself public, there is usually a three year back audit requirement. In addition, the date May 15 is important because, after that date, there needs to be some audit work done on the first quarter of the current year. If a dealership participates as a member of a roll-up or it is a more significant subsidiary, then the back audit requirement may be one year or two years.

FINAL COMMENT

This Wall Street Dealers Conference was excellent. Most all of the presentations are available on tape and may be ordered by contacting United Communications Group directly. Hopefully, this Conference will be presented again in the near future with a comparable roster of speakers and topics.

COMMISSIONS PAID TO SALESMEN FOR SELLING CREDIT LIFE INSURANCE *ARE* DEDUCTIBLE

Recently, the Tax Court held that commissions paid by two Michigan auto dealerships to their finance and insurance managers for selling credit life insurance were deductible as ordinary and necessary expenses (*Berger Chevrolet, Inc.,* Tax Court Memo 1997-499). Two dealerships were involved: Berger Chevrolet, Inc., a C-Corporation, and Classic Chevrolet, Inc., an S-Corporation.

As licensed "installment sellers," they were both authorized by the Michigan Motor Vehicle Sales Finance Act to enter into installment sale contracts with any of their customers who desired and qualified for financing. Using forms provided by various financial institutions, the dealers helped purchasers of vehicles obtain financing by entering into installment sale purchase agreements which would be accepted by, and assigned to, a financial institution with whom the dealer arranged financing.

At the same time prospective purchasers were assisted with financing arrangements, they were given the opportunity to purchase credit insurance policies, which, in the event of disability or death, would be payable to the financial institution that held the installment sale purchase agreement. Credit life and credit disability programs were written as group policies in which the buyer enrolled, rather than as individual policies.

During 1990, Classic Chevrolet sold 3,112 new and used vehicles, of which 1,888 were financed with dealer-arranged financing and which generated $280,529 of gross income from dealer arranged financing. During 1990, Berger Chevrolet sold 5,290 vehicles of which 2,561 were financed with dealer arranged financing and for which Berger received gross income from dealer arranged financing of $261,926. To provide credit insurance to its customers, Classic Chevrolet contracted with Western Diversified Life Insurance Company and Berger Chevrolet contracted with American Way Life Insurance Company.

When vehicle purchasers financed the cost of credit insurance as part of their installment sales contract, the premiums for credit insurance were included as a specific item in the contract. The dealerships each collected the full insurance premium as part of the remittance from the financial institution to whom the customer's installment obligation had been assigned. The dealerships made a single remittance each month of all of the insurance premiums they collected to Western Diversified and/or to American Way. The dealerships did not retain any portion of the premiums and they were not reimbursed by either Western Diversified or by American Way for any of their direct or indirect costs in connection with offering and marketing group credit insurance.

For the entire year of 1990, Berger Chevrolet and Classic Chevrolet each employed a finance and insurance manager (F&I manager) and certain salespersons. The responsibilities of the F&I managers and the salespersons included offering group credit insurance to the individuals purchasing vehicles who were financing their purchases by installment payments. If these buyers purchased credit insurance, the F&I manager and/or salesperson calculated the amount of premiums, completed insurance disclosures on the installment sale contract, obtained the buyer's signature, explained the coverages, insured that enrollment certificates were provided to the buyer, and completed the required documentation for the transaction for the respective insurance companies.

Berger Chevrolet paid its F&I manager commissions of $38,500 for selling credit insurance, and Classic Chevrolet paid its F&I manager commissions of roughly $26,000 in 1989 and $29,000 in 1990 for selling credit insurance. Neither Berger Chevrolet nor Classic Chevrolet paid commissions to salespersons other than the managers for selling credit insurance.

DEALER-RELATED AGENCIES AND MICHIGAN LAW

On each credit insurance premium sold and collected by Classic Chevrolet, Western Diversified paid a commission to the Woodcliff Agency, Inc., a duly licensed insurance agency in Michigan. Woodcliff was an S-Corporation whose sole shareholder and director was the wife of the sole shareholder of Classic Chevrolet. Woodcliff's only income was the commissions it received from the sale of credit insurance under Classic Chevrolet's group policy. Woodcliff had no employees and its sole expenses were for accounting fees.

With respect to each credit insurance premium sold and collected by Berger Chevrolet, American Way paid a commission to the Corsa Agency , Inc., also a duly licensed insurance agency in Michigan. Corsa also was an S-Corporation whose shareholders were R. Dale Berger, Sr. and Lynn Berger, each of whom held 50% of its stock. Other family members owned the stock of Berger Chevrolet. Like Woodcliff, Corsa's sole income was the commissions it received from the sale of credit insurance, it had no employees,

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and its only expenses were taxes, professional fees and administrative fees.

Under Michigan law, motor vehicle installment sellers are prohibited from directly or indirectly receiving any portion of the credit insurance premiums. Because of this law, insurance agencies are created to collect the commissions paid by the insurance companies. These agencies were recognized as legally separate from the dealerships under Michigan law even though they were closely related to the dealerships and were usually owned by individuals related to the dealerships' owners.

The Tax Court found that, realistically, the sale of credit insurance is part of the dealership's function. Dealerships perform a variety of services, including selling cars, arranging financing and fulfilling warranty obligations as defined in service contracts. Among the services, offering credit insurance is a "subservice of arranging financing."

Although the commissions paid by the insurance companies (Western Diversified and American Way) were paid to the dealer-related agencies, it was clear from the record that the dealerships earned these commissions. It was also clear that those commissions were paid to the dealer-related agencies only because the Michigan law mandates that result. The only role the dealer-related agencies play is as a repository of commissions paid by the insurance companies.

WHY DID THE IRS TAKE THE POSITION IT DID?

The Court stated that "because the earnings of the dealerships are diverted to the dealer-related agencies, it may be questioned why the Commissioner did not impute the agencies' earnings to the dealerships." It cited *Lucas v. Earl* to the effect that the Supreme Court held that income must be taxed to the person who earns it.

The Court observed that the Commissioner was not taking that approach or making that argument in the instant case involving Berger or Classic. "Instead, the Commissioner denied the dealerships' deductions for the commissions paid to their managers on the theory that the commissions are an expense of the dealer-related agencies."

Since the issue presented to the Tax Court was not whether the commissions paid by the insurance companies should be included in the gross income of the dealerships, but rather whether the dealerships were entitled under Section 162 (a) to a deduction for the commissions that they paid to the managers for selling credit insurance, the Court had to deal with the issue as it was presented.

Accordingly, the Tax Court held that the compensation/commissions paid by the dealerships to their managers were deductible as business expenses under Section 162 (a).

F&I COMMISSIONS ARE ORDINARY AND NECESSARY EXPENSES

Section 162 (a) allows as a deduction all the ordinary and necessary expenses paid and incurred during the taxable year in carrying on any trade or business. An ordinary expense is one that is "normal, usual, or customary" in a particular business even if it occurs only once or infrequently. One of the extremely relevant circumstances is the nature and scope of the particular business out of which the expense in question accrued. A necessary expense is one that is "appropriate and helpful." Ultimately, whether an expense meets the requirement of being "ordinary and necessary" is a question of fact.

> The Tax Court observed: "A dealership's business encompasses a wide range of activities beyond a mere sale of a vehicle. The arrangement of financing of sales on an installment plan is a familiar aspect of a dealership's business and the offer of credit insurance with respect to such sales is proximately related thereto."

Almost 61% of the new and used vehicles sold by Classic Chevrolet, and almost 50% sold by Berger Chevrolet were sold with dealer-arranged financing. Both the dealerships and the various financial institutions with whom they did business expected that someone at the dealership would be able to explain and offer credit insurance to the customer while the customer was filling out the installment sale purchase agreement.

The commissions paid by dealerships to individuals for selling the credit insurance constitute an "ordinary" expense because virtually all dealerships offer credit insurance. The offering of credit insurance on the installment agreement requires various explanations by a salesman or a manager. The employees whose duties included (1) explaining to customers the nature of the insurance coverage, (2) calculating its cost, and (3) arranging for the financing of the cost of that credit insurance itself ... would be entitled to receive some compensation for providing those services to the prospective purchasers.

see **COMMISSIONS PAID TO SALESMEN FOR SELLING CREDIT LIFE *ARE* DEDUCTIBLE**, page 10

The Court also found that the payment of commissions was "necessary." Because the installment sales purchase agreements offered the option for credit insurance, it was necessary to have people who could explain precisely what that option entailed.

In order to keep up with other competitor dealers, and in order to offer "one-stop" service for financing, the dealerships must have employees who can explain the function of credit insurance to customers and who are able to calculate the premiums. Paying commissions to the managers is an "appropriate and helpful" step in achieving those objectives.

THE IRS MISTAKEN RATIONALE ... ITS FAILURE TO RECOGNIZE THE BREADTH OF A DEALERSHIP'S BUSINESS

The Tax Court indicated that the IRS was relying on "an artificial distinction between the dealerships and the related agencies." The IRS position was that the compensation (or commissions) paid to the F&I managers constituted an expense of the dealer-related agencies, and not an expense of the dealerships. The IRS argument was that the dealerships were not entitled to a deduction unless they could show that compensating the managers resulted in a direct and tangible benefit to the dealerships. The IRS had further contended that the dealerships were not in the insurance business and, therefore, should not be allowed to deduct insurance expenses.

The Tax Court said that the IRS was mistaken in treating the dealerships and the dealer-related agencies as separate, autonomous organizations. The dealership provides the service of offering, explaining, and calculating credit insurance. The agencies have no employees and are merely shadow entities; they do not in fact sell insurance. The agencies receive the commissions on the premiums, but that result is required by Michigan law. Although Michigan law governs as to the rights created and the relationships involved, it is Federal law that is determinative as to tax consequences.

Second, ***the IRS failed to either recognize or give sufficient weight to the role F&I plays in a dealership.***

The Court held that ***credit insurance was a small, but nevertheless integral, part of a dealership's business***. As a result, it allowed the dealerships to deduct the commissions paid.

> ***"The Government fails to recognize*** the dealership's role in fact in the sale of credit insurance and in that connection ***the breadth of a dealership's business***.
>
> A motor vehicle dealership does more than merely sell vehicles. Among other things, it arranges for financing of installment sales and offers credit insurance in respect of such sales. Although the dealerships are not engaged generally in the insurance business, they do deal with credit insurance to the limited extent that it relates to dealer-arranged financing."

OBSERVATIONS

Although this case may be of somewhat limited interest insofar as it appears to affect only Michigan dealerships, it does suggest that should the IRS want to look further at these "dealer-related agencies" in the future, it may try a different challenge than it did in *Berger Chevrolet*.

In a 1972 case mentioned in a footnote *(First Security Bank of Utah)*, the Supreme Court held that income may not be allocated to persons who are prohibited from receiving it. In order for income to be allocated under Section 482, the taxpayer must have complete dominion over it; the taxpayer must have been able to receive the income if he had not arranged for it to be paid to someone else. With the encouragement of the two dissenting opinions in this case, might the IRS try to mount another attack?

For another possible ramification, consider the question of whether F&I managers qualify for favorable fringe benefit treatment if they are provided with demonstrator vehicles by their employers.

Dealers may want to remember some of the Court's language about the "breadth of a dealership's business" and "credit insurance being a small, but nevertheless integral, part of a dealership's business,"in connection with these F&I manager and employees who are provided demonstrator vehicles ... For more on this, see the discussion of LTR 9801002 in this issue.

MORE ON COVENANTS NOT TO COMPETE & *HOWARD PONTIAC-GMC, INC.*

In the last issue of the *Dealer Tax Watch*, we discussed the *Howard Pontiac-GMC* case in which the Tax Court looked at $500,000 paid in excess of net assets and valued the seller's non-compete agreement at $300,000. This was just about half-way between the taxpayer's allocation of $490,000 and the IRS' allocation of $125,000.

This case is another good example of the Tax Court's reminder to parties that bring before it valuation matters that it is impossible to infuse "a talismanic precision into an issue which should frankly be recognized as inherently imprecise and capable of resolution only by a Solomon-like pronouncement."

Many dealerships bought out other dealers and franchises after 1986 and before August, 1993. During this time interval, the interests of the sellers and the interests of the buyers in the allocation of sales price of the business to various intangibles, such as goodwill and covenants not to compete ... were not adverse. Consequently, the allocations before the enactment of Section 197 in August of 1993 relating to the amortization of intangibles may be looked at closely by the Internal Revenue Service.

Since many dealerships acquired others during this 1987-1993 time frame, they still may have open years during which the IRS may contest those allocations. The brief filed by the Internal Revenue Service in *Howard Pontiac-GMC, Inc.*, provides further insights into the current thinking of the IRS in challenging the deductions for the amortization of payments under non-compete agreements.

In general, the IRS looks at three factors:

1. Lack of adverse positions between the buyer and the seller,
2. Degree of negotiation between the buyer and the seller for a non-compete covenant, and
3. Overall substance of the transaction.

LACK OF ADVERSE POSITIONS

Before 1987 and the passage of the Tax Reform of 1986, the buyer and the seller had competing and conflicting tax interests in the allocation of the purchase price of a business to intangibles being sold including goodwill and covenants not to compete. Due to the differential in tax rates between capital gains and ordinary income, a "tension" existed between the buyer and the seller in negotiating the allocation of the purchase price to the covenant not to compete. The seller benefited with respect to his or her income tax position by allocating as little as possible to the covenant not to compete and by allocating as much as possible to the purchase price received for the business, including its goodwill. Amounts that the seller received in payment for stock were preferable to the seller because such payments represented more favorably taxed capital gain to the extent that the purchase price exceeded the seller's basis in the stock of the corporation.

On the other hand, the purchaser of the business preferred to allocate as much of the purchase price as possible to the seller's covenant not to compete because that amount would be amortizable by the seller over the term of the non-compete agreement as a deduction against other ordinary income. In contrast, the portion of the purchase price paid for the business which included transferred goodwill and going concern value was a non-depreciable capital asset or investment which the buyer could not immediately write off or deduct over a short-term amortization period.

The Tax Reform Act of 1986, among other things, eliminated the preferential income tax treatment for capital gains. Consequently, for transactions occurring after 1986, the tax interests of the buyer and of the seller with respect to amounts allocated to a covenant not to compete were not adverse. In other words, the seller would incur the same income tax costs regardless of whether an amount received was for goodwill (taxed as capital gain) or non-compete agreement payments (taxed as ordinary income).

With the elimination of the preferential capital gain tax treatment, the seller of the business no longer incurred any significant tax advantage if more of the purchase price were allocated to the covenant not to compete. As a result, the seller of a business would be more inclined to agree to include a covenant not to compete provision in the buy-sell agreement ... and would be more willing to allocate a larger portion of the purchase price to that covenant. This would benefit the purchaser of the business because it could amortize a greater portion of the total purchase price paid for the business with those deductions reducing the after-tax cost of purchasing that business.

Before the enactment of Section 197 in August of 1993, Section 167 was the controlling provision of the Internal Revenue Code for the amortization allowance for intangible assets. Reg. Sec. 1.167(a)-3 required that the intangible be known from other experience or other factors to be of use in the trade or business for only a limited time–the length of which

see **BUY-SELL AGREEMENTS: MORE ON COVENANTS NOT TO COMPETE & *HOWARD PONTIAC-GMC***, page 12

 (Continued from page 11)

could be estimated with reasonable accuracy–and that the deduction not be for goodwill. Because a covenant not to compete usually contained a specific provision stating its duration, its limited life in terms of years was known, and, therefore, the first requirement for deduction generally was met.

IRS attention, therefore, generally focused upon the genuineness and/or the value of the covenant not to compete. Several tests for determining the validity and the value of covenants not to compete have been developed by the Courts over a period of time.

"ECONOMIC REALITY" TEST

The economic reality test is primarily concerned with whether or not a non-compete covenant has independent business or economic significance. As such, this test inquires into the (1) reasonableness of requiring a seller to provide assurances that it will not compete and (2) reasonableness of the amount paid by the seller for such a covenant.

The economic reality test has been described in the following terms: "The covenant must have some independent basis in fact or some arguable relationship with business reality such that reasonable businessmen, genuinely concerned with their economic future, might bargain for such an agreement."

Where the seller is likely to pose a real threat of competition to the buyer, the Courts generally will sustain some allocation of the selling price to the seller's agreement not to compete with the buyer. Several factors are usually considered in this regard:

NON-COMPETE ISSUES

1. Whether any non-contractual restrictions would prohibit the seller from competing with the buyer in the absence of a covenant not to compete;
2. The seller's intention to compete, either by acquiring or starting a new business in the same market ... or by seeking employment with an existing competitor;
3. Scope of the covenant;
4. Enforceability of the covenant; and
5. Formalities of the covenant.

Non-contractual restrictions that might prohibit the seller from competing would include such things as "limited market entry." This was a factor that the IRS argued was present in the *Howard Pontiac-GMC* case. This factor is important where a covenant is granted in conjunction with the transfer of a franchise, license, or operating authority where market entry is limited. In the transfer of automobile dealerships, market entry may be limited by the franchisor/manufacturer or by state law.

With respect to the seller's ***intention*** to compete, a covenant is not meaningful if the seller has stated his or her intention to retire or to leave the geographic area covered by the covenant. Under these circumstances, the seller would pose no real threat of competition to the buyer.

Beyond the seller's ***intention*** to compete lies the subjective area of the relative competitive strength of the seller to compete with the buyer after the sale. Another factor in this regard relates to the degree of cooperation, advice, and consultation that a prospective seller might be committed or obligated to provide to the purchaser of the business during a period of "joint operation of the business." In *Howard Pontiac-GMC*, there was a period of joint operation during which the seller provided what the IRS regarded as "sufficient opportunity" for the purchaser to draw upon his special knowledge and expertise concerning the franchise (Jeep-Eagle) operations such that a consulting contract for that purpose was not required. The IRS concluded that the seller's "special knowledge and expertise" did not constitute a potential competitive advantage or significance.

The IRS brief discusses the limitations on the seller's reentry into the buyer's sales area imposed by both (1) Chrysler Corporation, the franchisor/manufacturer and (2) Oklahoma (state) law. The IRS observed that "With three franchises already in the market, no more would have been forthcoming. This is the same market entry limitation which caused the (buyer) to seek the seller's franchise instead of seeking to acquire an additional franchise from Chrysler."

With respect to the scope and formalities of the covenant not to compete, the IRS argued that the seller was permitted the opportunity to engage in significant competitive activity, if it wished, because of the presence, in some cases, and the absence, in others, of various provisions. The seller could compete in a county adjacent to the county in which the business was sold. The covenant did not preclude the seller from going to work for another Jeep-Eagle dealer provided the seller did not earn more than $100,000 per year.

LACK OF NEGOTIATION OVER ALLOCATION

Another theme in the IRS brief was that there was no evidence in the record that there was any negotiation concerning the expansion of the covenant not to compete to include new car sales <u>generally</u>. In its testimony at trial, the seller could not recall any real negotiations over the terms of the covenant and what adjustments might be made to provide additional opportunities to work in the new car market in Oklahoma City.

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The IRS brief argued that it appeared that the parties were not sufficiently concerned about the terms of a non-compete agreement to carefully review them before signing it. Further, the IRS inferred, the parties both made certain assumptions about the substantive content of the agreement without bothering to scrutinize the final document. The Service argued that the negotiations between the buyer and the seller were only as to the lump sum amount that the seller would receive over and above the tangible assets of the dealership. "This is the amount the seller required to give up a business that was successful and earning him a very good living."

SALES OF DEALERSHIPS INVOLVE STEP TRANSACTIONS... *"SUBSTANCE OVER FORM"*

In *Howard Pontiac-GMC, Inc.*, the IRS brief argued that in substance and in fact, Howard set out to acquire and did acquire a Jeep-Eagle franchise. The substance of the negotiations between the buyer and the seller was directed to the amount that the seller would receive from the buyer for his explicit agreement to sell his dealership ...and for his implicit agreement to release his franchise in the buyer's favor. The entering into a covenant not to compete was but one component of completing the deal. The key components were (1) release of existing franchise by the seller, (2) approval of the buyer by Chrysler Corporation to receive the franchise, (3) approval of the buyer's existing business location by Chrysler, and (4) approval of the buyer by the Oklahoma Motor Commission to receive the necessary license.

The IRS indicated that in the typical sale or transfer of a business founded on a franchise, the franchise is not directly sold by the seller to the buyer. Rather, it involves a series of transactions or step transactions in which the sale of the business is made contingent on the franchisor's agreement to transfer the franchise to the buyer. Only then is the deal consummated. In operation, the seller agrees to release the franchise back to the franchisor provided that the franchisor agrees to transfer the franchise to the buyer. The seller's agreement to release the franchise is of great value as it is the *sine qua non* by which the seller receives the future benefit inherent in the franchise and by which the seller transfers the underlying business activity.

The IRS cited the *Hampton Pontiac Inc.* case in which the Court stated that since all payments under the (non-compete) agreement were only to be made if and after the buyer acquired the franchise, that demonstrated indisputably that the payments were directly related to the acquisition of the franchise. In *Hampton*, the contract with the seller, and the obligations thereby undertaken by the buyer, were an integral part of buyer's expense of acquiring its Pontiac franchise. Accordingly, payments made thereunder represented items includible in the buyer's invested capital and were not deductible as business expenses. The Tax Court, in its opinion in *Howard Pontiac Inc.*, did not refer to the *Hampton Pontiac* case.

In the *Howard-Pontiac* case, the IRS observed that the future benefit of the Jeep-Eagle franchise was especially great to the buyer because the buyer had unused capacity in its auto mall and because it needed additional franchises so that it could implement the auto mall concept of attracting customers.

The IRS argued that the substance of the transaction in *Howard Pontiac* was the same as the substance in the *Hampton* case. Accordingly, once the substance of the transaction is thus recognized, the cost attributable to acquiring the future benefit bestowed by the franchise on the buyer must be capitalized. The IRS also cited *Indopco* in support of its position.

VALUATION OF COVENANTS NOT TO COMPETE

The factors referred to in evaluating the economic reality test also apply in considering the value or amount allocated to a non-compete agreement. In short, the value allocated to the covenant must reflect "economic reality" also.

The value of the non-compete agreement to the purchaser derives from the increased profitability and the likelihood of survival of the newly-acquired enterprise that the seller's agreement not to compete affords. The value of a non-compete agreement to the seller, on the other hand, is measured by the opportunities the seller is willing to forego to reenter a particular market for a given period. See *Better Beverages v. US*. Consequently, there generally is no correlation between the value of a non-compete agreement to the seller ... and the value of that same agreement to the buyer.

One method for valuing a covenant not to compete is the compensation-based approach under which the seller's average compensation is calculated, projected over the life of the covenant, and subjected to a discount rate to adjust the figure to its present value. This method attempts to measure the loss of earnings anticipated by the seller as a result of his forbearance from competing in the specified market area.

Another method for valuing what the buyer acquired in paying for the non-compete agreement looks at the protection of the continued profitability of the business from the seller's hostile use of his or her contacts in that market area. Under this method of approaching the valuation from the buyer's standpoint, one calculates the present value of the economic loss

see **BUY-SELL AGREEMENTS: MORE ON COVENANTS NOT TO COMPETE & *HOWARD PONTIAC-GMC***, page 14

to the buyer on the assumption that the seller reentered the market.

This was the essence of the method the IRS said it used in the *Howard Pontiac-GMC* case to come up with a valuation of $125,000 for the covenant not to compete. (The Tax Court determined the value of the covenant not to compete to be $300,000.) The IRS cited as authority for its approach *Ansan Tool and Manufacturing Company* (T.C.Memo 1992-121), which provides an interesting and very detailed backdrop of the different valuation methods.

CONCLUSION

Section 197 provides that for sales after August, 1993, amounts paid for goodwill and/or for any covenant not to compete will be treated as intangibles and must be written off over a 15 year period. For pre-Section 197 buyers who still have deductions for amounts paid for non-compete agreements in open years, the IRS' arguments and approaches in *Howard Pontiac* provide some idea of what current agents may be thinking.

In many other contexts, the necessity to determine values for non-compete agreements given by sellers still may require judicious consideration of the economic reality and other tests so that the seller obtains the best possible tax results in his or her individual tax return.

With the reintroduction of more favorable long term capital gains treatment by the Taxpayer's Relief Act of 1997, a whole new slant may have been given to the "tax adverse" or "tax indifferent" natures of buyers and sellers of dealerships. Sellers may now want less allocated to their non-compete agreements... and more to goodwill.

Furthermore, Project 2000 implications and dealer consolidation strategies ... especially the far greater reluctance of many manufacturers to automatically renew franchises ... or to re-award them to others in exactly the same market area ... in some instances may provide different rationale for amounts negotiated for non-compete agreements.

Will the IRS end up arguing against its previous positions if sellers now want to have less allocated to non-compete agreements ... and the buyers–entitled to 15 year write-offs for either goodwill or non-compete agreements–become "tax indifferent" to the allocation?

DEMONSTRATOR USE & LTR 9801002

It is important to put Letter Ruling 9801002 in perspective. This Letter Ruling/ Technical Advice Memo applies ***only*** to the auto dealer under audit to whom it was issued by the IRS ... and, it is based upon all of the facts comprising the entire dealership activity relative to the use of its demo vehicles by employees. The facts and the procedures that were followed ... and that were not followed ... resulted in the IRS reaching these unfavorable conclusions.

Dealers and their CPAs should be especially alert to avoid many–if not all–of the shortcomings evident from the factual recitation.

This Letter Ruling is based on very unfavorable facts as far as a dealership goes. Like all LTRs, it concludes with the statement that under Section 6110 (j)(3), it may not be used or cited as precedent. Most of us expect that in reality, this ruling will receive significant attention and make it all the more difficult in the future for dealers to satisfy IRS agents looking at demo use.

For a summary of the issues and holdings, see page 17.

For the applicable code sections and regulation citations, see pages 22-27.

Most readers would rather shout "Rubber Baby Buggy Bumpers" a few thousand times nonstop ...than try to navigate these detailed citations from start to finish in one sitting.

TAXABLE FRINGE BENEFITS FOR DRIVERS & BIG TAX LIABILITIES FOR AUTO DEALERSHIP CREATED BY DEMONSTRATOR USE

DEMOS
LTR
9801002

In September, 1997 we alerted readers to expect a major, adverse development very soon involving demonstrator vehicle use. On the doorstep of the New Year, the IRS released a Technical Advice Memo in which the National Office ruled that demo vehicle use by employees of an auto dealership could not be excluded from income as a working condition fringe benefit because of the lack of necessary substantiation.

In Letter Ruling 9801002, the IRS held that sales and nonsales employees of a dealership under audit were not entitled to exclude the value of the use of the vehicles from gross income as a working condition fringe because the substantiation requirements within the meaning of Section 274(d) were not satisfied. The Service held further that the more favorable lease valuation rule and tables could not be used. Finally, with every form of compensation –whether, indirect or fringe, there are related employment tax obligations and the liability of the dealership for "employment taxes" on the employee use of demo vehicles was not overlooked either. In this ruling, the IRS held that the dealership was liable for applicable employment taxes on all demo vehicles, including those for which no particular employee could be identified.

The Letter Ruling overflows with references to the labyrinthine Code sections and regulations that cover this area. The interplay between Code Sections 274, which requires documentation and substantiation, Section 61 which provides general and safe harbor rules for valuation of the benefits, and Section 132 which provides countless other rules for this fringe benefit treatment ... is marvelous to behold. And this was ***all*** brought to bear adversely to the dealership under audit.

The dealership did have demonstrator policies "in place," but those policies were far from adequate as far as the IRS was concerned ... as was the significant lack of effort evidenced by the dealership to police or verify the accuracy of the information provided by the users of the demonstrator vehicles. Many dealerships have ceased providing demonstrator vehicles to employees in recent years. However, there are still many that do so and feel safe simply because they have dusted off a "demo agreement" and have copies of it in the files. That simply is not enough ... as this Letter Ruling makes painfully clear. Furthermore, the amount of income that users of demo vehicles will have to report may be significantly greater as a result of the IRS holding that the Auto Lease Valuation Tables cannot be used for purposes of measuring the amount of income the driver of the demo has to report in his or her personal income tax return.

GENERAL BACKGROUND

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

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

3 TESTS

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

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

The preceding tests are met by determining a person's activities and job functions, and they are not affected or influenced by his or her job title. Therefore, in some dealerships, general managers would qualify under the exception if they satisfy all three tests above. In most dealerships, all salespeople should qualify, and in most

see **DEMONSTRATOR USE...**, page 16

cases, sales managers may qualify as well. It would appear that F&I managers and salespeople would only qualify for the exemption if it can be shown that in addition to selling finance and insurance, the employee also spends 50% of a normal business day negotiating or participating in the negotiation of vehicle sales.

Although the answer may vary from dealership to dealership, it appears the position of the IRS is that F&I managers or other F&I personnel driving demos would not qualify as "full-time salespersons." However, the Tax Court in late 1997 shed some light on its interpretation of the necessity for a F&I department in an auto dealership. In the *Berger* case, the Tax Court held that F&I departments were a small, but nevertheless, integral part of a dealership's activities. See the discussion of what the Tax Court said in the *Berger Chevrolet* decision in the article beginning on page 8.

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

FMV OF USE OF VEHICLE - BUSINESS USE = TAXABLE PERSONAL USE BY EMPLOYEE

IRS AUDIT ISSUES

Recently, the IRS has conducted several major audit programs specifically aimed at dealership demonstrator policies. A number of issues have been raised during these audits, including (1) what constitutes adequate recordkeeping and documentation and whether logs are required to be maintained, (2) the application of a special $3.00-per-day commuter rule, (3) the dealership's payroll tax liabilities in connection with demo use, and (4) whether F&I managers and salespeople may be *eligible* "salespersons".

In some of these audits, the IRS has taken the position that in order to qualify for the salesperson exemption, salespeople must keep daily logs to substantiate that their personal use was not excessive. The agents claim that if salespeople don't keep logs, they do not qualify for the exemption. Now, LTR 9801002 supports the IRS agents on this point. NADA and many dealers believed that the "adequate records" requirement could possibly be satisfied by the use of a written demonstrator policy which substantially restricts personal use of the vehicle and is monitored by dealership management or by a weekly mileage report which is also monitored on a regular basis by management.

In light of the recent increase in audit activity–and now especially with the issuance of LTR 9801002–dealers need to **immediately** reassess their procedures relative to demonstrators. Many may want to consider instituting the more conservative practice of requiring using logs to protect both the dealership and their employees. Despite the burden and practical problems that a daily log requirement creates for the dealerships and their employees, without a daily log, there seems to be little or no hope for favorable taxable treatment of demo use.

$3.00 PER DAY COMMUTER RULE ... VERY UNLIKELY TO APPLY

A number of methods can be used to determine the value of a demonstrator. Many dealers have used the $3.00-a-day commuter rule method to value salespersons' vehicles and also to value other non-salesperson employees' vehicles. In order to qualify for the commuting method under Reg. Sec. 1.61-21(f)(3), in which the employee is charged $3.00 per day for the use of the vehicle, only *de minimis* personal use (e.g., stopping at the store on the way home from work) is allowed.

Many dealership employees will not be able to use the commuter rule method to value their demonstrators because they exceed the *de minimis* personal use requirement. Even ***occasional*** use of the vehicle on weekends by the employee would exceed the *de minimis* personal use standard. Therefore, unless the employee is restricted to using the vehicle for commuting purposes only, the $3.00-per-day commuter rule method for valuation would not be available.

Furthermore, most dealers and general managers will not be eligible to use the $3.00-per-day commuting rule because it cannot be used by employees who are directors, 1% or more owners, or by employees whose compensation exceeds $100,000.

FACTS CONCERNING DEMO USE AND POLICIES IN LTR 9801002

During the years at issue, the dealer provided demonstrator vehicles to both sales and nonsales employees for both business and personal use. Except for employees who were hired or terminated during the year, each employee was assigned a demonstrator vehicle for the entire year. During the years at issue, no amount for the

see **DEMONSTRATOR USE...**, page 18

USE OF DEMONSTRATOR VEHICLES BY DEALERSHIP EMPLOYEES
LTR 9801002

ISSUES	HOLDINGS
Demos Furnished to *SALES* Employees 1. Are the applicable substantiation requirements satisfied so that the use of the vehicles provided to the dealer's *sales* employees is "qualified automobile demonstrator use" under Section 132(j)(3) of the Code and is, thus, excludable from income under Section 132(a)(3) as a working condition fringe for the years at issue?	1. Due to the lack of necessary substantiation within the meaning of Section 274(d), the use of demonstrator vehicles by the dealer's *sales* employees is not "qualified automobile demonstrator use" within the meaning of Section 132(j)(3) and is not excludable from gross income as a working condition fringe under Section 132(a)(3) for the years at issue. Neither the general substantiation requirements (of Reg. Sec. 1.274-5T) nor the safe harbor substantiation requirements (of Reg. Sec. 1.274-6T) have been met as required by the regulations under Sections 132 and 274.
Demos Furnished to *NONSALES* Employees 2. Are the applicable substantiation requirements satisfied so that a portion of the use of the vehicles provided to the dealer's ***nonsales*** employees is excludable from income under Section 132(a)(3) of the Code as a working condition fringe for the years at issue?	2. For the same reason, (i.e., due to the lack of necessary substantiation within the meaning of Section 274(d)), the use of demonstrator vehicles by the dealer's ***nonsales*** employees is not excludable from gross income as a working condition fringe under Section 132(a)(3) for the years at issue.
3. Is the dealer entitled to use the automobile lease valuation rule provided in Reg. Sec. 1.61-21(d) for purposes of valuing the personal use of vehicles provided to ***sales*** and ***nonsales*** employees during the years at issue?	3. The dealer is not entitled to use the automobile lease valuation rule in Reg. Sec. 1.61-21(d) for purposes of valuing the personal use of vehicles provided to ***sales*** and ***nonsales*** employees during the years at issue. Consequently, the fair market value of the fringe benefits must be determined using the general valuation rules. The safe harbor fair market values are not available. Under the general rules, the fair market value generally equals the amount that an individual would have to pay in an arm's-length transaction to lease the same or comparable vehicle on the same or comparable conditions in the same geographic area in which the vehicle is available for use. The cost incurred by the dealer for a vehicle is not determinative of its fair market value.
4. Is the dealer relieved of its obligation for any employment taxes imposed under Sections 3101, 3111 and 3401 on the employee use of demonstrator vehicles for which a particular employee cannot be identified? ***LTR 9801002***	4. The dealer is not relieved of its obligation for any employment taxes imposed under Sections 3101, 3111 and 3401 on the employee use of demonstrator vehicles for which a particular employee cannot be identified (i.e., "unknown" vehicles). The dealer is required to withhold and pay both portions of the FICA tax and the appropriate portion of income tax on all wages paid by the employer (subject to certain ceiling limitations for FICA tax purposes), including the benefit of personal use of employer-provided demonstrator vehicles. The fact that the inadequacy of the dealer's records may make it impossible to identify the particular employee to whom the employee use of the **unknown** vehicles should be attributed does not relieve the dealer from its withholding and payment obligations with respect to the amount of wages paid.

 (Continued from page 16)

use of any vehicle was included on the Forms W-2 issued to the sales employees. Conversely, the dealer did include amounts for the use of the vehicles on the Forms W-2 issued to the nonsales employees during the years at issue, purportedly to reflect the fair market value of the personal use of such vehicles.

The dealer conceded that no accurate records were kept during the years at issue indicating which employees used which vehicles during such time. During the course of the IRS audit, records were constructed as accurately as possible from information obtained from service department records and sales jackets and invoices. According to the reconstructed information, some employees had multiple vehicles assigned to them at one time, while other employees had gaps in which no known vehicle was assigned for their use, despite the dealer's assertion that each employee had been assigned a vehicle for the entire year. According to the reconstructed information, a few employees did not have a vehicle assigned to them. Perhaps correspondingly, a few demonstrator vehicles with accumulated mileage could not be attributed, based on the information from the various records, to particular employees.

The dealer provided two written policies regarding the use of demonstrator vehicles for the 1993 and 1994 years, respectively. According to the information submitted, the policies were updated periodically as needed, but not necessarily on a calendar year basis. Apparently, the dealer provided copies of the written policies to both its sales and nonsales employees for their signatures. The copies presented to the IRS during its audit were dated September, 1993 with respect to the 1993 policies and were not dated with a year or were dated 1995 with respect to the 1994 policies. According to the dealer, the policies were usually signed at the start of the model year (i.e., approximately September), but were effective on January 1 of the same calendar year.

Both demonstrator policies prohibited storage of personal possessions in the vehicles and limited the personal use of the vehicle to only commuting and local errands. However, only the 1994 policy expressly prohibited the use of the vehicles for vacations and by persons other than the employees. Neither policy expressly limited the amount of use of the vehicles outside the normal working hours. Both policies stated that the employee must contact a particular named individual to take a vehicle out of demonstrator service or to place a new vehicle in demonstrator service.

The 1993 demonstrator policy requested an employee's estimate of the total mileage to be driven using company vehicles during the year. However, such information was not provided by the employee on the copy presented to the IRS. The 1994 policy requested the following additional information: the vehicle's stock number, in-service and out-service dates, and model type, implying that the employee was to sign a new policy with respect to each separate demonstrator vehicle assigned to such employee. With the exception of the out-service date, this information was provided by the employees on the copies of the policy presented to the IRS; however, no employee had multiple policies for a year, despite the fact that the majority of the employees used more than one demonstrator vehicle during the year.

Although the policies for both years stated that the demonstrator vehicles must be taken out of demonstrator service when the odometer reached 6000 miles, many of the vehicles (approximately 47 percent during the years at issue) had mileage in excess ... some significantly in excess ... of 6000 miles before they were removed from the demonstrator vehicle roster. The dealer maintained that the 6000 mile limitation, notwithstanding the policies' use of the word "must" was only a goal...and not a requirement. The amount of miles placed on a vehicle in demonstrator status was, according to the dealer, a product of various factors, including the availability of replacement vehicles, the time of year with respect to the announcement of new models, the number of demonstrator vehicles currently out of service waiting to be sold, and the percentage of new car inventory not used as demonstrator vehicles. Furthermore, according to the dealer, some of the miles significantly in excess of 6000 were attributable to the parts and body shop managers.

During 1993, managers of the dealership completed monthly demonstrator mileage statements showing each nonsales employee's personal use percentage on demonstrator vehicles, presumedly based on the employee's <u>undocumented and unverified statement to the employer</u>. The total mileage of a particular demonstrator vehicle (or of all demonstrator vehicles) used by an employee during that month was not provided on such statement. The employees were not required to keep, nor to provide to the employer, any records to substantiate the implied percentage of nonpersonal (i.e., business) use not specifically indicated on the statement. The dealer used the provided percentage of personal use to calculate the amount to be included in the Forms W-2; however, the dealer <u>kept no records regarding how such calculation was made</u>. The only indications of the dealer's method of calculation were the references to "lease value" in the 1993 and 1994 demonstrator policies and the demonstrator mileage statements, the policies' indication that the lease value was based on "invoice plus $200 as a cost basis," and the dealer's reference to the current *IRS chart.*

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In 1994, the dealer changed its method for determining the Form W-2 amount for the nonsales employees because, according to the dealer, the managers did not feel that the information provided by the nonsales employees was realistic. Therefore, the managers began determining the percentage of personal use for each nonsales employee based on the distance of the employee's commute, whether the employee had another personal vehicle, and the duties of the employee. The dealer used this percentage to calculate the amount to be included on the Form W-2. No records were kept with respect to these calculations either.

IRS' INTERPRETATION OF SUBSTANTIATION REQUIREMENTS WHERE DEALERSHIP PROVIDES DEMONSTRATOR VEHICLES

The Service's explanation of its rationale for concluding that the demonstrator vehicles provided were not working condition fringe benefits contains specific references to all of the sections of the regulations upon which it relied. From here on, the reading gets tougher because of the intricate relationships of these sections to each other.

To be excluded as a working condition fringe under Section 132(a)(3),an employee's use of a demonstrator vehicle must be substantiated within the meaning of Code Section 274(d) and the regulations thereunder. While Section 132(j)(3) specifically provides that qualified automobile demonstrator use shall be treated as a working condition fringe, under Reg. Sec. 1.132-5(o)(6), the value of such use is not excluded as a working condition fringe unless the substantiation requirements of Code Section 274(d) are met with respect to the substantial restrictions imposed on the use of such vehicles.

The dealer provided demonstrator vehicles for the business and personal use of its **sales** employees during the years at issue. Whether the sales employees may exclude the entire value of the use of the vehicles from their incomes depends on whether the dealer substantially restricted the use of the vehicles, within the meaning of Reg. Sec. 1.132-5(o)(4), and whether such restrictions were substantiated, within the meaning of Reg. Sec. 1.132-5(o)(6) and Section 274(d).

Whether the substantial restrictions existed must be determined on the basis of all the facts and circumstances. LTR 9801002 states that the mere existence of a written policy, if its terms are not followed, does not satisfy the requirement that substantial restrictions limiting and prohibiting certain uses of the demonstrator vehicles exist.

In the instant dealership case, neither demonstrator policy expressly limited the total use by mileage of the vehicles outside of the employee's normal working hours. This is a necessary restriction under Reg. Sec. 1.132-5(o)(4). Second, the demonstrator policy effective during 1993 did not expressly prohibit the use of the vehicle by individuals other than the particular sales employee. This is another necessary restriction under Reg. Sec. 1.132-5(o)(4). Such prohibition was added to the policy effective for 1994. Third, a copy of the written demonstrator policy was apparently signed by each sales employee, however, in most, if not all cases, the policy was signed many months *after* the effective date of such policy, thus, calling into question the substance of the written policy. Finally, the incompleteness of the signed policies (i.e., no total mileage estimate, no out-of-service dates) and the lack of multiple policies for employees who used multiple vehicles also indicated that employee adherence to the restrictions may not have been sufficiently monitored, and therefore the alleged restrictions may have lacked substance.

However, even assuming that the necessary restrictions existed and that they existed in substance during both years at issue, both Reg. Sec. 1.132-5(c) generally and Reg. Sec. 1.132-5(o)(6) specifically require substantiation of such restrictions in accordance with the specific rules under Section 274(d) and the applicable regulations.

The sales employees were not required by the dealer to maintain any records nor were they required to submit any records to the dealer. Furthermore, the dealer did not maintain records regarding which employee used which vehicles. Consequently, neither the adequate records method of Reg. Sec. 1.274-5T(c)(2) nor the sufficient evidence corroborating the taxpayer's (i.e., employee's) statement method of Reg. Sec. 1.274-5T(c)(3) was satisfied with respect to the use of the demonstrator vehicles by the sales employees.

The dealer attempted to rely on the safe harbor substantiation method set forth in Reg. Sec. 1.274-6T(a)(3) However, in order to be able to rely on the safe harbor for satisfying the substantiation requirements of Section 274(d) without maintaining the otherwise necessary records, all of the listed criteria must be met. The dealer admitted that no amount was included in the sales employees Forms W-2 as the value of commuting under Reg. Sec. 1.61-21(f) in accordance with Reg. Sec. 1.274-6T(a)(3)(F). In light of that clear language, the IRS National Office found no valid basis for not applying the requirement of Reg. Sec. 1.274-6T(a)(3)(F) to all taxpayers who

see **DEMONSTRATOR USE...**, page 20

attempt to rely on the safe harbor of Reg. Sec. 1.274-6T(a)(3) for purposes of meeting the substantiation requirements without maintaining the otherwise necessary records.

The dealer cited Reg. Sec. 1.61-21(a)(2) in support of an argument that the requirement of Reg. Sec. 1.274-6T(a)(3)(F) to include the commuting value gross in income is inconsistent with the exclusion for automobile salesman under Section 132(j)(3) and, thus, should not apply to the salesman. Reg. Sec. 1.61-21(a)(2) states, in part, that "[t]he fact that another section of subtitle A of the Internal Revenue Code addresses the taxation of a particular fringe benefit will not preclude Section 61 and the regulations thereunder from applying, to the extent that they are not inconsistent with such other Section."

However, the commuting valuation rule of Reg. Sec. 1.61-21(f) is specifically made applicable to the otherwise total exclusion under Section 132(j)(3) for qualified automobile demonstrator use by Reg. Sec. 1.274-6T(a)(3)(F). If the dealer chooses to take advantage of the record-keeping relief provided in the safe harbor rule of Reg. Sec. 1 .274-6T(a)(3), the dealer must meet <u>all</u> the requirements of the rule, including the commuting value inclusion. Requiring this partial inclusion in exchange for lesser record-keeping requirements is not inconsistent with the total exclusion that is available under Section 132(j)(3) <u>when the general record-keeping requirements of Section 274(d) are met</u>. See the follow-up language in Reg. Sec. 1.61-21(a)(2) to the sentence quoted above: "For example, many fringe benefits specifically addressed in other sections of subtitle A of the Internal Revenue Code are excluded from gross income only to the extent that they do not exceed specific dollar or percentage limits, or only if certain other requirements are met. If the limits are exceeded <u>or the requirements are not met</u>, some or all of the fringe benefit may be includible in gross income pursuant to Section 61" (emphasis added).

Consequently, neither the general substantiation requirements of Reg. Sec. 1.274-5T nor the safe harbor substantiation requirements of Reg. Sec. 1.274-6T have been met as required under Reg. Sec. 1.132-5(c), 1.132-5(o)(6), and under 1.274-5T(e)(l). Therefore, the use of the demonstrator vehicles by the sales employees was held to be not qualified demonstrator automobile use under Section 132(j)(3). Therefore, it was not excludible from income as a working condition fringe under Section 132(a)(3).

With respect to the demonstrator vehicles provided to **nonsales** employees, as discussed above, to be excludible as a working condition fringe, Reg. Sec. 1.132-5(c)(1) requires that the applicable substantiation requirements be met. These nonsales employees were not required to maintain or submit any records to the employer. Consequently, the adequate records method of Reg. Sec. 1.274-5T(c)(2) was not satisfied.

Furthermore, even though it appeared that the nonsales employees may have provided oral statements to the employer for the 1993 year (but not for the 1994 year) regarding the percentage of monthly PERSONAL use of the demonstrator vehicles, such statements were not detailed as to the elements of the business use of the vehicles, and the statements were not corroborated by other sufficient evidence. The odometer mileage statements for the relevant demonstrator vehicles are not sufficient, direct evidence of the number of miles, if any, that were attributable to BUSINESS use by a particular employee. Therefore, the sufficient corroborating evidence method of Reg. Sec. 1.274-5T(c)(3) is not satisfied in either year. The dealer's admission that the managers doubted the accuracy of the employees' unverified statements further supports this conclusion.

Since no part of the nonsales employees' use of the demonstrator vehicles was substantiated to the employer within the meaning of Section 274(d), under Reg. Sec. 1.132-5(c)(1) and Reg. Sec. 1.274-5T(e)(1), the value of the vehicle use may not be excluded from the employee's gross income as a working condition fringe, by either the employer or by the employee.

VALUATION/AMOUNT OF TAXABLE INCOME TO BE REPORTED BY DEMO USERS

Reg. Sec. 1.61-21 (b)(1) provides the general rule that the fair market value of the use of the demonstrator vehicles by both the sales and the nonsales employees must be included in the employees' income. The issue the National Office was asked to decide was whether the dealer is entitled to use the (more favorable) special automobile lease valuation rule of Reg. Sec. 1.61-21(d) or the general valuation rule of Reg. Sec. 1.61-21(b).

With respect to the **sales** employees, for which no amount was included on the Forms W-2 during the years at issue, the automobile lease valuation rule was not properly adopted to take effect by the later of January 1, 1989, or the first day on which the automobiles were made available to an employee of the employer for personal use. This timely election is required by Reg. Sec. 1.61-21(d)(7)(i). Consequently, the dealer is not entitled to use the automobile lease valuation rule to value the use of the demonstrator vehicles provided to the **sales** employees during the years at issue.

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With respect to the **nonsales** employees, for which an amount was included on the Forms W-2 during the years at issue, the analysis is even more complicated. The National Office stated that it appears, although it is not entirely clear, that the dealer intended to adopt, under Reg. Sec. 1.61-21(d)(7), the automobile lease valuation rule for valuing the personal use of the demonstrator vehicles provided to the **nonsales** employees. However, Reg. Sec. 1.61-21(c)(5) provides that if a special valuation rule is not properly applied to a fringe benefit (or when a special valuation rule is used to value a fringe benefit by a taxpayer who is not entitled to use that special valuation rule), the fair market value of that fringe benefit may not be determined by reference to any value calculated under any special valuation rule, but it must instead be determined pursuant to the general valuation rules of Reg. Sec. 1.61-21(b).

The dealer-in two respects-did not properly apply the automobile lease valuation rule in connection with the **nonsales** employees' use of the demonstrator vehicles: First, the employer did not have any of the necessary records to substantiate the portion of the "lease value" that was excluded from the Forms W-2 as allegedly business use (see discussion above). Second, each demonstrator vehicle's fair market value (for purposes of determining the vehicle's "lease value" under Reg. Sec. 1.61-21(d)(2)) was apparently based on "invoice plus $200," a seemingly unauthorized method for determining fair market value under Reg. Sec. 1.61-21(d)(5). Consequently, under Reg. Sec. 1.61-21(c)(5), the fair market value of the fringe benefits demonstrator use must be determined for the years at issue by using the general valuation rules of Reg. Sec. 1.61-21(b). Thus, the safe harbor fair market values under Reg. Sec. 1.61-21(d)(5)(ii) and Notice 89-110 are not available.

Under the general rules, the fair market value generally equals the amount that an individual would have to pay in an arm's-length transaction to lease the same or comparable vehicle on the same or comparable conditions in the same geographic area in which the vehicle is available for use. Furthermore, the cost incurred by the dealer for a vehicle is not determinative of its fair market value.

EMPLOYER TAXES DUE BY DEALERSHIP ON ALL DEMO VEHICLES

Under Section 3121(a) and 3401(a), benefits paid as remuneration for employment, such as the personal use of employer-provided vehicles, are wages for FICA tax and income tax withholding purposes, unless an exception applies.

In the instant case, the dealer did not maintain records regarding which employees used which demonstrator vehicles. Records were reconstructed for purposes of the IRS audit by compiling information from the relevant sales jackets, invoices and service department records. However, the sales and service records were not helpful in identifying which employees were assigned to a few of the demonstrator vehicles that had accumulated mileage (referred to as the *"unknown"* vehicles). No part of the mileage on the *"unknown"* vehicles had been substantiated by the dealer as business use. Therefore, to the extent the mileage appeared to be attributable to employee use, such mileage is deemed to be for personal employee use and is treated as wages for employment tax purposes.

Sections 3101, 3111 and 3402 impose payroll tax obligations on the dealer. These sections require the dealer to withhold and pay both portions of the FICA tax and the appropriate portion of income tax on all wages paid by the employer (subject to certain ceiling limitations for FICA tax purposes), including the benefit of personal use of employer-provided demonstrator vehicles. The fact that the inadequacy of the dealer's records may make it impossible to identify the particular employee to whom the employee use of the "unknown" vehicles should be attributed does not relieve the dealer from its withholding and payment obligations with respect to the amount of wages paid.

CONCLUSION

Dealers, especially those in the Northeast and in the Midwest where recent IRS audits of demonstrator use and activity have been fairly heavy, need to reassess just how much attention they really have been paying to their demo "policies." They should also consider a far more intrusive series of procedures to validate and verify information they are receiving from demo users.

The June, 1996 *Dealer Tax Watch* included a discussion of the NADA recommendations to dealers relative to demo use and the NADA Sample Policy Statement for use of demos by full-time auto sales persons. The September, 1995 *Dealer Tax Watch* included a sample agreement for demonstrator vehicles. These should be referred to for additional information. Our conclusion in the June, 1996 article on demo use was that "dealers must institute and monitor a formal written demonstrator policy for all employees who drive dealership vehicles." Recent Letter Ruling 9801002 shows that the IRS really looks at how closely a dealer monitors its demo policy, and it shows what it can cost a dealer who fails to have proper procedures in place or to monitor information it receives from demo users.

DEMONSTRATOR VEHICLES

FRINGE BENEFIT USE, SUBSTANTIATION & VALUATION

CODE & REGULATION CITATIONS

SECTION 132 - WORKING CONDITION FRINGE BENEFITS: USE OF DEMONSTRATOR VEHICLES

Section 132(a)(3) - Gross income shall not include any fringe benefit which qualifies as a working condition fringe.

Section 132(d) - Defines the term "working condition fringe" as any property or services provided to an employee of the employer to the extent that, if the employee paid for such property or services, such payment would be allowable as a deduction under Section 162 or 167. ***Section 162(a)*** allows a deduction for ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business and ***Section 167*** allows a deduction for depreciation.

Section 132(j)(3(A) - Provides that "qualified automobile demonstrator use" is treated as a working condition fringe.

Section 132(j)(3(B) - The term "qualified automobile demonstrator use" means any use of an automobile by a full-time automobile salesman in the sales area in which the automobile dealer's sales office is located if (i) such use is provided primarily to facilitate the salesman's performance of services for the employer, and (ii) there are substantial restrictions on the personal use of such automobile by the salesman.

Reg. Sec.1.132-5(c)(1) - The value of property or services provided to an employee may not be excluded from the employee's gross income as a working condition fringe, by either the employer or the employee, unless the applicable substantiation requirements of either Section 274(d) or Section 162 (whichever is applicable) and the regulations thereunder are satisfied.

Reg. Sec.1.132-5(c)(2) - Provides that the substantiation requirements of Section 274(d) are satisfied by "adequate records or sufficient evidence corroborating the (employee's) own statement." Therefore, such records or evidence provided by the employee and relied upon by the employer to the extent permitted by the regulations under Section 274(d) will be sufficient to substantiate a working condition fringe exclusion.

Reg. Sec. 1.132-5(d) - The safe harbor substantiation rules of Reg. Sec.1.274-6T are also applicable for the purposes of a working condition fringe.

Reg. Sec. 1 .132-5(f) - For a vehicle described in Reg. Sec.1.274-6T(a)(3) (relating to certain vehicles not used for personal purposes other than commuting), the working condition fringe exclusion is equal to the value of the availability of the vehicle for purposes other than commuting ***if*** the employer used the method prescribed in Reg. Sec. 1.274-6T(a)(3). This rule applies only if the special rule for valuing commuting use, as prescribed in Reg. Sec. 1.61-21(f), is used ***and*** the amount determined under the special rule is either included in the employee's income or reimbursed by the employee.

Reg. Sec. L132-5(o)(2) - A "full time automobile salesman" is defined as any individual who:

(1) Is employed by an automobile dealer,
(2) Customarily spends at least half a normal business day performing the functions of a floor salesperson or sales manager,
(3) Directly engages in substantial promotion and negotiation of sales to customers,
(4) Customarily works a number of hours considered full-time in the industry (but at a rate not less than 1,000 hours per year, ***and***
(5) Derives at least 25 percent of his or her gross income from the automobile dealership directly as a result of the activities described above.

Special rules relate to #5 above: Income is not considered to be derived directly as a result of activities described above to the extent that the income is attributable to an individual's ownership interest in the dealership. An individual will not be considered to engage in direct sales activities if the individual's sales-related activities are substantially limited to review of sales price offers from customers. An individual, such as the general manager of an automobile dealership, who receives a sales commission on the sales of an automobile is not a full-time automobile salesman ***unless*** all of the requirements above are met.

Personal use of a demonstrator automobile by an individual other than a full-time automobile salesman is not treated as a working condition fringe. Therefore, any personal use, including commuting use, of a demonstrator automobile by a part-time salesman, automobile mechanic, or other individual who is not a full-time automobile salesman is not "qualified automobile demonstrator use" and thus is not excludable from gross income.

Reg. Sec. 1.132-5(o)(4) - In order to qualify for the specific exclusion of the value of qualified automobile demonstrator use as a working condition fringe, the necessary substantial restrictions on the personal use of a demonstrator automobile exist when ***all*** of the following conditions are satisfied:

(1) Use by individuals other than the full-time automobile salesman (e.g., the salesman's family) is prohibited,
(2) Use for personal vacation trips is prohibited,
(3) The storage of personal possessions in the automobile is prohibited; ***and***
(4) The total use by mileage of the automobile by the salesman outside the salesman's normal working hours is limited.

Reg. Sec.1.132-5(o)(6) - Provides that the value of the use of a demonstrator automobile may not be excluded from gross income as a working condition fringe, by either the employer or the employee, unless, with respect to the restrictions of Reg. Sec.1.132-5(o)(4), the substantiation requirements of Section 274(d) and the regulations thereunder are satisfied. This applies notwithstanding anything in Reg. Sec. 1.132-5 to the contrary. Reg. Sec.1.132-5(o)(6) indicates that both the general rule and the safe harbor rules relating to the requirements of Section 274(d) are applicable.

SECTION 274 - SUBSTANTIATION & DOCUMENTATION REQUIREMENTS FOR DEDUCTIBILITY OF EXPENSES

Section 274(d) - Provides that no deduction shall be allowed with respect to any listed property (as defined in Section 280F(d)(4)) unless the taxpayer substantiates by adequate records or by sufficient evidence corroborating the taxpayer's own statement:

(1) The ***amount*** of such expense or other item,
(2) The ***time*** and place of the use of the property,
(3) The ***business purpose*** of the expense or other item, ***and***
(4) The ***business relationship to the taxpayer*** of persons using the property.

The requirements of Section 274(d) must be met in order to deduct the expenses incurred in connection with the business use of a vehicle because ***Section 280F(d)(4)(A)(i)*** includes any passenger automobile in the term "listed property."

Reg. Sec. 1.274-5T(c)(1) - ***General Substantiation Requirements***. Generally, the taxpayer must substantiate each element of an expenditure or use by adequate records or by sufficient evidence corroborating his own statement.

Reg. Sec. 1.274- 5T(c)(2) - In order to meet the "adequate records" requirements of Section 274(d), a taxpayer shall maintain an account book, diary, log, statement of expense, trip sheets, or similar record, and documentary evidence which, in combination, are sufficient to establish each element of an expenditure or use.

Generally, documentary evidence is required for (1) any expenditure for lodging while traveling away from home, and (2) any other expenditure of $75 or more. See Reg. Sec. 1.274-5T(c)(2)(iii), as amended by T.D 8715, March 25, 1997.

An account book, diary, log, statement of expense, trip sheet, or similar record, must be prepared or maintained in such manner that each recording of an element of an expenditure or use is made at or near the time of the expenditure or use. The phrase *"made at or near the time of the expenditure or use"* means recorded at a time when, in relation to the use or making of an expenditure, the taxpayer has full present knowledge of each element of the expenditure or use. An expense account statement which is a transcription of an account book, diary, log, or similar record prepared or maintained in accordance with this paragraph shall be considered a record prepared or maintained in the manner prescribed in the preceding sentence if such expense account statement is submitted by an employee to his employer in the regular course of good business practice. For example, a log maintained on a weekly basis, which accounts for use during the week, shall be considered a record made at or near the time of such use.

Reg. Sec. 1.274-5T(c)(1): Are Logs Rrequired In Connection With Demo Use? *Reg. Sec.* 1. 274-5T(c)(1) recognizes that a contemporaneous log is not required. However, it does indicate that a record of the elements of an expenditure or of a business use of listed property made at or near the time of the expenditure or use, supported by sufficient documentary evidence, has a high degree of credibility not present with respect to a statement prepared subsequent thereto when generally there is a lack of accurate recall. Thus, the ***corroborative evidence*** required to support a statement not made at or near the time of the expenditure or use ***must have a high degree of probative value to elevate such statement and evidence to the level of credibility*** reflected by a record made at or near the time of the expenditure or use supported by sufficient documentary evidence. The substantiation requirements of Section 274(d) are designed to encourage taxpayers to maintain the records, together with the documentary evidence from (...From LTR 9801002, Note #4).

Reg. Sec. 1 .274-5T(c)(2)(ii)(C) - In order to constitute an adequate record which substantiates the business use of listed property, the record must contain sufficient information as to ***each*** element of ***every*** business use.

Reg. Sec. 1 .274-5T(c)(3) - If a taxpayer fails to establish to the satisfaction of the District Director that he has substantially complied with the "adequate records" requirements discussed above with respect to an element of an expenditure or use, then, the taxpayer must establish such element:

(1) By his own statement, whether written or oral, containing specific information in detail as to such element; ***and***
(2) By other corroborative evidence sufficient to establish such element.

If such element is the cost or amount, time, place, or date of an expenditure or use, the corroborative evidence shall be direct evidence, such as a statement in writing or the oral testimony of witnesses setting forth detailed information about such element, or by documentary evidence.

Reg. Sec. 1.274- 5T(c)(6)(i) - Each separate use by the taxpayer shall ordinarily be considered to constitute a separate expenditure for purposes of substantiation. However, uses which may be considered part of a single use, for example, a round trip or uninterrupted business use, may be accounted for by a single record. The level of detail required in an adequate record to substantiate business use may vary depending on the facts and circumstances.

Reg. Sec. 1.274-5T(e)(1) - An employee may not exclude from gross income as a working condition fringe any amount of the value of the availability of listed property provided by an employer to the employee, unless the employee substantiates for the period of availability the amount of the exclusion in accordance with the requirements of Section 274(d) **and** either Reg. Sec. 1.274-5T or Reg. Sec. 1. 274-6T.

Reg. Sec. 1.274-5T(e)(2) - For purposes of an employer's substantiation of the business use of listed property that is provided to an employee and for purposes of the employer's necessary disclosure on returns, the employer may rely on adequate records maintained by the employee **or** on the employee's own statement if corroborated by other sufficient evidence unless the employer knows or has reason to know that the statement, records, or other evidence are not accurate.

The employer must retain a copy of the adequate records maintained by the employee or the other sufficient evidence, if available. Alternatively, the employer may rely on a statement submitted by the employee that provides sufficient information to allow the employer to determine the business use of the property unless the employer knows or has reason to know that the statement is not based on adequate records or on the employee's own statement corroborated by other sufficient evidence.

If the employer relies on the employee's statement, the employer must retain only a copy of the statement. The employee must retain a copy of the adequate records or other evidence.

Reg. Sec. 1.274- 6T(a)(1) - ***Safe Harbor Substantiation Rule***. Two types of written (demonstrator) policy statements satisfying certain conditions, if initiated and kept by an employer to implement a policy of no personal use, or no personal use except for commuting, of a vehicle provided by the employer, qualify as sufficient evidence corroborating the taxpayer's own statement and therefore will satisfy the employer's substantiation requirements of Section 274(d).

Reg. Sec. 1.274-6T(a)(3) - An employee, in lieu of substantiating the business use of an employer-provided vehicle under Reg. Sec. 1.274-5T, may substantiate any exclusion allowed under Section 132 for a working condition fringe by including in income the commuting value of the vehicle (determined by the employer pursuant to Reg. Sec. 1.61-21(f)(3)) if all the following conditions are met:

(1) The vehicle is owned or leased by the employer and is provided to one or more employees for use in connection with the employer's trade or business and is used in the employer's trade or business;

(2) For bona fide noncompensatory business reasons, the employer requires the employee to commute to and/or from work in the vehicle,

(3) Under a ***written policy*** of the employer, neither the employee, nor any individual whose use would be taxable to the employee, may use the vehicle for personal purposes, other than for commuting or de minimis personal use (such as a stop for a personal errand on the way between a business delivery and the employee's home),

(4) (The employer reasonably believes that) except for de minimis personal use, neither the employee, nor any individual whose use would be taxable to the employee, uses the vehicle for any personal purpose other than commuting;

(5) The employee required to use the vehicle for commuting is not a control employee required to use an automobile; ***and***

(6) The employee includes in gross income the commuting value determined by the employer as provided in Reg. Sec. 1.61-21(f)(3) (to the extent that the employee does not reimburse the employer for the commuting use).

There must also be evidence that would enable the Commissioner to determine whether the use of the vehicle met the preceding six conditions.

SECTION 61 - VALUATION & TAXATION OF FRINGE BENEFITS

Section 61(a)(1) - Except as otherwise provided, gross income means all income from whatever source derived, including compensation for services, including fringe benefits.

Reg. Sec. 1.61-21(b) - An employee must include in gross income the amount by which the fair market value of the fringe benefit exceeds the sum of (i) the amount, if any, paid for the benefit by or on behalf of the recipient and (ii) the amount, if any, specifically excluded from gross income by some other Section of subtitle A of the Code. The fair market value of a fringe benefit is the amount that an individual would have to pay for the particular fringe benefit in an arm's-length transaction. Thus, for example, the effect of any special relationship that may exist between the employer and the employee must be disregarded. Similarly, an employee's subjective perception of the value of a fringe benefit is not relevant to the determination of the fringe benefit's fair market value nor is the cost incurred by the employer determinable of its fair market value.

Reg. Sec. 1.61-21(b)(4) - ***General Fair Market Value Determination***. Unless a special valuation rule applies, the value of the availability of an employer-provided vehicle is determined under the general valuation principles. In general, that value equals the amount that an individual would have to pay in an arm's-length transaction to lease the same or comparable vehicle on the same or comparable conditions in the geographic area in which the vehicle is available for use. An example of a comparable condition is the amount of time that the vehicle is available to the employee for use, e.g., a one-year period.

Reg. Sec. 1.61-21(c)(5) - The valuation formlulae contained in the special valuation rules in paragraphs (d), (e), and (f) of Reg. Sec. 1.61-21 are provided only for use in connection with those rules. Thus, when a special valuation rule is not properly applied to a fringe benefit, or when a special valuation rule is used to value a fringe benefit by a taxpayer not entitled to use the rule, the fair market value of that fringe benefit may not be determined by reference to any value calculated under any special valuation rule, but must be determined pursuant to the general valuation rules of Reg. Sec. 1.61-21(b).

Reg. Sec. 1.61-21 (d)(1) - ***Automobile Lease Valuation Rule***. The value of the use of an employer-provided automobile for an entire calendar year is the Annual Lease Value as set forth in the Table found at...(d)(2)(iii).

Reg. Sec. 1.61-21(d)(2) - The Annual Lease Value of a particular automobile is calculated by determining the fair market value of the automobile as of the first date on which the automobile is made available to any employee for personal use and locating the Annual Lease Value as provided in the Annual Lease Value table in Reg. Sec. 1.61-21(d)(2)(iii) for the applicable dollar range.

Reg. Sec. 1.61-21(d)(2)(iii) - Table of applicable dollar ranges of automobile fair market values for determining Annual Lease Values.

Reg. Sec. 1.61-21(d)(3) - The fair market value of maintenance and insurance, but not fuel, is included in the Annual Lease Value.

Reg. Sec. 1.61-21(d)(5)(i) - For purposes of determining the Annual Lease Value of an automobile, the fair market value of an automobile is the amount that an individual would have to pay in an arm's-length transaction to purchase the particular automobile in the jurisdiction in which the vehicle is purchased or leased. That amount includes all amounts attributable to the purchase of an automobile such as sales tax and title fees as well as the purchase price of the automobile. Any special relationship between the employee and the employer must be disregarded. Also, the employee's subjective perception of the value of the automobile is not relevant to the determination of the automobile's fair market value, and, except as provided under a safe harbor rule discussed below, the cost incurred by the employer in connection with the purchase or lease of the automobile is not determinative of the fair market value of the automobile.

Reg. Sec. 1.61-21(d)(5)(ii) - ***Safe Harbor Fair Market Value***. For purposes of calculating, the Annual Lease Value of an automobile, the safe harbor value of the automobile may be used as the fair market value of the automobile. For an automobile owned by the employer, the safe-harbor value of the automobile is the employer's cost of purchasing the automobile (including sales tax, title, and other expenses attributable to such purchase), provided the purchase is made at arm's-length. Notwithstanding the preceding sentence, this safe harbor value is not available with respect to an automobile manufactured by the employer.

For an automobile leased by the employer, the safe harbor value of the automobile is either the manufacturer's suggested retail price of the automobile less eight percent (including sales tax, title, and other expenses attributable to such purchase), or the value determined by reference to the retail value of such automobile as reported by a nationally recognized pricing source. Alternatively, under Notice 89-110 (1989-2 C.B. 447), the employer will be permitted to use (for leased vehicles) the manufacturer's invoice price (including options) plus four percent as a safe harbor estimation of fair market value for all purposes under Reg. Sec. 1.61-21(d)(5)(ii).

Reg. Sec. 1.61-21(d)(6)(ii) - ***Special Rules For Continuous Availability Of Certain Automobiles***. If an automobile dealership provides an employee with the continuous availability of a demonstrator automobile during a period (though not necessarily the same demonstrator automobile for the entire period), the employee is treated as having the use of a single demonstrator automobile for the entire period, e.g., an entire calendar year.

When applying the automobile lease valuation rule of Reg. Sec. 1.61-21(d), the employer may treat the average of the fair market values of the demonstrator automobiles which are available to an employee and held in the dealership's inventory during the calendar year as the fair market value of the demonstrator automobile deemed available to the employee for the period for purposes of calculating the Annual Lease Value of the automobile. If under the facts and circumstances it is inappropriate to take into account, with respect to an employee, certain models of demonstrator automobiles, the value of the benefit is determined without reference to the fair market values of such models.

Reg. Sec. 1.61-21(d)(7) - ***Consistency And Timely Election Rules***. Notwithstanding any of the principles discussed above, an employer may adopt the automobile lease valuation rule for an automobile only if the rule is adopted to take effect by the later of (A) January 1, 1989, or (B) the first day on which the automobile is made available to an employee of the employer for personal use (or, if the commuting valuation rule of Reg. Sec. 1.61-21(f) is used when the automobile is first made available to an employee of the employer for personal use, the first day on which the commuting valuation rule is not used).

Reg. Sec. 1.61-21(f)(3) - ***Special Commuting Valuation Rule***, The value of the commuting use of an employer-provided vehicle is $1.50 per one-way commute, ***if*** the necessary requirements are met by the employer and employees with respect to the vehicle. The requirements are identical to the first five requirements listed previously under the safe harbor substantiation rule in Reg. Sec. 1.274-6T(a)(3).

The commuting valuation rule of Reg. Sec.1.61-21(f) is specifically made applicable to the otherwise total exclusion under Section 132(j)(3) for qualified automobile demonstrator use by Reg. Sec. 1.274-6T(a)(3)(F). If the taxpayer chooses to take advantage of the record-keeping relief provided in the safe harbor rule of Reg. Sec.1.274-6T(a)(3), the taxpayer must meet all the requirements of the rule, including the commuting value inclusion. Requiring this partial inclusion in exchange for lesser record-keeping requirements is not inconsistent with the total exclusion that is available under Reg. Sec.1.32(j)(3) when the general record-keeping requirements of Section 274(d) are met. See the follow-up language in Reg. Sec.1.61-21(a)(2) to the sentence quoted above: "For example, many fringe benefits specifically addressed in other sections of subtitle A of the Internal Revenue Code are excluded from gross income only to the extent that they do not exceed specific dollar or percentage limits, or only if certain other requirements are met. If the limits are exceeded or the requirements are not met, some or all of the fringe benefit may be includable in gross income pursuant to Section 61."

Note: The dealership in Letter Ruling 9801002 cited Reg. Sec.1.61-21(a)(2) of the regulations(...which states, in part, that "[t]he fact that another Section of subtitle A of the Internal Revenue Code addresses the taxation of a particular fringe benefit will not preclude Section 61 and the regulations thereunder from applying, to the extent that they are not inconsistent with such other section"...) in support of its argument that the requirement of Reg. Sec.1.274-6T(a)(3)(F) to include the commuting value in gross in income is inconsistent with the exclusion for an automobile salesman under Section 132(j)(3) and, thus, should not apply to the salesman. The immediately preceding paragraph was the National Office's rebuttal to the dealership's argument.

PAYROLL TAX RELATED SECTIONS

Section 3111 - Imposes the employer portion of the Federal Insurance Contributions Act (FICA) tax on wages paid by the employer with respect to employment.

Section 3101 - Imposes the employee portion of the FICA tax on wages received by the employee with respect to employment.

Section 3102 - Provides that the tax imposed by Section 3101 shall be collected by the employer, by deducting the amount of the tax from the wages as and when paid.

Section 3121(a) - Defines the term "wages" for FICA tax purposes as all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash, with certain exceptions.

Section 3401(a) - Defines the term "wages" as all remuneration for services performed by an employee for his employer, including the cash value of all remuneration (including benefits) paid in any medium other than cash, with certain exceptions.

Section 3402 - Requires every employer making payment of wages to deduct and withhold upon such wages an income tax determined according to prescribed tables or procedures.

LIFO CONFORMITY REQUIREMENTS
ADDITIONAL PROBLEMS & UNANSWERED QUESTIONS
REVENUE PROCEDURE 97-44

In our last issue, we discussed some questions and problems under Revenue Procedure 97-44. One of the most significant involves dealers who have LIFO conformity violations on statements sent to the manufacturer, but who never financed with the Factory's affiliated credit subsidiary (GMAC, FMCC, CCC, etc.). Dealers who sent non-conforming year-end Income Statements ***only*** to the manufacturers bear a tremendous risk and are left to proceed in the dark because the National Office may not rule on this issue before D-Day (May 31, 1998). Will any dealer step forward to request a ruling on this question? Any volunteers?

Another major issue involves coming to grips with what the IRS will accept as a ***reasonable*** estimate of the LIFO change on the year-end Factory Income Statement. There are no standards on this. Who really knows? How much risk are you willing to bear if you don't have projections to back up your "estimate" as reasonable? Here, too, the consequences to a dealer who "feels" there was a reasonable estimate could be extreme if the IRS "feels" that the estimate was not reasonable.

For a refresher on the other problem areas, see pages 10-12 of the September, 1997 *LIFO Lookout*. Since then, still more questions have emerged.

FIRST: Can a dealer with a conformity violation avoid paying the 4.7% Settlement Amount by simply terminating the LIFO election before May 31, 1998 ***and*** before any penalty payments have been made? The answer seems to be "**yes**", if you file a Form 3115 under Revenue Procedure 97-37 before making any payments. For more on this, see the discussion on "Will Terminating the LIFO Election Avoid the 4.7% Penalty?" in our analysis of NADA's *Dealer Guide To The LIFO Conformity Settlement* on page 11.

SECOND: What are fiscal year dealerships really supposed to do? See the discussion on page 10 regarding the fiscal year ***assumption*** trap. Also, see item #3 in discussion of Revenue Ruling 97-42 on page 7.

THIRD: What happens if one member of a consolidated or an affiliated group has a conformity violation? Does the 4.7% penalty apply only to the member with the violation, or does Code Section 472(g) require 4.7% to be applied to the LIFO reserves of ***all*** members? It would appear that Section 3 of Rev. Proc. 97-44 narrowly construes the definition of "taxpayer" in such a way that the 4.7% penalty tax would be applied only to the LIFO reserves of the group member with the conformity violation. However, it would be reassuring to see this spelled out more clearly.

FOURTH: Many CPAs have asked whether it would be advisable to provide an affirmative notice to the Internal Revenue Service... are we talking about the National Office, the Cincinnati/Covington special collection center or the District Director? ...that the self-audit found that the dealer had no conformity violations during the 1991-1996 period. The thought is that it would be important to affirmatively notify the IRS in some way that the dealer did not violate the conformity requirement during this period. Otherwise, might the IRS infer that since no penalty payment was made, the dealer was simply waiting for the IRS to come out and catch him?

"Remedies" discussed included attaching a statement to the corporate tax return or sending a copy of the Memorandum intended to accompany payments to the Cincinnati office stating that no payment was being made because no violation had been found (ditto to the IRS National Office). Some have thought that some type of affirmative notice to the IRS might "protect" them from an IRS audit or compliance check on this matter. In a recent discussion on this with Mr. Mitchell, he expressed the opinion that it would **not** be advisable to send a statement in this regard because of the likelihood that such statement would not be read, or might be interpreted to be missing an accompanying penalty payment! What do you think? Should you take a chance that the IRS might actually read something you send them?

FIFTH: Another "sleeper" in Rev. Proc. 97-44 relates to its reference to taxpayers "under examination" on October 14, 1997. For these taxpayers, the first payment of their Settlement Amount was due December 1, 1997 (and that's already past) instead of on the May 31, 1998 which is the date for the first installment date for taxpayers not under examination. It appears NADA—and many others—"thought" that this accelerated payment date related only to those two dozen or so auto dealers with the burning, big dollar LIFO termination liabilities hanging over their heads. Suprise! Now ... come to find out that some folks in the IRS interpret the provision requiring the first settlement payment on December 1, 1997 to apply to all taxpayers "under examination" on October 14, 1997 ... and not just those where the LIFO conformity issue had been raised and the IRS subsequently agreed to put the audit on hold pending finalization of the IRS' position on if and how relief might be granted. *

NADA'S *DEALER GUIDE*
TO THE LIFO CONFORMITY SETTLEMENT

NADA'S GUIDE

NADA recently mailed out its summary of the IRS' Revenue Ruling 97-42 and Revenue Procedure 97-44 in a pamphlet entitled *A Dealer Guide to the LIFO Conformity Settlement.*

In explaining the importance of these recent IRS pronouncements, NADA reminded dealers that previously, the consequences of LIFO conformity violations could have been catastrophic. In addition to the significant financial impact that might be imposed on dealers forced to cough up almost $400,000 in tax, plus interest, on a $1,000,000 LIFO reserve, the open-ended nature of the liability and the impossibility of ever rectifying or curing a conformity violation makes the "LIFO conformity settlement" look pretty attractive.

The normal 3-year statute of limitations does not apply as a defense to conformity violations... nor to any other LIFO eligibility issues. Often, in real audits, the IRS will seek out violations all the way back to the first LIFO year, which may be many, many years removed.

The NADA *Guide* explains the Ruling and the Procedure and it tells dealers how to conduct a self-audit of their Factory statements for the look-back years 1991-1996. In addition, it includes a list of "Frequently Asked Questions" and discusses the benefits of taking advantage of the IRS' conformity settlement.

Overall, the NADA *Guide* does not contain much new information nor further clarification regarding the settlement. Specifically, it sheds no light on any of the questions raised in the September, 1997 *LIFO Lookout.* NADA comments, and rightly so, that the IRS leniency on where a LIFO adjustment may be placed in the Income Statement will significantly reduce the number of dealers who have LIFO conformity violations. As most dealers and CPAs are aware, the LIFO adjustment can be made in any account as long as it impacts the computation of net income in the year-end Income Statement. In other words, a LIFO adjustment must appear somewhere on the year-end Income Statement ... and it does not have to be buried in Cost of Goods Sold.

FISCAL YEAR DEALERS—WATCH OUT FOR THAT ***ASSUMPTION***

In connection with fiscal year dealers, NADA's *Guide* states that: "A dealer who is on a fiscal year for tax purposes may make his/her LIFO adjustment on the fiscal year-end statement *or* on the December statement. The adjustment does not have to be made on both statements." It further adds: "*Note*: if Dealership A were a fiscal year taxpayer with a fiscal year ending in June, it would have been in compliance if it had made a LIFO adjustment on either the June (fiscal year end) statement *or* the December statement. The dealership would *not* have to make an adjustment in both months."

Readers should be careful to appreciate that the above general statements are based **on the assumption** that the LIFO reserve change adjustment reflected in the Income Statement for the end of the fiscal year will be carried forward automatically and appear as a LIFO reserve change adjustment in the December (calendar year-end) Income Statement. For more on this, see the discussion in the accompanying article · A few callers have interpreted NADA's generalizations to mean that if the fiscal year-end Income Statement reflected a LIFO adjustment, then the calendar year-end statement would not need to ... and that is clearly not the case!

CONDUCTING A SELF-AUDIT & GETTING A LETTER "FROM YOUR CPA"

For dealers who want to conduct their own "self-audit," NADA advises them to (1) check the 12th month Factory statements for the years 1991-1996 to determine if a LIFO conformity violation exists and (2) see whether or not LIFO adjustments were made on 12th month statements in a way that did impact the calculation of net income. If not, was a 13th month statement with a correct adjustment in the Income Statement sent to all parties who received the 12th month statement before the date the January statement for the following year was due? Yes___ No___. A *Yes* answer saves the dealer. Dealers are also advised to determine if copies of factory statements were provided to shareholders, partners, and creditors.

The *Guide* indicates that if a CPA conducts the self-audit for the dealer and indicates that no conformity violations exist, the dealership should "obtain a letter from your CPA indicating that the review has been completed and that the dealership is entitled to relief under Rev. Proc. 97-44." In addition, these dealers are advised to create a file containing the 12th month statements, highlighting the LIFO adjustment on each statement after they have been "specifically shown where on each 12th month statement the LIFO adjustment was made."

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These letters may be easy for CPAs to provide in some cases. In other cases, especially where the dealership has changed CPA firms during the 1991-1996 look-back period, such letters may prove to be very troublesome for CPAs to sign off. Nevertheless, dealers are well advised to request—or even insist on—such a letter because, according to NADA, "Dealers who conduct the self-audit for the period 1991-1996 and find no violations are deemed to be in compliance with Rev. Proc. 97-44 ***and are therefore protected from any conformity violations which may have occurred <u>prior to 1991</u>.***"

IF A CONFORMITY VIOLATION IS FOUND

NADA points out that if a conformity violation is found during the dealer's self-audit, a dealer must decide whether or not he or she wishes to take advantage of the IRS' settlement offer. The consequences of failing to pay the 4.7% settlement fee to the dealer are addressed. CPAs should be aware that if a violation is found during the self-audit, and the dealer decides not to take advantage of the settlement, that could place the CPA in a "no win" position relative to that CPA's responsibilities as a tax return preparer before the IRS. This involves possible liabilities and/or penalties that might be assessed for undervaluation of inventories and all the related infractions (against <u>both</u> taxpayer <u>and</u> practitioner) an overzealous IRS agent might come up with.

On this point, the *Guide* further provides that: "If XYZ does not elect to settle its conformity violation under Rev. Proc. 97-44 and is later audited by the IRS, it would be subject to immediate termination of its use of the LIFO method and could be required to include the full amount of its LIFO reserve in income immediately, in one taxable year." One might fear the consequences could be far worse than that for a dealer willing to play the "will they ever catch me" game: The LIFO election termination could be retroactive to a prior year with significant interest and penalties added. As a practical matter, it would appear that the likelihood of the IRS auditing dealers who do not pay a settlement fee seems very strong. Isn't it likely that every IRS auditor's checklist or document request from now on will include inquiries into the dealer's status relative to Revenue Procedure 97-44? The chances of a dealer with a LIFO conformity violation during the 1991-1996 look-back period not being found out by the IRS would seem to be extremely small. Although... it could happen!

Appendix C of NADA's *Guide* includes a Memorandum format that dealers paying the Rev. Proc. penalty amount might follow. Revenue Procedure 97-44 states in Section 5.04 that each Memorandum shall be signed under penalties of perjury. NADA's format does not specifically include an affirmative statement under the penalties of perjury, although it does include a statement that the dealer agrees to all terms of Revenue Procedure 97-44. More cautious taxpayers using the format in Appendix C might want to insert specific "penalties of perjury" language in this regard to avoid any doubt.

WILL TERMINATING THE LIFO ELECTION AVOID THE 4.7% PENALTY?

On page 8 of its *Guide*, NADA states three options open to a dealer with a violation: (1) pay the settlement fee, (2) "roll the dice," and (3) terminate LIFO. The *Guide* states that if a dealer is thinking about getting off LIFO, it should not pay the Settlement Amount. Instead, the dealer can elect to terminate its use of the LIFO method and simply pay the income tax owed on the LIFO reserve over a four-year period. <u>It would appear that Rev. Proc. 97-44 offers a strong incentive for dealers with conformity violations to simply walk away now from their LIFO election with nothing but recapture of their LIFO reserves over a four year period</u>.

NADA clearly states that if a dealer wants to get off of LIFO, it should not make any payment under Rev. Proc. 97-44 and it should simply go ahead and terminate its LIFO election. Under recent Revenue Procedure 97-37 (Appendix Section 10), the Service seems to have done away with the distinction it previously made between (1) taxpayers who were trying to terminate their LIFO elections because they had an eligibility violation in a prior year, and (2) taxpayers who simply wanted to terminate their LIFO election for other reasons—such as an anticipation that severe price deflation might lie ahead.

In the current situation, according to NADA, as long as the dealer goes off of LIFO before it makes its first 4.7% settlement installment payment, the dealer can avoid any liability for its former LIFO conformity violations. NADA's listing of "Frequently Asked Questions" includes: "If I no longer want to use the LIFO method, do I have to do the self-audit and make the settlement payment?" Its answer is: "No. You can voluntarily terminate your LIFO election and pay the income tax liability on your LIFO reserve over four years. You do not have to pay the settlement fee."

Section 7.03 of the Revenue Procedure provides that: "A taxpayer that makes one or more payments under this Revenue Procedure may not change from the LIFO inventory method pursuant to Rev. Proc. 97-37, 1997-33 I.R.B. 18, for a taxable year beginning before the date that the entire Settlement Amount is paid in accordance

see **NADA'S *DEALER GUIDE TO THE LIFO CONFORMITY SETTLEMENT,*** page 31

SOME GENERALIZATIONS & ADVICE FOR DEALING WITH REV. PROC. 97-44

PRACTICE AID

1. What you (a CPA) can say to your auto dealer client about Rev. Proc. 97-44 will depend on several factors including ... your prior oral and/or written advice on financial statement conformity to the dealer ... and whether the dealership accepted and reflected your prior advice.
2. Dealers with specific problem fact patterns should consider requesting a Letter Ruling from the Internal Revenue Service, and requesting expedited consideration in order to receive an answer before May 31, 1998.
3. A dealer's potential liability under Rev. Proc. 97-44 should be considered immediately so that any material amounts or implications may be reflected in the financial statements (or in accompanying notes thereto) issued in reports for the dealership for years ending after October 31, 1997.
4. It may be appropriate to advise a dealer with a conformity violation to seek legal advice before making its first payment under Rev. Proc. 97-44, especially if another CPA firm is involved in a prior violation year.
5. Each dealership should compile a "defense file" with respect to the years 1991-1996. This file should include:
   A. Copies of dealer Factory financial statements for the years 1991 through 1996.
   B. An attestation that those statements are copies of the statements originally filed.
   C. Copies of any written communications in prior years to the dealership regarding conformity matters.
   D. Copies of any year-end LIFO reserve change projections.
   E. Copies of any adjusting entries or journal entries made to reflect LIFO reserve changes.
   F. If another CPA firm was involved with any of the prior "look-back years:"
      (1) Copies of any correspondence with that prior CPA firm relative to conformity matters or issues, and
      (2) Copies of any replies received from that prior CPA firm.
6. Any CPA firm compiling a "defense file" for a dealership with respect to Revenue Procedure 97-44 should retain a complete copy of that file for its own purposes. The dealership may change CPA firms in a later year and questions may arise in the future relative to these determinations and/or liabilities thereunder.
7. Under certain circumstances, if a CPA firm needs to compile a "defense file" of its own, notification to its insurance carrier should be considered.
8. If a dealership requests a CPA firm to provide a written opinion relative to its liability under Revenue Procedure 97-44, consideration should be given to having that opinion reviewed by legal or insurance counsel prior to its issuance.
9. As early as practical, CPAs should begin to communicate with prior CPA firms who might be involved with prior look-back years in which there may be LIFO conformity violations. Consideration should be given to reducing all such communication to writing.
10. Consideration should be given to the ramifications of the IRS positions expressed in Revenue Ruling 97-42 and Revenue Procedure 97-44 to other business on LIFO that submit year-end pre-formatted financial statements to manufacturers, suppliers and/or creditors.

See the September, 1997 *LIFO Lookout* (pages 10-12) and the December, 1997 *LIFO Lookout* (page 9) for discussions of problem areas and unanswered questions arising under Revenue Procedure 97-44.

NADA's *Dealer Guide to the LIFO Conformity Settlement*

(Continued from page 30)

with this Revenue Procedure." Apparently, the key here is that in order for a dealer to get off Scot-free, he should have made no payments under the Revenue Procedure before he decides to terminate the LIFO election and effects that termination by filing Form 3115.

This was recently confirmed "unofficially" by phone calls as the current position of NADA and of several IRS officials, including the principal authors of Rev. Proc. 97-44 and of Rev. Proc. 97-37. Consequently, it appears the IRS has intentionally conferred a real benefit to dealers by letting them walk away from their LIFO elections with only a 4-year repayment spread of their LIFO reserves... if they act fast.

Notes:

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