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. Demonstrator vehicles: In our last issue, we discussed IRS Letter Ruling 9801002 which held that sales and non-sales 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. It also held that the special valuation rules could not be used to report lower amounts of income.

This Letter Ruling seems to be just the beginning. In the meantime, several dealer publications have printed advice and letters from CPAs suggesting that dealers drop their demos altogether. A more reasoned point of view suggests that demos are, indeed, here to stay. Also, the dealer in the ruling had bad facts and should have been more careful in policing its demo agreements.

We understand that the IRS will soon release another Technical Advice Memorandum/Letter Ruling with more bad news restricting the special valuation rules for demo use. The point to keep in mind is simply that the taxpayers in these rulings were not following the general advice provided by NADA and many CPAs to their dealers regarding the need to take demonstrator documentation requirements seriously.

LIFO conformity for dealership financial statements: What will the IRS be doing after May 31 when the first round of LIFO conformity penalty payments has been received? Audits? ... Compliance checks? ... What? Will we get an answer to the most frequently asked question in the last few months: "What constitutes a *reasonable* estimate?" There is a lot riding on the answer: Usually it is the viability of the dealer's LIFO election.

Recently, one insurer of CPA firms sent out materials to their clients handling auto dealers advising and suggesting how to handle Revenue Procedure 97-44 with existing dealer clients ... and with former dealership clients at any time during the 6-year look-back period. For more on the "reasonable estimate" question and the insurer's materials, see page 22.

For those looking for last minute information, advice ... or speculation ... on this subject, one opportunity is the *SPRING '98 CPA-AUTO DEALERSHIP NICHE CONFERENCE* on May 20-22 in Las Vegas. See #10 re: Upcoming Conference of Interest.

WATCHING OUT FOR

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#2. OTHER HOT & EMERGING ISSUES: Two subjects previously written about in the *Dealer Tax Watch* have received recent notice.

First, the application of the Section 475 Mark-to-Market rules to Buy-Here, Pay-Here dealer receivables now seems to be taken for granted ... even though the IRS doesn't like it. The AICPA recently warned that the Clinton Administration in its fiscal year 1999 budget plans to propose terminating the Mark-to-Market rules on a prospective basis. Apparently, more taxpayers–including auto dealers–found themselves eligible for year-end receivable writedowns than were originally intended.

Second, several sources have recently reported that the National Independent Automobile Dealers Association (NIADA) is working with the Internal Revenue Service to develop a revenue procedure that will allow used car dealers to spread out the reporting of their gross profit on installment sales.

Apparently, the IRS has agreed to proceed with the project and further details will be reported when a tangible revenue procedure has been released. We expect that payment to the IRS of some interest factor compensating for the time-value of the use of money will be a major component of any compromise reached. In the meantime, the NIADA web site (http://www.niada-online.com/accounts.htm) does have some information on this.

#3. TAX COURT ACTION. In connection with a summary of the recent, major guidance issued by the IRS on accounting method changes, we are also covering a related Tax Court Memo decision. This case clearly shows how the IRS ... and the Tax Court ... will penalize a taxpayer who waits (until it is too late) to consider filing a Form 3115 to change a questionable accounting method. The result was that 3 more years were covered by the method the IRS required. See page 4.

#4. A NOT TOO FLATTERING LOOK AT THE IRS ... AND WE DON'T MEAN THE CONGRESSIONAL HEARINGS. For a real eye opener, read "Unbelievable! The IRS Mess is Worse Than You Think," in *Fortune*, April 13, 1998. Just consider the subtitle: "A year-2000 problem? Try 1950. The IRS's computer code was old when the Beatles were young. **The taxman has more troubles** than Washington wants you to know."

The "revelations" in this article will come as no surprise to any CPA who has ever set foot inside an IRS facility for a meeting and, while there, taken a look around to see what was going on. The *Fortune* article by Jeffery Birnbaum points out that the IRS' most

(Continued from page 1)

nagging problem is "lame technology" and that even the new Commissioner (Rossotti) is awed by what he faces: "I have never seen a worse situation in a large organization ... The technology is just remarkable for how backward it is."

To save time, some clerks don't count tax returns into the batches, instead they weigh them on a vintage scale applying a rule of thumb that one hundred Forms 1040A weigh an average of 3 pounds. Some of the 1994 mainframes photographed in the article are labeled Sperry Univac, but they aren't the IRS' oldest: that honor belongs to their Hitachi computers built in the 1970s. And, if you think the clutter on your desk is bad, see the picture of the "Tingle Tables" on which tax forms are sorted in Philadelphia.

The article points out that in 1996, the IRS' year 2000 conversion project had a budget of $20 million and a staff of 3. Now it's a $900 million project with 600 workers, and many of them are consultants ... not IRS employees. The IRS' latest modernization program could take *as long as 15 years*, which veteran computer consultants understand to mean "probably never".

Publicly held companies are now required to disclose situations where material Y2K problems are expected to be encountered. Wouldn't it be interesting to see what the IRS would say if Congress were to subject it to a similar reporting requirement?

There's a lot of talk about the IRS attempting to change its mindset and culture with a renewed focus on taxpayer assistance. Perhaps Congress or the IRS should consider another name change, something like *Taxpayer Service and Compliance Assistance Bureau*. The IRS name was last changed in 1955; before that, it was called the Internal Revenue Bureau.

Right now, *Service* comes last in its name, and often that is what Agency personnel deliver ... last. Moving *Service* forward in its name might help emphasize to employees and to management the change in focus and behavior that is intended and that we are asked to believe will occur.

#5. DEALER TRIPS, PRIZES & AWARDS REPORTED ON FORMS 1099. Many dealers receive Forms 1099 on which the Factory reports the value of trips and prizes awarded by the manufacturer to the dealer. In some instances, the amounts reported are substantial and attributable to taxable programs and trips taken outside the USA. Some dealers contend that the amount reported by the Factory on the Form 1099-MISC is significantly in excess of the fair market value of the trip–as measured by the costs they would have incurred–had they

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traveled on their own and without the "baggage" of the Factory accounting system and personnel being included in the amount reported as "non-employee compensation."

Under these circumstances, in their personal returns, some dealers report the total amount shown on Form 1009-MISC in Schedule C ... then they claim a subtraction from this amount on the face of Schedule C. This subtraction is described in various terms as being attributable to a reduction of the amount reported on Form 1099 in order to arrive at a reasonable market value of the award or travel based on comparable travel costs and accommodations.

Have any readers claimed deductions of this nature in a dealer's tax return and later had to justify them to the Internal Revenue Service? How did you do so and were you successful? Reader comments and experiences are invited.

#6. CHANGE IN CAPITAL GAINS RATES: TAXPAYER RELIEF & RETURN PREPARER GRIEF. In looking through the so-called "tax breaks" included in the Taxpayer Relief Act of 1997, there isn't really much for dealers and their advisors to get excited about. Education incentives, Roth IRAs, even the so-called "estate tax breaks" for family owned companies aren't likely to significantly help the average auto dealer.

The change most likely to be beneficial is the lowering of the maximum long-term capital gain rate from 28% to 20% for qualifying assets. The handling of capital gains in the preparation of individual tax returns over the last few months required considerably more time and patience than in previous years. We've included a look at some special 1997 Schedule D situations on page 10.

#7. PORCS: MORE ATTRACTIVE AFTER TRA '97. One application deserving a renewed look after the TRA '97 changes in capital gains rates is PORCs. Over the years, the *Dealer Tax Watch* has covered planning activity and IRS audit activity in connection with Producer Owned Reinsurance Corporations (PORCs) and Vehicle Service Contracts (VSCs), ...including the 1997 Tax Court cases involving *Rameau Johnson* and *William F. McCurley*.

In the context of aftermarket reinsurance companies, Steve (John S.) Mailho of the Mailho Reinsurance Network recently reported a significant increase in new reinsurance formations. He expects this trend to continue and increase over the next few years because of (1) the repeal of the Alternative Minimum Tax for small corporations by the '97 Act, and (2) the significant spread now in place between the maximum 20% long-term capital gains tax rate and the personal, maximum tax rate on ordinary income which runs between 39.6% and 42%.

Steve's newsletter is reprinted on page 16 and should be of interest if you are reviewing or considering the formation of PORCs or other reinsurance companies. Note that in his conclusion, he is referring to companies domiciled in Nevis which now seems to be the "jurisdiction of choice." You can obtain more information from Steve Mailho at (800) 262-4546.

#8. NADA '98 CONVENTION. The 1998 NADA Annual Convention in New Orleans earlier this year included several workshops which touched on dealer and dealership tax planning strategies: (1) "New Financial Horizons for Dealers: Public Ownership and Real Estate Investment Trusts" (James Beers; James Hale; Jack Pohanka), (2) "Strategies for Maximizing the Value of Your Dealership" (Dave Duryee), (3) "Successorship in the Family Auto Business: 'The Good, the Bad, and the Ugly'" (Chris Martens; Jack Krenzen) and (4) "Advanced Estate Planning When Your Dealership is Your Most Valuable Asset" (Robert Seaburg).

You might want to purchase these tapes for future reference.

Mr. Seaburg's workshop on dealer estate planning ties in well with prior *Dealer Tax Watch* articles on the subject. Mr. Seaburg emphasized the importance of employing relatively simple techniques, singly at first and then—in advanced stages—in combination with others. His workshop presentation is summarized on page 18.

#9. EFTPS ELECTRONIC FILING UPDATE. The IRS granted another six-month extension ... to January 1, 1999 ... to taxpayers to begin making their Federal tax deposits through the Federal Electronic Tax Payment System. Penalties will not be imposed until after January 1, 1999.

#10. UPCOMING CONFERENCE OF INTEREST. *Spring, '98 CPA-Auto Dealership Niche Conference,* May 20-22, at Alexis Park Resort in Las Vegas.

Topics include: Industry outlook, Project 2000 downsizing, new financial products, auto dealership valuations, financial statement analysis and benchmarks, computers: negotiation and utilization, LIFO conformity penalty tax due May 31, 1998, demonstrator use and LTR 9801002, other IRS issues and Tax Court cases, LIFO, PORCs & VSCs, and CPA firm risk & loss minimization.

For more information, call 847-577-3977 or visit the Conference web site at http://www.defilipps.com.

CHANGES IN ACCOUNTING METHODS ... RECENT CASE SHOWS PENALTY FOR WAITING TOO LONG TO FILE FORM 3115

YEAR OF CHANGE

The IRS is always interested in how dealers are accounting for routine transactions and for their inventories. In the last year, the IRS revised several old revenue procedures and issued considerable new guidance on how taxpayers should go about changing accounting methods which do not clearly reflect income. Even Form 3115, which is the form required to be filed when methods are changed, was revised again in November of 1997 to reflect and coordinate all these changes. From all this, one conclusion is obvious: The IRS is very interested in accounting methods that aren't what they should be.

The basic rules, terms and conditions for changes in accounting methods were previously found in Revenue Procedure 92-20. In 1997, the IRS updated these in Revenue Procedure 97-27. Shortly thereafter, the Service dealt with a broad variety of "automatic" accounting method change requests by bringing them all under the single umbrella of Revenue Procedure 97-37. At the same time, the Service updated and restated some 5 year old revenue procedures dealing with certain specialized accounting methods used by automobile dealers. These recent changes are summarized on pages 7-9.

Buyers Home Warranty Company, recently decided in the U.S. Tax Court, (T.C. Memo 1998-98) clearly shows the hazards in playing a "wait and see" game with the IRS over questionable accounting methods. The IRS determined that the taxpayer's method of accounting did not accurately reflect income and proposed to change the method, with a corresponding adjustment under Section 481(a). The Tax Court upheld the IRS in determining that the year of change for starting the new accounting method was the earliest open year (1990), and not three years later in 1993 when the IRS started its examination. The earlier the year of change, the more expensive it is for the taxpayer.

THE BUSINESS

The taxpayer in this case sold home warranty contracts to buyers and sellers of previously owned residential property. These contracts were not sold directly to the ultimate homeowners; instead they were sold through realtors and escrow companies. Under the terms of the basic home warranty contract, which was non-cancelable and non-refundable, the Company agreed to repair or replace covered systems (such as heating) and appliances (ovens, refrigerators, etc.) that became inoperative during the term of the contract. Additional coverage for other systems (for example air conditioning systems) and other appliances (such as swimming pool equipment) was available for additional consideration. The contracts only covered claims submitted within the contract period.

The Company did not directly repair or replace any failed system. Instead, it contracted with a network of technicians and independent contractors to make such repairs. Upon notification by a contractholder that a covered system or appliance had failed, the Company would dispatch a technician or tradesperson who would assess the damage and was then required to obtain authorization from the Company before commencing any work. The contractors and technicians were required upon each visit to collect from the contractholder a "trade call fee," which represented the contractholder's portion of the repair bill. The contractholder or technician would then bill the Company for any fees in excess of the trade call fee.

The Company only conducted business in California, and that State regulated the Company as an insurance company. Accordingly, it was required to pay State premium taxes, file an annual statement with the State, and maintain certain statutory reserves and minimum net worth. These additional details were not incorporated into the Tax Court decision but come from the underlying Technical Advice Memorandum 9416001 dated December 10, 1993.

THE COMPANY'S METHOD

The Company reported as income 1/12th of the income received for each month a contract was in effect during a taxable year. It also employed a half-month convention for the month in which the contract was sold. For example, if a one-year contract was sold for \$240 in July, the taxpayer would recognize \$10 as income for July and \$20 would be recognized as income for each month from August through December of that first year. Thus, the Company would report \$110 (\$20 times 5 plus \$10 for the half-month). The remaining \$130 (\$240-110) would be deferred until the second year in which the Company would recognize \$20 for each month from January through June and \$10 for July of the second year. This would seem like pretty good basic accounting.

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In addition to the above, the Company deducted as an "other deduction" an amount of 20% of the premiums it recognized. This deduction was described as "provision for reserves." Thus, when the Company recognized $110 in its first year, it would also take a corresponding deduction of $22 ($110 times 20%). In the second year, the Company would recognize as income the "provision for reserves" deduction from the prior year. Thus, to complete the illustration, in year one the Company effectively reported $88 ($110 minus $22) and in the second year it reported income of $152 ($130 plus $22). Over the entire 12 months of the contract, $240 was reported in full.

IRS AUDIT & TECHNICAL ADVICE

In March of 1993, the IRS began an examination of the Company's 1990 and 1991 tax returns. The IRS later extended its examination to include the year 1992. Before the start of the IRS examination, the taxpayer had not applied for a change in its method of accounting. During the audit, one issue was whether or not the home warranty contracts constituted insurance contracts for purposes of Section 832. The taxpayer and the IRS agreed to obtain technical advice on this question from the IRS National Office in Washington, DC. In the technical advice proceedings, the taxpayer's position was that the contracts it sold were insurance contracts; and the IRS examining agent took the position that the contracts sold were "something other than insurance contracts," i.e., they were in the nature of prepaid service contracts.

In December of 1993, the IRS National Office held in its Technical Advice Memo (LTR 9416001) that the home warranty contracts were insurance contracts for purposes of Section 832.

At no time during the IRS examination process had the taxpayer submitted a Form 3115 requesting a change in accounting method. However, while in Appeals, the taxpayer requested that it be treated "as if it had requested a change in method."

TAX COURT'S DISCUSSION

The taxpayer had reported its income and deductions from the sale of its contracts using a method it believed to be acceptable under Generally Accepted Accounting Principles (GAAP). However, the method of accounting that the taxpayer used for the years 1988 through 1992 was not in accordance with Section 832 which governed accounting methods for "insurance companies other than life insurance companies."

The issue for the Tax Court to decide was which year, 1990 or 1993, should be the year of change, i.e., the first/earliest year for which the new accounting method was to be employed.

Section 446(b) provides that if the method of accounting used does not clearly reflect income, then the computation of taxable income shall be made under such method as does clearly reflect income. Furthermore, when a taxpayer's accounting method is changed, Section 481(a) requires that adjustments must be made to the taxpayer's income "to prevent amounts from being duplicated or omitted." The adjustments made to implement the new accounting method are applied in the "year of change" which is defined by Reg. Sec. 1.481-1(a)(1) as "the taxable year for which the taxable income of the taxpayer is computed under a method of accounting different from that used for the preceding taxable year."

Neither Section 481 nor the regulations thereunder explain how the year of change is chosen. If the taxpayer had requested a change in accounting method, the IRS would have used Revenue Procedure 92-20 (1992-1 CB 685) to determine the year of change. However, where the taxpayer makes no request for permission to change an accounting method, "the changes required by (the IRS on) examination are applied by default to the earliest open year for which the limitations period has not expired." In this case, 1990.

Reg. Sec. 1.481-1(c)(5) provides that "a change in the taxpayer's method of accounting ***required*** as a result of an examination of the taxpayer's income tax return will not be considered as initiated by the taxpayer." Both the regulations and Revenue Procedure 92-20 differentiate between accounting method changes initiated by the taxpayer and changes initiated by the IRS Commissioner. Generally, the year of change is more favorable to the taxpayer if the change in method is initiated by the taxpayer.

TAXPAYER'S ARGUMENTS

The taxpayer raised two arguments in trying to move the year of change forward to 1993. First, it contended that it had participated in a "compromise" and that as a result of so doing, "there was no *requirement* that (the taxpayer) change accounting methods." The Tax Court found that nothing in the record indicated that the taxpayer had initiated any of the events related to its change in accounting method ("despite the spin Petitioner attempts to place on [the] events"). Furthermore, the stipulation of facts also contradicted that contention.

The Court held simply that the taxpayer was required to submit to the audit, and that it was required by the IRS Notice of Deficiency to change its accounting method. Under these circumstances, it fell squarely within the portion of the regulation that dealt with

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accounting method changes "required as a result of an examination of the taxpayer's income tax return."

The taxpayer also contended that Revenue Procedure 92-20 violated its right to "equal protection" because there were no cases or other rulings that indicated that its original method of accounting was erroneous. The taxpayer attempted to strengthen this argument by pointing out that the IRS agent who proposed that the warranty method be used was overruled when the issue was addressed by the IRS National Office. The taxpayer argued that the fact that the National Office did not agree with the field agent meant that the taxpayer had no reason to presume that its accounting method was incorrect.

The Tax Court did not accept the taxpayer's "equal protection" argument either. The Court stated that even if one method advocated by the IRS was not adopted, it does not necessarily follow that the taxpayer's existing method of accounting was correct. It observed that the regulations acknowledge that the same method of accounting cannot be used by all taxpayers, and that what is required is that the method of accounting chosen "clearly reflect income." Since the taxpayer had agreed that it operated as "an insurance company," it was required to use the method of accounting prescribed by Section 832 of the Internal Revenue Code.

The Court pointed out that the taxpayer was trying to inject a subjective element into the Code that does not exist. The Court said: "There is nothing in the statute or regulations concerning what to do if the taxpayer thought, incorrectly, that the method used clearly reflected income. The IRS is concerned with collecting the correct amount of revenue. Nowhere in the applicable provisions of the Code does the taxpayer get credit if it thought it correctly calculated income. If the taxpayer acts in good faith, but is incorrect, it owes the deficiency. If it is willfully or negligently incorrect, it may also owe penalties and additions to tax. Petitioner here owes only the deficiency."

The Tax Court observed that the purpose of Rev. Proc. 92-20 was to "encourage prompt voluntary compliance" by attempting to get taxpayers to request permission to make accounting method changes before the IRS came in and began audits. The Court also noted that the Revenue Procedure (84-74) that Rev. Proc. 92-20 had replaced had been used by some taxpayers to request a change in a later year and on better terms than those contained in the statute.

In other words, Revenue Procedure 92-20 deliberately raised the stakes for taxpayers who simply waited to see if the IRS might raise an accounting method issue on audit.

The Court noted that if the taxpayer in this case were allowed to use 1993 as the year of change, it would be allowed to knowingly use an incorrect method for three (extra) years. This result is exactly what Revenue Procedure 92-20 was implemented to prevent.

CONCLUSION

The *Buyers Home Warranty Company* case gives clear, convincing evidence of the risk a taxpayer takes in deciding to not voluntarily change what might be a questionable accounting method. Although Revenue Procedure 92-20 has been superseded by Revenue Procedure 97-27, that would make no difference in the holding. The year of change would still be the earliest open year.

AT A GLANCE	REVENUE PROCEDURE 97-27 ACCOUNTING METHOD CHANGE REQUESTS	REGULAR
TIME FOR FILING FORM 3115	• Any time before the end of the year of change. Old 180-day ... mid-year ... filing deadline eliminated.	
SPREAD PERIOD FOR SECTION 481(a) ADJUSTMENTS	• Except for changes made employing the cut-off method, taxpayers are granted a four (4) year spread period for all accounting method change adjustments, whether positive or negative. The 4-year spread replaces the old 3 or 6-year spread periods available under Rev. Proc. 92-20.	
90-DAY WINDOW FOR CHANGES AFTER START OF IRS AUDIT	• ELIMINATED under new rules: The 90-day window that began with start of IRS audit for making changes under more favorable terms and conditions than those resulting if taxpayer were forced by the IRS to change method. • LIFO taxpayers could be particularly disadvantaged by the change.	
NOT CHANGED	• Cut-off method and audit protection for prior years still available for LIFO method changes "voluntarily" requested by taxpayers before the start on an IRS audit. • *Hamilton*-type changes require Section 481(a) adjustments. • Risk of termination of (entire) LIFO election (due to an eligibility violation) in a year prior to the year in which a LIFO sub-method is being changed. • $25,000 *de minimis* election allows taxpayers to take entire Section 481(a) adjustment into income if less than $25,000 in the year of change. • Ability to offset Section 481(a) positive adjustments against net operating losses. • Five (5) year wait to readopt LIFO.	
FEWER SPECIAL RULES	• Elimination of Category A, Category B, Designated A and Designated B classifications and distinctions. • Special rules for taxpayers under continuous IRS audit examination. • Notification procedure replaces the consent requirement for taxpayers before an Appeals Officer or a Federal Court. • Clarification of the term "under examination."	
EFFECTIVE DATE	• May 15, 1997 ... Supersedes Revenue Procedure 92-20.	
SPECIAL TRANSITION RULES	• Forms 3115 filed and pending on May 15, 1997 May elect application of new Rev. Proc. 97-27 rules by notifying the IRS before IRS issues letter granting or denying pending change request(s). • Forms 3115 filed after May 15 and before December 31, 1997: May elect to use provisions of old Rev. Proc. 92-20 instead of new terms. • For taxpayers who came under audit between Feb. 15 and May 15, 1997, and who could still make changes under the old 90-day audit window of Rev. Proc. 92-20.	

	FORMER	SUBJECT	REPLACED BY
RELATED CHANGES	Rev. Proc. 92-20	General Rules for Changing Methods	Rev. Proc. 97-27
	Rev. Proc. 92-79	Alternative LIFO Method for Automobile Dealers	Rev. Proc. 97-36
	Rev. Proc. 88-15	Termination of LIFO Elections	Rev. Proc. 97-37
	None	Used Vehicle Cost Determinations	Rev. Proc. 97-37
	None	Determining Current Year Cost Under the LIFO Method	Rev. Proc. 97-37
	Rev. Proc. 92-97	Treatment for Deducting Insurance Premium Payments on VSCs	Rev. Proc. 97-37
	Rev. Proc. 92-98	Service Warranty Income Method (SWIM) for Extended Warranty/Vehicle Service Contracts	Rev. Proc. 97-38

AT A GLANCE	REVENUE PROCEDURE 97-37 *AUTOMATIC* ACCOUNTING METHOD CHANGE REQUESTS	AUTOMATIC

GENERAL	• Very long and comprehensive document. • Provides simplified and uniform procedures, terms and conditions to obtain ***AUTOMATIC*** consent to make some 25 changes in methods of accounting. • Because of its length, Rev. Proc. 97-37 includes various detailed procedural rules for LIFO method changes in Section 10 of an Appendix.
EFFECTIVE DATE	• Effective for tax years ending on or after August 18, 1997 ... Superseding various revenue procedures.
USER FEE	• A user fee is ***not*** required for applications filed under Rev. Proc. 97-37. • IRS National Office will not acknowledge receipt of an application filed under Rev. Proc. 97-37. • **Suggestion:** It would seem advisable to send/file the copy of the Form 3115 to the IRS National Office by certified mail or with one of the IRS approved carriers (Fed Ex, UPS, etc.) providing documentation of delivery. You should then retain the receipt or other evidence of delivery provided as proof of the date that the copy was filed with the National Office.
TIME AND PROCEDURE FOR FILING FORM 3115	• Changes in accounting method that involve "automatic" consent changes are not required to be filed with the Internal Revenue Service until after the end of the year. • Such changes are made along with the filing of the (corporate) income tax return for the year of change. • Additional procedural step: When the income tax return for the year of change is filed with the IRS Service Center, ***a copy*** of Form 3115 is required to be filed with the IRS National Office in Washington, DC. • Form 3115 must be completed and filed ***in duplicate***. The ***original*** of Form 3115 must be attached to the taxpayer's timely filed (including extensions) original Federal income tax return for the year of change. A ***copy*** of the Form 3115 application must be filed with the National Office ... no earlier than the first day of the year of change and no later than when the original is filed with the Federal income tax return for the year of change. • **Observation:** Taxpayers now have added "planning flexibility" and the opportunity to benefit from a defensive strategy after the year is over by using these automatic consent change procedures. The risk in delaying the filing of Form 3115, of course, is that the longer one waits to file Form 3115, the greater the possibility that during that "waiting period," the IRS may just happen to start an audit and challenge the method of accounting being used. See accompanying article discussing consequences in *Buyers Home Warranty Company* (T.C. Memo 1998-98). • It may be desirable to file the *copy* of the Form 3115 with the National Office well in advance of the time when the original Form 3115 will be included as part of the Federal income tax return filed for the year. This, hopefully, will demonstrate the taxpayer's good faith intention to make the change at a time before it is contacted by the IRS for audit. Note that the filing with the National Office cannot occur before the start of the year of change.
FORM 3115	• Current Form 3115 bears November, 1997 revision date. This revision should now be used for all changes. • Requires attachment of a narrative statement describing and justifying to the IRS the change being made.
SPREAD PERIOD FOR SECTION 481(a) ADJUSTMENTS	• Except for changes made employing the cut-off method, taxpayers are granted a four (4) year spread period for all accounting method change adjustments, whether positive or negative. The 4-year spread replaces the old 3 or 6-year spread periods available under Rev. Proc. 92-20.

AT A GLANCE

REVENUE PROCEDURE 97-37
AUTOMATIC
ACCOUNTING METHOD CHANGE REQUESTS

AUTOMATIC

INCLUDES CHANGES TO ALTERNATIVE LIFO & SWIM METHODS

- Alternative LIFO Method (Rev. Proc. 97-36) & SWIM Method (Rev. Proc. 97-38).
- Each method is repeated word for word as it was in the original, with no real modification or clarification of the original.
- All cumbersome transition rules necessary in the original revenue procedures (92-79 and 92-98) have been deleted.
- If an auto dealer previously elected to make these accounting method changes under the original revenue procedures, then no further action is required by the dealer.

TERMINATION OF LIFO ELECTIONS (SECTION 10.01 OF APPENDIX)

- To qualify for automatic change, taxpayer must ...
  A. Terminate LIFO Method for **<u>ALL</u>** LIFO Inventories, and change to a "Permitted Method."
  B. If taxpayer does not want to terminate <u>ALL</u> LIFO elections at the same time, then Rev. Proc. 97-27 applies (to "partial" LIFO termination situations).
- Allows 4-year spread period for recapture of LIFO reserve ... (same as the general Section 481(a) spread for positive adjustments under Rev. Proc. 97-27).
- Provides specific rules for determining what inventory method must be used by taxpayer based upon one of four possible scenarios.
  A. If the taxpayer has inventoriable goods not included in its LIFO inventory computations (non-LIFO inventory) and, for all the taxpayer's non-LIFO inventory, the taxpayer uses an inventory method that is a permitted method, then the taxpayer <u>must use that same inventory method for its entire inventory</u>.
  B. If the LIFO inventory method is used by the taxpayer with respect to all its inventoriable goods, then the taxpayer must use the same inventory method it used prior to the adoption of the LIFO inventory method, if that prior method is a permitted method.
  C. If the taxpayer has only LIFO inventory and the method used by the taxpayer prior to the adoption of the LIFO inventory method is not a permitted method, then the taxpayer must use a permitted method.
  D. If the taxpayer did not use an inventory method prior to the adoption of the LIFO inventory method and has no inventoriable goods other than its LIFO inventory, then the taxpayer must use a permitted method.
- Defines "Permitted Method" which consists of...an identification method <u>and</u> a valuation method.
  A. ***Identification*** method must be either (1) First-In, First-Out (FIFO) or (2) specific identification.
  B. ***Valuation*** method must be either (1) cost, (2) cost or market, whichever is lower ... (market, farm price methods and retail method are provided for other taxpayers).
  C. Specifically prohibits the use of the average cost method ("rolling average method" described in Rev. Rul. 71-234).
- **Five (5)-Year Wait:** Taxpayer may not re-elect LIFO for at least five years, unless, based on a showing of unusual and compelling circumstances, IRS grants consent to change back to LIFO.
- Supersedes Rev. Proc. 88-15 ... which allowed taxpayers a filing deadline as late as 270 days.

OTHER LIFO METHOD CHANGES

- **<u>DETERMINING THE COST OF USED VEHICLES PURCHASED OR TAKEN AS A TRADE-IN</u>**

  This does not set forth an *official* or *IRS approved* LIFO methodology for used vehicles ... It only indicates that taxpayers agreeing to use the (somewhat restrictive) methods for determining cost of used vehicles <u>*that it describes*</u> are permitted to make <u>*those*</u> changes under the automatic consent provisions ... These changes are permitted to be made using the cut-off method (i.e., no Sec. 481(a) adjustment is required).

- **<u>DETERMINING CURRENT YEAR COST UNDER THE LIFO INVENTORY METHOD</u>**

  IRS now allows changes involving the determination of current year cost to be made under the automatic consent provisions ... These changes are permitted to be made using the cut-off method (i.e., no Section 481(a) adjustment will be required).

- **<u>INVENTORY PRICE INDEX COMPUTATION (IPIC) METHOD CHANGES</u>**

  Certain changes involving the IPIC method are now allowed under the automatic consent provisions.

CAPITAL GAINS TAXATION ... A LOOK AT SOME SPECIAL SCHEDULE D SITUATIONS

FORM 1040 SCHEDULE D 28% v. 20% v. 39.6%

With the "filing season" over for now, except for a handful of inevitable extensions, most readers are glad to put Form 1040 and the so-called "taxpayer relief provisions" out of their minds ... at least for a while.

The April 8 *Wall Street Journal* commented that the "new complexity may encourage more people to file for extensions this year. Many frazzled taxpayers wrestling with the new capital gains rules and form would be well-advised to take advantage of the IRS' offer of an automatic four-month extension." The new "form" was, of course, Part IV of Schedule D, entitled "Tax Computation Using Maximum Capital Gains Rates."

SCHEDULE D ... THE CAPITAL GAINS TAX MAZE

The Taxpayer Relief Act of 1997 (TRA '97) significantly changed the taxation of certain long-term capital gains. The new law reduced the maximum individual tax rate on long-term capital gains from 28% to 20% for assets held more than 18 months and sold after July 28, 1997. The "old" 28% maximum rate for long-term capital gains continues to apply to assets sold with a holding period of more than one year but less than 18 months. These assets are referred to as "mid-term" assets.

Assets sold with a holding period of less than one year would be taxed at the individual's regular highest tax rate of up to 39.6% per the rate schedules. This nominal rate is effectively a little higher, sometimes reaching as high as 42%.

Now, assets sold after July 28, 1997 which qualify for the new 20% maximum tax rate on long-term capital gains are referred to as "long-term" assets. Due to a glitch, for a very short period of time (from May 7, 1997 through July 28, 1997), assets held for more than one year and less than 18 months were allowed to be taxed at the maximum capital gains rate of 20% rate as well. All of this is summarized in the table below.

Some dealers (and other clients) closely review their tax returns and take a serious interest in understanding everything that is going on in them. Even these more critical observers had difficulty grasping the correctness of a tax computation involving these mixed-mongrel capital gains rates.

In short: Schedule D, Part IV is not a very pretty sight. However, with a little thought and a macro or "side schedule", it is easy enough to "see" that the tax computation was properly made and all "pieces" were properly taxed.

One dealer's return with a good "mix" of information shows how short-term capital gains, mid- and long-term capital gains all fit together in the 1997 jigsaw puzzle that is capital gains taxation. Although you wouldn't know it by simply looking at page 1 of Schedule D, during 1997, this dealer realized $11,104 of net long-term capital gains which are taxable at the new, lower 20% maximum rate. (Can you find *Waldo*?) This only becomes evident by looking at the information in Schedule D, Part II, Line 8, and then subtracting the amounts in column (g) from the amounts in column (f): ($103,336 - 92,974 = $10,362 + 742 = $11,104).

The table below shows that the Schedule D, Column (g) 28% rate could actually have come from any one of three possible transactions: Assets sold before May 7, 1997 and held over one year and either (1) more than or (2) less than 18 months, or (3) assets sold after July 28, 1997 held more than one year, but held less than 18 months.

Both pages of the dealer's Schedule D appear on page 12. Page 13 shows the format for the schedule used to walk the dealer through the capital gains taxation maze.

Date Sold	Short-Term Holding Period Up to 1 Year	Mid-Term Over 1 year and less than 18 months	Long-Term Holding Period Over 18 months
Jan. 1 - May 6, 1997	39.6%	28%	28%
May 7 - July 28, 1997	39.6%	20%	20%
After July 28, 1997	39.6%	28%	20%

As a further cause of "Schedule D" confusion, it was estimated that the IRS will send one million letters to taxpayers who forgot to send in Schedule D due to another technicality. For 1997, it was not possible to omit Schedule D where all the taxpayer had to report was capital gains distributions. In past years, these amount could be entered directly on page 1 of Form 1040, if no other entries were required on Schedule D ... and the need to attach Schedule D was bypassed. Alas, not so for 1997.

INCORRECTLY COMPUTED CAPITAL LOSSES ON MUNICIPAL BOND REDEMPTIONS

In addition to the complications caused by the new holding periods and tax rate gymnastics, another common error to guard against is reporting capital losses on the pre-funding or retirement of municipal bonds that were previously purchased at a premium.

Often, transactions related to municipal bonds reported in Schedule D do not take into account the required downward adjustment for the amortization of bond premiums paid in prior years. These rules are found in Section 171 of the Code. Accordingly, what appears on the surface to be a loss on a call or redemption of a municipal bond (where a premium had been paid years ago on its purchase) should turn out to be no loss at all for income tax purposes.

MUNICIPAL BOND PREMIUM & DISCOUNT AMORTIZATION RULES

1. Bond premiums should be adjusted downward to arrive at a lower adjusted tax basis. This amortization of premiums paid is not deductible in any way, shape or form. In reality, the amortization of the premiums is simply an offset against the stated rate of interest which will be received on the bonds, and this amortization adjusts the net yield to current market rates.

2. Bond discounts should not be amortized upward (to reach par) to increase the adjusted tax basis.

3. The above rules are to be applied every year in determining the proper amount of (taxable) interest income from municipal bonds.

4. Sales (or calls) of bonds purchased at either premiums or discounts:

A. Bonds purchased at a discount: When the bonds are sold, the basis is the original cost (unamortized as indicated in Rule #2 above) if the bond is sold at a loss.

B. If the bond is sold at a gain, there is simply that much more gain to be recognized. This is a one-way street, working against the taxpayer.

APPLICATION OF AMORTIZATION RULES TO CERTAIN 1997 TRANSACTIONS.

Assume that during 1997 a $50,000 State X Student Loan Revenue bond was called on March 3, 1997 at 102.000. Assume further that this bond had been purchased on October 26, 1995 at a premium of $2,730 for a total cost of $52,730.

For tax purposes, the difference between the cost of $52,730 and the $51,000 (which was the 102.000 priced-to-call pre-funded amount based on the original issuance at 7.30% due March 1, 1999) should be amortized downward (see Rule #1) over the period of time from date of purchase (October 26, 1995) to the pre-refunded date of March 3, 1997. With this amortization occurring, year-by-year, the adjusted tax basis for the bond ratably drops from $52,730 down to $51,000 on March 3, 1997. Accordingly, the correct result for tax purposes on the call is zero (no) gain or loss ... and not a capital loss of $1,730 calculated as the difference between the $52,730 paid and the $51,000 proceeds received.

Another variation with the same result: Assume $55,000 worth of State X Development Finance Authority Pollution Control Revenue bonds were priced to call at June 1, 1997 at 103 (i.e. $56,650) and were called on that date. Assume further these bonds had been purchased on January 22, 1993 at a premium of $4,400 for a total of $59,400). Similar to the Student Loan Review Bonds, the difference between the original cost (including premium) of $59,400 and the $56,650 (which was the $55,000 x 103.00 priced-to-call pre-funded amount) would be amortized downward (see Rule #1) over the period of time from date of purchase (January, 1993) to the call date of June 1, 1997. With this amortization, the adjusted tax basis of the bond ratably drops from $59,400 down to $56,650 on June 1, 1997 and the amount realized on surrender of the bonds ($56,650) exactly equals this adjusted tax basis (cost minus amortization of premium). For income tax purposes, there is no gain or loss recognized on this call transaction either.

see **CAPITAL GAINS TAXATION... A LOOK AT SOME SPECIAL SCHEDULE D SITUATIONS**, page 14

Schedule D (Form 1040)
Department of the Treasury Internal Revenue Service

Capital Gains and Losses

► Attach to Form 1040. ► See instructions for Schedule D (Form 1040).
► Use Schedule D-1 for more space to list transactions for lines 1 and 8.

OMB No. 1545-0074
1997
12

Name(s) Shown on Form 1040: MR. & MRS. DEALER XYZ
Your Social Security Number: 999-66-4444

Part I Short-Term Capital Gains and Losses – Assets Held One Year or Less

	(a) Description of property (Example: 100 shares 'XYZ' Co)	(b) Date acquired (Mo, day, yr)	(c) Date sold (Mo, day, yr)	(d) Sales price	(e) Cost or other basis	(f) GAIN or (LOSS) FOR ENTIRE YEAR. Subtract (e) from (d)
1	30 AAA LAREDO INC	08/12/96	06/27/97	4,709.	3,754.	955.
	100 BBB SCOTT CO, INC	06/27/97	07/09/97	7,997.	8,128.	-131.
	300 LAND LINKS CO	07/09/97	09/23/97	11,304.	9,050.	2,254.
	100 ABBOT & COSTELLO	07/24/97	09/23/97	4,522.	3,651.	871.
2	Enter your short-term totals, if any, from Schedule D-1, line 2		2	205,165.		5,907.
3	**Total short-term sales price amounts.** Add column (d) of lines 1 and 2		3	233,697.		
4	Short-term gain from Forms 2119 and 6252, and short-term gain or (loss) from Forms 4684, 6781, and 8824				4	
5	Net short-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1				5	
6	Short-term capital loss carryover. Enter the amount, if any, from line 9 of your 1996 Capital Loss Carryover Worksheet				6	
7	**Net short-term capital gain or (loss).** Combine lines 1 through 6 in column (f) ►				7	9,856.

Part II Long-Term Capital Gains and Losses – Assets Held More Than One Year

	(a) Description of property (Example: 100 shares 'XYZ' Co)	(b) Date acquired (Mo, day, yr)	(c) Date sold (Mo, day, yr)	(d) Sales price	(e) Cost or other basis	(f) GAIN or (LOSS) FOR ENTIRE YEAR. Subtract (e) from (d)	(g) 28% RATE GAIN or (LOSS) * (see instructions)
8	50 XYZ MFG CO.INC	06/24/96	06/27/97	7,849.	7,107.	742.	
	SCHEDULE ATTACHED			218,927.	115,591.	103,336.	92,974.
9	Enter your long-term totals, if any, from Schedule D-1, line 9		9				
10	**Total long-term sales price amounts.** Add column (d) of lines 8 and 9		10	226,776.			
11	Gain from Form 4797, Part I; long-term gain from Forms 2119, 2439, and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824				11		
12	Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1				12		
13	Capital gain distributions				13		
14	Long-term capital loss carryover. Enter in both columns (f) and (g) the amount, if any, from line 14 of your 1996 Capital Loss Carryover Worksheet				14		
15	Combine lines 8 through 14 in column (g)				15		92,974.
16	**Net long-term capital gain or (loss).** Combine lines 8 through 14 in column (f) ►				16	104,078.	

*** 28% Rate Gain or Loss** includes all gains and losses in Part II, column (f) from sales, exchanges, or conversions (including installment payments received) **either:** • **Before** May 7, 1997, or
• **After** July 28, 1997, for assets held more than 1 year but not more than 18 months.
It also includes **All** 'collectibles gains and losses' (as defined in the instructions).

BAA For Paperwork Reduction Act Notice, see Form 1040 instructions. Schedule D (Form 1040) 1997
FDIA0612 10/24/97

Schedule D (Form 1040) 1997 MR. & MRS. DEALER XYZ 999-66-4444 **Page 2**

Part III Summary of Parts I and II

17	Combine lines 7 and 16. If a loss, go to line 18. If a gain, enter the gain on Form 1040, line 13	17	113,934.
	Next: Complete Form 1040 through line 38. Then, go to **Part IV** to figure your tax if: • Both lines 16 and 17 are gains, **and,** • Form 1040, line 38, is more than zero.		
18	If line 17 is a loss, enter here and as a (loss) on Form 1040, line 13, the **smaller** of these losses: • The loss on line 17; or • ($3,000) or, if married filing separately, ($1,500)	18	
	Next: Complete Form 1040 through line 36. Then, complete the **Capital Loss Carryover Worksheet** if: • The loss on line 17 exceeds the loss on line 18, or • Form 1040, line 36, is a loss.		

Part IV Tax Computation Using Maximum Capital Gains Rates

19	Enter your taxable income from Form 1040, line 38			19	947,123.
20	Enter the **smaller** of line 16 or line 17	20	104,078.		
21	If you are filing Form 4952, enter the amount from Form 4952, line 4e	21			
22	Subtract line 21 from line 20. If zero or less, enter -0-	22	104,078.		
23	Combine lines 7 and 15. If zero or less, enter -0-	23	102,830.		
24	Enter the **smaller** of line 15 or line 23, but not less than zero	24	92,974.		
25	Enter your unrecaptured section 1250 gain, if any (see instructions)	25			
26	Add lines 24 and 25	26	92,974.		
27	Subtract line 26 from line 22. If zero or less, enter -0-			27	11,104.
28	Subtract line 27 from line 19. If zero or less, enter -0-			28	936,019.
29	Enter the **smaller** of line 19 or $41,200 ($24,650 if single; $20,600 if married filing separately; $33,050 if head of household)			29	41,200.
30	Enter the **smaller** of line 28 or line 29			30	41,200.
31	Subtract line 22 from line 19. If zero or less, enter -0-			31	843,045.
32	Enter the **larger** of line 30 or line 31			32	843,045.
33	Figure the tax on the amount on line 32. Use the Tax Table or Tax Rate Schedules, whichever applies ►			33	308,157.
34	Enter the amount from line 29			34	41,200.
35	Enter the amount from line 28			35	936,019.
36	Subtract line 35 from line 34. If zero or less, enter -0-			36	0.
37	Multiply line 36 by 10% (.10) ►			37	0.
38	Enter the **smaller** of line 19 or line 27			38	11,104.
39	Enter the amount from line 36			39	0.
40	Subtract line 39 from line 38. If zero or less, enter -0-			40	11,104.
41	Multiply line 40 by 20% (.20) ►			41	2,221.
42	Enter the **smaller** of line 22 or line 25			42	0.
43	Add lines 22 and 32	43	947,123.		
44	Enter the amount from line 19	44	947,123.		
45	Subtract line 44 from line 43. If zero or less, enter -0-			45	0.
46	Subtract line 45 from line 42. If zero or less, enter -0-			46	0.
47	Multiply line 46 by 25% (.25) ►			47	0.
48	Enter the amount from line 19			48	947,123.
49	Add lines 32, 36, 40, and 46			49	854,149.
50	Subtract line 49 from line 48			50	92,974.
51	Multiply line 50 by 28% (.28) ►			51	26,033.
52	Add lines 33, 37, 41, 47, and 51			52	336,411.
53	Figure the tax on the amount on line 19. Use the Tax Table or Tax Rate Schedules, whichever applies			53	349,371.
54	**Tax.** Enter the **smaller** of line 52 or line 53 here and on Form 1040, line 39 ►			54	336,411.

FDIA0612 10/16/97

MR. & MRS. DEALER XYZ

FORM 1040: COMPUTATION OF TAX LIABILITY FOR 1997

TAXABLE INCOME: PAGE 1, LINE 38				$ 947,123
Less: Capital Gains in Schedule D, consisting of				
Short-Term Capital Gains			$ 9,856 *	
Long-Term Capital Gains taxed at old max rate of 28%		$ 92,974		
Long-Term Capital Gains taxed at new lower rate of 20%		11,104		
Subtotal Long-Term Capital Gains		$ 104,078	104,078	(104,078)
Net Capital Gains, Per Schedule D			$ 113,934	
Income Taxed at Ordinary Income Rates ... Wages, Interest & Dividend Income, K-1 Income & Short-Term Capital Gains				$ 843,045
TAX ON INCOME TAXED AT ORDINARY INCOME RATES				
First - $271,050 @		$ 81,647		
Remainder $571,995 @ 39.6%		226,510		
Total $843,045		$ 308,157		$ 308,157
Tax on Net Long-Term Capital Gains taxed at 28%:	$ 92,974 x 28% =		26,033	
Tax on Net Long-Term Capital Gains taxed at 20%:	11,104 x 20% =		2,221	
Tax on Net Long-Term Capital Gains	$104,078		$ 28,254	28,254
TOTAL INCOME TAX FOR 1997 Form 1040, Page 2, Line 39 and Schedule D, Part IV, Line 54				$ 336,411

* Short-Term Capital Gains are Taxed at Regular Ordinary Income Rates

** Note: Effective Tax on Long-Term Capital Gains $\frac{\$\,28,254}{\$104,078} = 27.15\%$

 (Continued from page 11)

TAX RETURN DISCLOSURES FOR CHARITABLE GIFT ANNUITIES

Often in working with dealers' estates and focusing on their estate planning, the opportunity exists to assist in estate planning for other family members. In some instances, if the dealer is already extremely wealthy and has *estate tax problems,* inheriting more assets from a parent may not be the best planning alternative available. This is where "disclaimers" can be useful in passing property to heirs without ever owning (or having a right to) the property. In other instances, the planning may more directly involve a dealer's parent.

One such situation involved a dealer's mother, age 94, who had transferred appreciated stock, with a value slightly in excess of $500,000, to a charitable organization, in return for which she received a lifetime annuity. In this instance, everyone wanted to be sure she would not "outlive" a stream of income providing her with a comfortable source of income for essential nursing home care for the rest of her life. Accordingly, the simple charitable annuity gift approach was selected, instead of using a charitable remainder trust arrangement.

Since the "gift" to the charitable organization, was in reality, a part sale–part gift (or bargain sale) transaction, several interesting income tax reporting and gift tax reporting considerations were involved. Technically, the transfer resulted in the sale of stock, the purchase of an annuity and the making of a charitable contribution to the extent of the excess of the fair market value of the stock ($520,000) over the present value of the annuity the donor would receive during the remainder of her lifetime.

INCOME TAX RETURN REPORTING. Disclosures were made in her individual income tax return, Form 1040, to reflect this transaction in several different places: Schedule D, Form 8283 (Noncash Charitable Contributions), and in a supporting schedule describing the charitable gift annuity transaction (see page 15). In addition, copies of certain documentation were attached to the return, including schedules provided by the charitable organization which summarized the computation of the charitable gift value of $342,500, and its donee acknowledgment letter.

Coordinated disclosures in the Form 1040, Schedule D, Part II (Long-Term Gains and Losses–Assets Held More Than One Year), for this taxpayer also included a reference on line 8 which said "...See Form 8283 relative to disposition of appreciated corporate stock to charity in exchange for an annuity." This statement in Schedule D notifies the IRS that the taxpayer disposed of corporate stock listed in the attachment, and that all of the details relating to it were included in the statement attached in support of Form 8283 for noncash charitable contributions.

As a final note on the income tax side of this transaction, the charitable contribution deduction of $342,500 resulting from the valuation of this annuity transaction created a charitable contribution deduction for 1997 that was in excess of the applicable limitation. Accordingly, it generated a charitable contribution carryforward from 1997 to future years that requires some monitoring, due to the relatively limited carryforward period (5 years) and conditions.

GIFT TAX RETURN REPORTING. Don't forget the *gift* tax return. In addition to the reporting of the transaction in the *income* tax return, a U.S. Gift Tax Return, Form 709, was required to be filed. The Gift Tax Return is required to be filed even though no gift tax was payable in connection with the gift to the charitable organization. The reporting instructions are clear that Form 709 is required to be filed, even though the deduction (on page 2) for gifts to charitable organizations eliminates any taxable gift for the year.

One further technicality related to the question on the top of page 2 of Form 709 which asks whether any discount has been claimed in connection with the value of the gift. One response to that question might be:
"The value of the Charitable Gift Annuity does not reflect a valuation discount, per se, for any of the reasons stated in the instructions to Form 709. However, the valuation of the gift does reflect appropriate reductions for actuarial purposes necessary to compute the present value of the stream of future payments to be received by the donor / annuitant for the remainder of her life."

CONCLUSION. This type of Charitable Gift Annuity may not be encountered very often since charitable gift annuities seem to be a less common form of estate-gift planning. However, this approach should not be overlooked as it is relatively less complicated than creating trusts which, as separate entities, require annual tax return filings and may result in the donor receiving a fluctuating–rather than a fixed–income stream every year.

MRS. CHARITABLE GIFT ANNUITANT

INFORMATION RE: CHARITABLE GIFT ANNUITY TRANSACTION WITH XYZ CHARITABLE ORGANIZATION IN 1997

FORM 1040: U.S. INDIVIDUAL INCOME TAX RETURN - 1997

During 1997, taxpayer transferred shares of stock in various corporations having a total value of $518,210 in exchange for a Gift Annuity which has a charitable gift value (after appropriate actuarial valuation factors are applied to reflect the taxpayer's age and AFR rate) of $342,518.

The appreciated corporate stock which was transferred to the XYZ Charitable Organization, City, State, was as follows:

1. 4,426 shs. Big Bank Co., Inc.
2. 2,043 shs. Power & Light, Inc.
3. 3,000 shs. MNO Railroad Company
4. 768 shs. XYZ Co., Inc.

This transfer constituted both the purchase of an annuity and the making of a charitable contribution in the amount of the excess of the fair market value of the stock over the annuity purchased.

Part of the gain on the transferred shares is allocated to the charitable gift amount and there is no capital gains tax on that portion. The remainder of the gain on the transferred shares is allocated to the annuity portion and that amount is taxed each year over the projected life expectancy of an annuitant/taxpayer.

Below are the consequences of the Charitable Gift Annuity Transaction described above:

Amount Transferred in Exchange for Gift Annuity:	$ 518,210
Present Value of Annuity; based on taxpayer age 94, 12% guaranteed payout rate, quarterly, including IRC Section 7520(a) election using October AFR rate of 7.6% (IRS Pub. 1457, Table S)	(175,692)
Charitable Contribution Deduction Claimed in Schedule A, Line 16 (and Form 8283)	$ 342,518

<u>Annuity Payment Information</u>

Annual Payments, 12% Guaranteed Payout Rate	$ 62,185
Amount of Annual Payment That is Tax Free for Life Expectancy of 3.8 Years	(46,266)
Amount Reportable by Taxpayer/Annuitant as Ordinary Income Each Year	$ 15,919
Payments Received by Taxpayer/Annuitant During Calendar Year 1997:	NONE

PORCs: MORE ATTRACTIVE AFTER TRA '97

TAX COMPLICATION ACT OF 1997

Spread in Tax Rates

In the early eighties there was a vast difference in rates of tax for individuals, corporations and long term capital gains. President Reagan changed the law thus reversing the gap between favorable corporate tax rates and high individual tax rates; the result made corporate rates higher than individual rates. Most automobile dealerships switched the form of their tax operation to subchapter S. At that time the personal maximum tax rate was the same as the long-term capital gains rate (28%). Owners of automobile dealerships also began to lose their appetite for reinsurance companies.

Since the mid to late-eighties the personal maximum tax rate has crept up to it's current 39% (and in many cases in the 42% range) while the long term capital gain rate stayed at 28%. As this spread increased, there was a commensurate increase in numbers of reinsurance companies formed. Whoever said tax law doesn't influence business decisions lives on another planet.

The spread will now increase by another 66%, which is one reason to predict increased reinsurance company formations. Another bright light is the change in Alternative Minimum tax. Finally, there is also an increased emphasis on the aftermarket because it has become a more vital part of all franchise operations.

The tax bill signed by Clinton in early August 1997 created enhanced opportunities for owners of dealerships who currently own reinsurance companies. Also opportunities exist for those not yet having launched a reinsurance operation. Two areas of change dramatically affect reinsurance companies:

Alternative Minimum Tax

This section of the Act exempts small companies (defined as those with annual gross receipts less than $5,000,000) from the Alternative Minimum Tax. It is understood that this would mostly affect medium sized casualty companies that heretofore could elect to be treated only on investment income but feared the AMT. This would be eliminated making the medium sized reinsurance company (>$350,000 but less than $1,200,000 in premium) very attractive. The effective date is for tax years after 1997.

EXAMPLE	*BEFORE*	*AFTER*
TOTAL PROFIT	$200,000	$200,000
UNDERWRITING	(160,000)	(160,000)
NET TAXABLE	40,000	40,000
INITIAL TAX DUE	6,000	6,000
ADDED AMT TAX	18,000	-0-
TOTAL TAX DUE	$24,000	$6,000
EFFECTIVE RATE	12%	3%

Result

We will see more and more reinsurance company owners pushing premium levels up over $350,000 with addition of other aftermarket products. The obvious beneficiaries are credit insurance writers. Many reinsurance companies over the past five years have concentrated solely upon the Extended Service Contract type of risk. Now there should be more emphasis on credit insurance products – furthermore these products are expected to be reinsured on a written/written premium basis.

Capital Gains Treatment

The most talked about portion of the Act is lowering of long term capital gains rates down to 20%. This means that an asset (stock in a reinsurance company) that is sold or liquidated after being held for a "long term" would net the owner favorable tax treatment in the form of lower capital gains rates.

Of course with all Washingtonian designed products, this too is convoluted.

1. Long Term definition – Previously, long term was defined as an asset held twelve (12) months or more. Now the period of holding has stretched to eighteen (18) months in order to be considered long term. Except when an asset was held for 12 months in the period from May 7th, 1997 and July 29th, 1997 and sold in that time period; they receive capital gains treatment at the 20% level. If an asset was held for 12 months and sold after the July 28th, 1997 deadline, that unfortunate owner must pay tax at 28%. If however that asset was sold after July 28th, 1997 and had been held for more than 18 months,

that owner gets to treat the income at the new 20% rate.

2. Corporation owned assets – If a corporation owns an asset that has a capital gain, they still pay tax at a rate of 35%. There were no breaks in the Act for corporate ownership of long term appreciable assets. Curiously the definition of "long term" for corporate assets remains at 12 months.
3. Multiple Rates – The Act prescribes a long term rate of 28% for **collectibles** (art, antiques, gems, metals, stamps, coins, bullion, and alcoholic beverages – time to drink your wine because you are not going to get a break selling it!). A 25% tax on **real estate** that has been depreciated to the extent of all depreciation taken. **Future breaks** (hold your breath) start in ten (10) years for assets bought after 2000 and held more than five years – 18% top rate.

To simplify what this means to owners of reinsurance companies, consider the following chart (we presume that the owners are not on welfare for if they are, they get a better break – what a surprise)

Company Formed	Company Sold	Tax Rate
Individual owned Anytime	Held a minimum 12 months and sold after 6th May, 1997 but before 29th July, 1997	20%
Individual owned Anytime	Sold after 28th July, 1997 and held more than 12 but less than eighteen (18) months	28%
Individual owned Anytime	Sold after 28th July, 1997 and held longer than 18 months	20%
Corporate Owned Anytime	Held for 12 months and sold anytime	35%

Result

There will be demand from some owners to sell their companies. Lacking buyers, the reinsurance company management will request recapture of business in the company, then file a closing return and enjoy the distribution at long term capital gains rates. The owners may want to immediately form another company but this is not recommended. The IRS will go back and reclassify the distribution of the collapsed corporation as dividend income at the 39-42% tax rates.

Owners considering such tactics should wait at least one and preferably two tax years to avoid reclassification. This will cause many writers to warehouse premiums and enjoy investment income on the reserves. Painting this realistic scenario to the owners will likely make them revisit their plans to liquidate.

Other owners of automobile dealerships that heretofore have not been inclined to reinsure risks will change their mind. Just as the capital gains and personal income tax rates merged in the eighties, interest in reinsurance companies waned. With the dramatic differential in rates caused by the Act (20% versus 39-42%), many more entrepreneurs will form reinsurance companies. This will more than replace those that immediately cash-in for current capital gains.

Conclusion

The next five years will be a very positive boom in the aftermarket reinsurance arena. Those that offer their products, enhanced through the single owned reinsurance concept will reap the benefits of this renewed wave of interest from automobile dealership owners. History indeed does repeat itself.

You are positioned in the extraordinary jurisdiction of Nevis. We will have no regulatory interference to hinder the growth in the number of your single owner reinsurance companies. Other favorite reinsurance domiciles have ramped-up their regulatory controls and will soon disappear to the great reinsurance domicile graveyard in the sky joining such places as Arizona, the British Virgin Islands, etc.

The Mailho Network is ready to assist in your attaining this growth potential. Thank you for your support.

ESTATE PLANNING WHERE THE DEALERSHIP IS THE MOST VALUABLE ASSET

'98 NADA WORKSHOP

In this 1998 NADA workshop session "Estate Planning where the Dealership is the Most Valuable Asset," Robert Seaburg pointed out that the key questions the dealer should be asking cluster around: What do you want to happen to your dealership? Are you going to sell the dealership? Are you going to hold it within the family? How are you going to get out all of the dealership value that your efforts have created?

Mr. Seaburg challenged attendees to consider whether they have spent as much time thinking about reducing transfer taxes as they have spent thinking about reducing income taxes and income tax matters. These transfer taxes, known as the unified estate and gift tax transfer structure, reach as high as 55% of one's taxable estate, and high net worth Americans can expect to lose more to estate taxes than all they have paid out cumulatively during their lifetimes in income tax. The transfer tax rates start at 37%—almost the same top rate as for individual income taxes—and increase up to 55%. Since estate and gift taxes are unified, estate planning is not only about what is going to happen when a dealer dies; it also is about what is going on in his or her life right now and avoiding the confiscatory transfer taxes which are simply intended to redistribute wealth.

ESTATE TAX RELIEF FOR DEALERS? DON'T HOLD YOUR BREATH

Some dealers may think they are going to be greatly helped by the Taxpayer Relief Act of 1997. In particular, they may think that the increase in the unified credit will make a major difference. This amount is also known as the $600,000 "freebie" or estate exclusion amount. Before the change, each person had $600,000 that could be sheltered from estate and gift taxes, and together, a husband and wife could shelter $1.2 million. Those amounts have increased from $600,000 up to $625,000 for 1998, and they are scheduled to increase until the year 2006 when the amount will be $1,000,000 for each person. Unfortunately, the bulk of the future increases in the exemption come in the years after the year 2003.

Congress realized that it had not increased the exemption amount since 1986. To put things in perspective, if one takes the original $600,000 in 1986 and adjusts it for 3% inflation per year for 20 years, the compounded result approximates the $1,000,000 target exemption in the year 2006. As stated above, most of the future phased-in increase in the unified credit amount comes after the year 2003. Coincidentally, that is right after the last year when the Clinton Budget Plan is expected to balance the budget.

For Decedents Dying in, or for Gifts During	*Unified Credit Amount*	*Equivalent Exemption or Exclusion*
1997 ... no change	*$192,800*	*$600,000*
1998	*202,050*	*625,000*
1999	*211,300*	*650,000*
2000 and 2001	*220,550*	*675,000*
2002 and 2003	*229,800*	*700,000*
2004	*287,300*	*850,000*
2005	*326,300*	*950,000*
2006 and beyond	*345,800*	*1,000,000*

Another factor which Seaburg calls the "exclusion illusion" reduces future benefits under the 1997 Act. To explain, go back again to the year 1986: If $600,000 had been put into large company stocks in 1986, that amount over 10 years might have grown to almost $2,500,000. Projecting another 10 years to the year 2006, that amount might further accumulate to as much as $10,000,000. With Congress raising the exemption to $1,000,000 by the year 2006, that leaves the $9,000,000 difference between the $1,000,000 exemption and the $10,000,000 worth of projected value unsheltered from estate tax rates which can go as high as 55%.

Considering the fact that some dealerships have increased significantly in value over the last several years, the exposure to significant estate taxes becomes apparent. This will be even more significant if the growth in the value of assets out-paces the increases Congress provided for in the unified credit amount through the year 2006.

In the 1997 Act, Congress created a new "family owned business exclusion" starting in 1998. This is an extra $675,000 in addition to the $625,000 available right now, for a combined $1.3 million exemption. However, the $1.3 million combined total does not increased in the future. It remains fixed or constant at that ceiling amount. What happens in the future is that as the unified credit amounts increase according to schedule, the family owned business exemption will decrease by the same amount as the unified credit increases.

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Unfortunately, there are several difficult requirements to be met in order to qualify for the family owned business exclusion. These include: (1) the business has to be over 50% of the estate, (2) the deceased owner must have materially participated in the business in the past, and (3) the heirs who receive the business must "materially participate" in the business in the future after the death of the business owner. Furthermore, if the business is sold outside the family group within the period of 10 years, the benefit of this special exclusion has to be recaptured or repaid.

Accordingly, most advisors are telling dealers not to anticipate any significant benefits from the 1997 Act changes, including the new "family owned business exclusion". If it so happens that some benefits do result, that's fine ... however, considering all the restrictions involved, these benefits are likely to be more cosmetic than real.

FAMILY SUCCESSION ISSUES: "YOU REALLY DON'T KNOW SOMEONE UNTIL..."

In discussing family succession issues, Seaburg recalled the old saying: "You really don't know someone until you've shared an inheritance with them." This goes to the heart of the question of how heirs coming into an operating dealership might be expected to get along with each other in running and managing the business. Problems they are going to have to deal with include maintaining adequate cash flow, paying off debt, and retaining in the business some good managers who are not family members.

Mr. Seaburg expects that the growth and the value of most dealerships will far exceed the comparatively paltry increases available through the increased exemption amounts and the family owned business exclusion recently provided in 1997. Therefore, to protect the value of most dealerships, other planning vehicles need to be considered. In addition, a written plan that covers the dealer's "vision" and strategies should be prepared, and this should address who is going to receive the dealership and what method or methods will be applied to transfer the dealership assets. Will the successors receive the dealership while the dealer is alive or must they wait to receive it by inheritance after death? Will active participation in the dealership be required as a condition of ownership? Will there be any distinctions in voting rights? And, what about issues of "involved" vs. "non-involved" family members?

Seaburg urges dealers to not necessarily think about treating family members ***equally***. Instead, they should think about treating family members ***equitably*** ... or ***fairly***. Family members should be treated in terms of what is right and fair for them as individuals. This does not necessarily equate with their receiving equal shares in a dealership business. Dealers should look at all the assets and try to pass them on in such a way so that there is an ***equitable***—and not necessarily an ***equal***—distribution of assets among family members.

Dealership succession involves dealership agreements, valuation and family buy-sell issues. In terms of dealership agreements, can the restrictive conditions on dealership transfer be revised? Restrictions on dealership stock distribution need to be dealt with upfront and immediately, rather than eventually. Valuation becomes a critical issue as well. One should expect that the IRS will look at overall industry measures for valuing dealerships and compare them with any value placed upon a dealership in an isolated buy-sell or family situation.

In terms of buy-sell agreements, the easiest way to fund a buy-sell agreement is by purchasing life insurance on the owner(s). The IRS looks at buy-sell agreements involving family members expecting to find the same arms-length terms as would be found in buy-sell agreements not involving family members. In some cases, it may be easier to simply transfer the dealership at death and to fund that transfer/inheritance by an irrevocable life insurance trust vehicle for that purpose. Seaburg points out that sometimes advanced techniques involve relatively simple strategies.

Dealers can expect that their estate tax returns will undergo a thorough IRS examination. Another key issue will be the valuation of the dealership. Typically, if there is a business valuation formula included in a buy-sell agreement, if that formula is reasonable, it will prevail unless and until some major changes occur to make the formula unsuitable. Judgment calls will always be needed to determine whether new developments, local factors, or changes in the valuation of the underlying real estate at its highest and best use are sufficient to warrant a resetting of a price for the business in the buy-sell agreement.

GIFTING IS "TAX-EXCLUSIVE"

The simple concept of long-term gifting is most attractive. Long-term gifting is governed by two concepts: (1) the annual $10,000 exclusion, and (2) the removal (from the eventual estate) of any further appreciation or income flow related to the property gifted. Gifting is important because when property is gifted, not only is the current value of this property removed from the estate, but whatever future appreciation that property might experience, <u>and</u> all of the income that the property might earn in future years, is also removed from the estate.

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 (Continued from page 19)

The applicable exclusion amount $625,000 is available now and can be used immediately. It is not necessary to wait until death to use it. For some, using all or most their lifetime exemption immediately may provide far greater overall estate tax savings than staying only within the $10,000 (or $20,000 if married) annual exclusion amounts. If a gift of $625,000 were made fully utilizing the lifetime exemption now, if that property earned 8% per year for 20 years, it would accumulate or compound to $3 million at the end of 20 years. This amount would have been transferred to heirs without being subject to any estate tax.

As an alternative, a dealer might consider setting up an irrevocable life insurance trust or "sinking fund" to accomplish similar, significant results. These are achieved by gifting $10,000 or $20,000 annually to an irrevocable life insurance trust under which the trustee applies for and owns insurance on the life of the dealer. If the dealer is not the owner of the life insurance and does not possess any "incidents of ownership," the insurance proceeds will not be included in his or her estate at death.

Although the same unified rates apply for gift and for estate tax purposes, the gift tax is "tax-exclusive," whereas the estate tax is "tax-inclusive." When property is passed to an heir through an estate, the amount necessary to equal the intended gift to be passed to that heir includes the amount of estate tax which is paid on that gift. In other words, for the very wealthy in the highest brackets, in order to make a gift of $1 million, the gift tax paid would be roughly $500,000. Instead, if the $1 million gift were deferred and not made until death when the property was passed through the estate, it would take $2 million worth of property value to create the residual property worth $1 million being "gifted" at death to that same beneficiary.

Discounts are another means by which more property value can be transferred at a lower transfer tax cost. Certain business structures or organizations such as S Corporations and limited partnerships are more conducive to the transfer of large amounts of value at lower transfer costs. These structures facilitate gifting pieces or units of the business at discounted values. Discounts for gifting a minority interest and for lack of marketability, in combination, can range up to 40% where limited partnership interests are involved. In some instances, those discounts may be even greater. With a 30% discount, property worth $13,500 could be gifted annually and still result in a net gift valuation of less than the $10,000 annual exclusion amount.

Another important planning device is the GRAT or Grantor Retained Annuity Trust. If the stock is put into a Grantor Retained Annuity Trust, and the term of the trust and the terms of the annual pay-out are determined, at the end of that term of years for the trust, the stock will pass to family members. Since the family has to wait a number of years to get the stock, *and* if the grantor dies during the term of the trust the property is placed back in his estate, a discount may be taken against the value of the property when the property is placed in the GRAT.

Assuming a 65 year-old puts stock in a closely-held business worth $1 million into a GRAT for a ten year period, with the grantor receiving a 6% interest from the trust annually while he is alive, the grantor will receive a $60,000 annuity every year. Under these circumstances, the value of the gift property put into the GRAT is not $1 million because the children who will ultimately receive the property have to wait ten years in order to receive it. In this case, the taxable gift is only about $625,000 ... a reduction of 37.5% of the total amount originally placed in the GRAT.

In this case, the donor could apply his entire unified credit/lifetime exemption against that net amount, and would end up paying only a small amount of gift tax on the gift.

What is important to focus on is what happens if the value of the stock placed in the GRAT continues to appreciate ... especially if it appreciates significantly ... during the ten-year term of the trust. All of that appreciation will ultimately pass to the children at the end of the ten year period without any transfer tax. The key to the benefit (or in order to win the game):

The donor has to outlive the term of the trust.

One of the examples Seaburg gave involved the combination of a dealership restructuring with GRATs where a dealership elected S treatment and the dealer kept 1% of the voting stock with the remaining $990,000 was divided into two equal portions. Each half was gifted into a GRAT, and the results were as follows: $495,000 reduced by a 30% minority interest nets down to $346,000. This $346,000 is further discounted when the stock interest is put into a ten-year GRAT and the original $495,000/$346,000 now nets down to $217,000. Since there were two halves or equal portions, putting each portion into a separate GRAT resulted in a total gift of $434,000 ($217,000 x 2). The dealer could then use his lifetime exemption of $625,000 to more than offset the gift tax liability on $434,000 ... thus combining discounts and GRATs for significant transfer tax minimization.

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REAL ESTATE REITS & UPREITS

For possible application to situations where family members are not going to be involved in the business, it may be desirable to restructure or rearrange the business so that the real estate is separate from the business. After the reorganization of the business portion of the assets into an S Corp., the GRAT arrangement might be employed. The real estate portion of the business might be traded in for operating real estate partnership interests. In other words, for the real estate, an UPREIT or **U**mbrella **P**artnership **R**eal **E**state **I**nvestment **T**rust might be considered.

When a dealer considers an UPREIT or **U**mbrella **P**artnership **R**eal **E**state **I**nvestment **T**rust, he is exchanging or trading in his real estate for operating partnership units. A REIT has several levels to it. First, it is an operating partnership and that is the entity to which the dealer transfers the real estate. In return, the dealer receives operating units in the partnership so that he owns pieces of every other dealers' real estate who is participating in the REIT.

The partnership then creates a REIT which the general partner takes public. The cash from going public is what is available to be distributed or transferred back to the original dealers if they choose to take cash back. If the dealer takes cash back, he has to pay a capital gains tax. However, if he instead takes back units in the REIT, that is a non-taxable event (i.e., a tax-deferred exchange). The dealer may then decide to gift the units of the UPREIT to the children who are the non-involved family members, and these gifts also can be made subject to discounts because these are operating partnership units.

THE *FOREVER* DEALER

What about a dealer who simply and flat-out does not want to give up control of the dealership during his lifetime? In this case, there definitely should be a buy-sell agreement because of the likelihood that the business will have to be sold upon the dealer's death. Hopefully, if a buy-sell agreement is not in place, the eventual purchase of the dealership stock is being funded through an irrevocable life insurance trust in order to gain at least some leverage for the eventual purchase procedure or process. Typically, this is necessary because an outside source of funds will have to be accessible in order to pay the estate tax on the value of the dealership interest when the dealer dies. Otherwise, it will be necessary to drain operating cash out of the business in order to pay the estate tax.

If a dealer believes his marriage is stable, he might consider gifting the dealership stock to his spouse ... assuming the Factory will concur with the transfer. During lifetime or at death, any amount can be gifted to a spouse without the payment of any estate or gift tax. The plan here would be that the spouse would turn around and gift the business interest to the children. This again brings into play the fact that the estate tax is "tax-inclusive," whereas the gift tax is "tax-exclusive." Consequently, by having the spouse gift the value over the remainder of her lifetime, a lesser transfer tax should result. However, the spouse should be aware that gifting is a vital element in the overall plan ... and hopefully the spouse will live long enough to make significant effective gift transfers. Note that if the Factory will not agree to the gifting of stock in the dealership, these techniques can still be applied to other entities for which Factory permission prior to gifting is not required.

Seaburg added that it is often important to consider gifting as part of the overall transfer strategy even though gifting does not result in a step-up in basis for the property in the hands of the donee. His point is that the maximum capital gains rate on commercial real estate depreciated in a business is 25%, and this income tax rate should be contrasted with the estate tax maximum rate of 55% if that commercial real estate were to be included in the dealer's estate subject to tax. Ah yes, it is a complicated chess game involving gift, estate and income tax interrelationships.

Even if the dealership has sold off the operating assets, there still ought to be some external source of funds available to pay the estate tax. One alternative under these circumstances might be a Charitable Remainder Trust (CRT) that is set up to receive property which it will hold during the life of one or more persons. During their lifetimes, these persons will receive income from the CRT based on a rate of return for the assets in the Trust. After the death of the donor/annuitants (i.e., the people who have contributed the property and/or who received the annuities during their lifetimes), the property in the Trust will be turned over to the named charities.

Alternatively, a dealer may wish to set up a Family Charitable Foundation in order to become more actively involved with charitable dispositions and beneficiaries.

Seaburg concluded with three observations: (1) the longer a dealer waits to plan, the fewer options there are available; (2) a dealer can't get something for nothing–control has to be given up or alternative arrangements have to be made; and (3) a dealer planning with family members, should not make it a zero-sum game. Instead, a dealer should strive for ***equable*** treatment of all family members ... and that does not necessarily mean ***equal*** treatment of all family members.

AUTO DEALER CONFORMITY UPDATE COUNTDOWN TO COLLISION

MAY 31 1998

Coming this summer: Another disaster movie with an unsuspecting and unbelieving populous ultimately delivered from harm by the breathtaking feats of the stalwart heroes. Something about a meteor (or do you say "meteorite"?) approaching planet Earth and results that not even the word "disastrous" adequately describes. Far more immediate, and not quite so potentially devastating–but certain to be unpleasant financially, at a minimum–is a smaller catastrophe ...scheduled to impact a more limited target: Auto dealers on planet Earth ...in the United States... who have used the LIFO (Last-In, First-Out) Inventory Method ...and who had LIFO conformity violations on their dealer Factory financial statements... during any one of the six years 1991-1996.

Yes ...that day is coming... soon. And it's too late to repent. And the proverbial spot between a "rock and a hard place" will be no fun to be in.

May 31, 1998 is the date on which the first installment of the *Settlement Amount* payment for dealers not under audit on October 14, 1997 is due to compensate the IRS for a prior conformity violation. The first payment due date for dealerships that were under examination on October 14, 1997 has already receded into the dim past: that day was December 1, 1997.

The September & December 1997 *LIFO Lookouts* generously responded to the lament of prior issues: "What Ever Became of LIFO Conformity?" We all found out ... on September 25, 1997 ... with a subtle vengeance!

Unfortunately, there is not much ***new*** to be said about these prior questions arising under the Revenue Ruling and Revenue Procedure. Not surprisingly, answers have not been forthcoming.

Selecting just one of those questions, and amplifying it with the underlying fact pattern gives you an idea of how little guidance there really has been in "clarifying" the conformity "problem." The question we've selected relates to the use of ***reasonable*** estimates and the statement in Revenue Ruling 97-42 that if a ***reasonable*** estimate were used on the year-end financial income statement, the actual change in LIFO reserve did not have to be (eventually) reflected in the income statement.

WHAT'S A *REASONABLE* ESTIMATE?

How does one arrive at a sense of comfort relative to estimates that were placed on (or thrown at) income statements in an effort to satisfy the conformity requirement? "Among other interpretations of this suggestive question, the following is full of teaching:" Prior to year-end, the (CPA's?) estimate of the change in the LIFO reserve was that it would increase income (i.e., the LIFO Reserve would go down) by $20,000. Accordingly, net income was increased by that amount on the preliminary December 31 Factory statement. Afterward, when the LIFO computations for the year were actually made, they showed that the LIFO reserve increased by $130,000.

What we have here is a "swing" of $150,000 in (taxable) income. Is this ***reasonable****?* Will the estimate of an increase in income of $20,000 be regarded by the IRS as ***reasonable*** in satisfying Rev. Rul. 97-42 and avoiding Rev. Proc. 97-44?

What would you do if you had almost $100,000 of LIFO penalty tax riding on the answer?

INSURANCE CONSIDERATIONS

Recently, one major CPA firm insurer released a special report on "Auto Dealer Clients' LIFO Conformity" consisting of a cover letter/memo; a more detailed technical memorandum discussing LIFO conformity, Revenue Ruling 97-42 and Revenue Procedure 97-44; and two sample letters to be sent to auto dealer clients (one sample letter for current clients and the other sample letter for former auto dealer clients).

This package was provided by the Loss Prevention Department of CAMICO, 255 Shoreline Drive, Redwood City, California. Their cover memo is reproduced in the March, 1998 *LIFO Lookout*. In it CAMICO stresses the importance for immediate action to be taken with both current and former auto dealer clients before April 1, 1998. It indicates that because CPAs are almost never involved in preparing their clients' Factory statements, it is unlikely that a CPA firm has any responsibility for any incorrectly prepared statements. This letter, realizes, however, that some clients may assert that a CPA firm has such responsibility, and it suggests that its policyholders should review their files as far back as 1991, and determine former, as well as current, auto dealer clients. It recommends that the appropriate sample letter be sent as soon as possible, but not later than April 1, 1998, and it recommends meeting with selected current clients to discuss the issues in the letter before sending the letter, if that might be appropriate. It also advises that after meeting with dealers to discuss the issues, the CPA firm should send a letter to confirm that discussion in writing.

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CAMICO suggests that the following steps be considered if in the following course of discussions with auto dealer clients an assertion is made that the CPA firm is responsible for the Factory statement LIFO non-conformity.

1. Document whether or not the Factory financial statement was prepared by the client with or without assistance from the CPA firm.

2. Emphasize that the immediate focus should be on determining what actions, if any, the client should take to correct the LIFO non-conformity and whether the client will utilize the relief provided by Revenue Procedure 97-44 if it pays the penalty tax.

3. State that after the decisions referred to above have been made, then a clear assessment can be made of all the facts and circumstances around the involvement of the CPA firm in its past engagements relative to the question of whether any responsibility exists on the part of the CPA firm relative to the LIFO non-conformity.

CAMICO stresses to its policyholders that their Firms should avoid assuming any improper legal duties or responsibilities in connection with these matters, and that if the client–or another party–asserts Firm responsibility for either the Factory statement LIFO non-conformity and/or the Revenue Procedure 97-44 fee, the Claims Department should be notified immediately.

The technical memorandum issued by CAMICO stresses the IRS' assertion that the LIFO conformity issues are not subject to the usual 3 year statute of limitations which, in turn, underscores the importance of addressing the matter of LIFO conformity (or non-conformity) in the 6 year look-back period. The technical memorandum indicates that a self-check should be conducted by each auto dealer–or its representative–to determine whether or not LIFO conformity violations exist. If a dealer does not have a LIFO conformity violation during the look-back period, the dealer should retain the self-check documentation. Obviously, this documentation should be retained *permanently*. If the self-check reveals a LIFO conformity violation during any one of the six most recent taxable years ending on or before October 14, 1997 (i.e., for the calendar years 1991-1996), then the alternatives or options narrow down to only three:

OPTIONS

1. ***Pay*** the settlement fee and file a memorandum statement by May 31, 1998,
2. ***Play*** "IRS audit roulette," or
3. ***Run away:*** i.e. terminate the LIFO election.

All are very unpleasant prospects standing alone or in comparison with the others.

LETTER FOR CURRENT DEALER CLIENTS. The sample letter provided for (CPAs to send to their) current auto dealer clients states, in the first paragraph, that "it would be best to call our office as soon as possible to discuss the relief provisions and their application to your business." This letter is four pages long and provides a comprehensive discussion of the LIFO conformity problem and what the IRS has said in Rev. Rul. 97-42 and Rev. Proc. 97-44. It also clearly sets forth the three alternatives which a dealer will have to consider if, in fact, a LIFO conformity violation has occurred during any one of the years 1991-1996. The letter concludes by requesting that the dealer contact the sending CPA as soon as possible so that they may discuss the alternatives available to the dealership if it has LIFO conformity violations.

LETTER FOR FORMER DEALER CLIENTS. The sample letter to the former or prior auto dealer client is only two pages. It begins by indicating that, although the CPA Firm does not currently render services to the dealership, it would like to take the opportunity to notify it of an important tax issue. The "important tax issue" is the increased IRS enforcement of the LIFO conformity regulations. The former-client letter then overviews the recent developments, and closes by telling the dealer that because each business is unique, it would be best to consult with your current CPA regarding (1) whether your business might have any LIFO conformity violations and (2) the IRS relief provisions specifically as they apply to your dealership.

With respect to both letters–the current-client dealer letter and the former-client dealer letter–CAMICO emphasizes the importance of dating the letter to document the date of the correspondence. The senders might also wish to send those letters by certified mail in certain instances.

In its technical memorandum to policyholders, CAMICO points out that if a dealer was under IRS audit on October 14, 1997, the first payment of its Settlement Amount or "penalty tax" was due December 31, 1997. Note: this is a technical error because the first payment was actually due December 1, 1997, (Revenue Procedure 97-44, Sections 5.03(2)). That is not the point. It goes on to state that if the dealer under examination on October 14, 1997 did not make a timely payment of this first installment on its accelerated, early payment date, then it is "likely the IRS will assert that the dealer has lost its ability to cure its past LIFO conformity violations."

Notes:

The *De Filipps' Dealer Tax Watch* newsletter is a quarterly publication of essential tax information by Willard J. De Filipps, CPA, P.C., 317 West Prospect Avenue, Mt. Prospect, IL 60056. It is intended to provide accurate, general information on tax matters and it should not be construed as offering accounting or legal advice or accounting or legal opinion on any specific facts or circumstances. The contents are intended for general information purposes only. Readers should consult their certified public accountant, attorney and/or other competent advisors to discuss their own situations and specific income, gift and estate tax questions. Mechanical or electronic reproduction or photocopying is prohibited without permission of the publisher. Annual subscription: $325. Back issues available for $70 each. Not assignable without consent. Any quoted material must be attributed to *De Filipps' Dealer Tax Watch* published by Willard J. De Filipps, CPA, P.C. Editorial comments and article suggestions are welcome and should be directed to Willard J. De Filipps at (847) 577-3977; FAX (847) 577-1073. **INTERNET**: http://www.defilipps.com. © Copyright 1998 Willard J. De Filipps.
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