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. LIFO conformity for dealership financial statements: As far as *auto* dealers are concerned, nary a peep from the IRS now that it has collected its first installment. For medium and heavy-duty truck dealers, the IRS has extended relief, retroactively ... for more, see Update #3 below and pages 25-27.

Demonstrator vehicles: Nothing new to report at this time. Is no news good news?

Changes in accounting method: Lots of bodies have complained about the new rules the IRS wants to enforce where agents initiate changes in taxpayers' accounting methods. For more, see Update #7.

Vehicle service contracts: While not necessarily a hot and emerging tax issue (because the proper tax treatment seems fairly well settled by now), but obviously still festering with some dealer-obligors out there, see Update #9 regarding *Rameau Johnson*.

#2. OTHER HOT & EMERGING ISSUES. Not rising to the level of "IRS audit" issues, but hot or at least warmer than luke-warm and still emerging in their own rights: Buy-here, pay-here dealers still thinking about making a mark-to-market election can forget about it. This one "de-emerged." See Update #8.

For used car dealers waiting for the NIADA-initiated revenue procedure anticipated to allow them to spread out reporting of their gross profit on installment sales, or some end result equivalent thereto, ... keep waiting. There's nothing new at this time to report.

#3. MEDIUM- & HEAVY TRUCK DEALERS GET LIFO CONFORMITY VIOLATION RELIEF. Last year, the IRS extended relief to auto and light-duty truck dealers who had LIFO conformity violations on their year-end Factory statements in any one of the years from 1991 through 1996. *Rev. Proc. 97-44* allowed them to keep their LIFO elections and their LIFO reserve savings if they paid a 4.7% penalty tax—in installments—based on their LIFO reserves at December 31, 1996.

Now, the IRS ... in Rev. Proc. 98-46 ...has extended this conformity-violation relief to all medium- and heavy-duty truck dealers. Most of the same requirements and conditions for relief apply. They pay

WATCHING OUT FOR

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

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

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their three equal annual installments with the first one due January 31, 1999. For more, see pages 25-27.

#4. TECHNICIAN TOOL RENTALS: SOUND PLANS OR SCHEMES? We've been looking forward to including an article, brief or otherwise, on this subject for quite some time. These technician tool rental plans are for dealers (and lots of other taxpayers with comparable fact patterns) who employ technicians who own their own tools and use them on the job.

As the story goes, dealers separate the payment for the use of their employees' tools from the hourly wages they are paid. Thus, a two-fold tax savings occurs. The dealership saves employer taxes and reduced insurance costs, while the technicians receive income not subject to Social Security tax. These plans are set up to be "accountable" plans under Section 62(c) and allow some part of the technician's income to be characterized as either reimbursement for tools provided on the job as a condition of employment or a rental equivalent.

Several months ago, we were aware of only one organization sponsoring or offering a tool rental program for auto dealers. Recently, we've become aware of three, apparently all springing from common origin. Presumably, some "big name" accounting firms have *endorsed* these programs ... and some even issued opinion letters concerning them. One firm specializing in auto dealerships indicated in its recent newsletter that it was actively marketing one brand of tool rental program. We've not seen anything resembling a tax opinion letter from any firm on these plans yet.

We're not suggesting that one has to have a letter ruling from the IRS on a plan like this before proceeding. Often, the naysayers feel they have a pretty good idea of what the IRS would say if approached with all the facts and requested to give an opinion. Or maybe common sense suggests that the broad language of the law and regulations is set up so that the real determination will have to be made on a case-by-case, facts and circumstances, basis.

Given the run-around dealers have been getting on payroll tax issues from the IRS lately, demonstrator use and factory incentive payments coming readily to mind, do dealers really need another *talking point* on their IRS agent's discussion agenda? Unlike the Wendy's commercial, we're not asking "where's the beef?" ... rather, simply: Have any *DTW* readers either seen ***real*** opinion letters or undergone IRS audits on these plans? If so, we're all ears.

#5. TAX-FREE SPIN-OFFs & SPLIT-OFFs FOR DEALERSHIPS OVER 5 YEARS OLD. The IRS National Office recently issued Letter Ruling 9829050 awarding tax-free treatment to a dealership that di-

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vided its business in order to put an end to shareholder dissension and disagreement. This was a "split-off" in both the literal and the tax technical sense of the word.

Reviewing this dealership ruling eventually led to our looking at a quintet of other tax-free spin-off rulings involving dealerships. Before we knew it, one thing led to another and ... lo and behold ... this issue of the *Dealer Tax Watch* almost entirely focuses on spin-offs and their relevance to dealerships.

Dealerships that may be involved eventually in Project 2000 mandated changes—or that are otherwise thinking about doing some significant long-term planning—might find the Section 355 tax-free spin-off or split-off techniques especially enticing. Why? Because these techniques beat both levels of tax on the distribution. The dealership shareholders pay no tax, unless there is *boot* on the receipt of the new stock ... and the corporation pays no tax on the indirect transfer of assets even though otherwise it would be deemed to have constructively sold them at their current, appreciated values. A neat, sweet deal.

To our surprise, one IRS letter ruling issued some 10 years ago looks like it could have been sent out by the IRS just yesterday to a dealer realigning his dealership's franchises under one of the current Project 2000 mandates. When the Factory insisted that the dealer "dedual" (no, that's not a type of stomach ulcer) he agreed and did so tax-free under Section 355.

After more than a decade, the tax-free holdings from that Section 355 ruling would still seem to be applicable to dealers today who can qualify and get their act together to request a ruling from the National Office. But, and take this as a big warning, any dealer relying on that ruling—instead of getting his own *in advance*—could be inviting one, maybe two, tax disasters.

#6. IRS Y2K READINESS UPDATE. In our last issue, we wondered aloud (i.e., actually, in print) about how big the IRS Y2K readiness problem really might be. At the end of September, the *Wall Street Journal* reported that Commissioner Rossotti acknowledged the Service was "very close to the point where the moment of truth arrives for us." He said that the Service had made "very, very important" progress recently, but there still is a lot of risk, and he didn't want to minimize that.

Just a few weeks earlier, the project director at the IRS for Y2K indicated that the Service was tracking every piece of software it owns and running about 2% ahead of schedule. It seems that by January, 1999, the IRS is scheduled to convert 67 "mission-critical" computer systems to recognize the year 2000. The IRS plans (read that as "is hoping") to finish converting systems this year, which should allow all of the year →

1999 to test changes and make necessary corrections or adjustments.

The Government Accounting Office (GAO) and various Congressional subcommittees are all watching the IRS and hoping for goods news, as are we. Based on just about every experience we've ever had over 35 years in dealing with various and sundry individuals at all levels who comprise ***the IRS***, those individuals have, in general, bungled the job, done it less than thoroughly and/or failed to meet deadlines. If our admittedly small, but certainly random, experiences accurately reflect the norm, with less than 500 days to go, the handwriting is already on the wall.

#7. CONTROVERSY OVER IRS NOTICE 98-31 RULES FOR AGENTS CHANGING ACCOUNTING METHODS ON AUDIT. The June 1998, *Dealer Tax Watch* covered IRS Notice 98-31 and we emphasized that the result was dealers should think twice about waiting for an IRS agent to come in on audit and make them change from an improper accounting method. In 1997, the IRS issued Revenue Procedure 97-27 in which it updated basic rules, terms and conditions for changes in accounting methods, and the Service revised Form 3115 to reflect these changes. Last year, the IRS also issued Revenue Procedure 97-37 for making changes in accounting methods before an IRS audit examination is underway.

Earlier this year, with Notice 98-31, the IRS raised the stakes for taxpayers who persist in using improper methods of accounting and hope to just hide from the IRS and never get caught. Notice 98-31 explains how IRS examining agents in the future are to handle adjustments where they change a taxpayer's accounting method. These taxpayers can expect a 100% pick-up of income in the earliest open year ... along with an effort by the IRS to get around the usual three year statute of limitations by picking up adjustments for otherwise closed years through a Section 481(a) adjustment.

Lately, many organizations, including the American Bar Association, the AICPA and some accounting firms, have soundly criticized Notice 98-31. When the IRS "defended" its issuance of Notice 98-31 recently, it indicated that perhaps criticism of the Notice wasn't taking into consideration all the IRS had done in 1997 and what it plans to do in the future to issue even more guidance in this area. More guidance... Yikes! Much of it may be helpful for the big case audit taxpayers, but the smaller taxpayers will still be stuck with all the basic adverse changes.

#8. BUY-HERE, PAY-HERE DEALERS LOSE MARK-TO-MARKET RULES. Some buy-here, pay-here dealers thought about using the mark-to-market accounting method to write down their receivables and take their losses at year-end. See the June, 1997 *DTW* discussing Letter Ruling 9723004 and what seemed to be "beneath the surface ... deeper waters ... greater opportunities." As it turned out, the then inartfully drafted statute didn't seem to prevent dealers from taking advantage of the Section 475 mark-to-market rules. Obviously, the IRS wasn't pleased with the result and brought it to the attention of Congress that more taxpayers–including auto dealers–found themselves eligible for year-end receivable writedowns than were originally intended. Well, you can guess the rest.

Any dealer still thinking about mark-to-market valuation writedowns can forget about it because this alternative is no longer available. The mark-to-market window of opportunity under Section 475 was closed ... not by the IRS ... but by Congress as one of the changes made by the IRS Restructuring and Reform Act of 1998.

The 1998 Act amended the Code to provide that trade receivables generated and held by a taxpayer whose principal activity is the selling or providing of nonfinancial goods and services are not eligible for mark-to-market for taxable years ending after July 22, 1998. So, starting with calendar 1998, that option is gone and it's too late.

#9. VEHICLE SERVICE CONTRACTS: *RAMEAU JOHNSON* CONTINUES TO FIGHT. The cases of several dealerships selling vehicle service contracts were tried in the Tax Court in *Rameau Johnson Et Al. v. Comm.* a year ago. These cases involved dealer-obligors who used escrow funds under a third-party administrator program. The Tax Court upheld the IRS in requiring the dealerships to include in gross income–in the year of sale–the entire amount of VSC sales proceeds, even though a substantial portion of the proceeds received was immediately deposited in escrow accounts in anticipation of future repair liabilities.

The Court concluded that the dealers could not justify excluding portions of the VSC sales under the theories that the amounts were either "customer deposits" or held in a "trust fund" for the benefit of the VSC purchasers. This case was written up in the September, 1997 *Dealer Tax Watch* along with discussions of Revenue Procedure 97-37, 97-38 and the *SWIM* method which affords partial relief to dealer-obligors.

Rameau Johnson filed its appeal to the Tax Court's decision in the Eighth Circuit and the Department of Justice filed its brief in reply earlier this summer. Stay tuned for the higher Court's verdict.

TAX-FREE SPIN-OFFS AND SPLIT-OFFS FOR DEALERSHIPS OVER 5 YEARS OLD

TAX-FREE SPIN-OFFs

In the atmosphere of current Project 2000 activities and significant dealer consolidation into giant publicly-held chains, many dealers and their CPAs talk about realigning their businesses to compete more effectively as one century draws to a close and another takes its place. In these and in other settings, some dealers have a great opportunity to use the tax-free rules of Section 355 for dividing up their corporate businesses and activities.

Most CPAs have a nodding acquaintance with–or at least recognize the name of–one of the older landmark tax cases: *Gregory vs. Helvering.* This case arose out of the attempt in 1928 by Mrs. Gregory to use a spin-off as a device to beat the tax on ordinary dividends. More recently, in the early 80's, AT&T sucessfully used the same principles in spinning off its seven regional holding companies.

Attracting far less attention than either of these more notable situations (but nevertheless just as accessible), average/ordinary dealerships can use Section 355 in a variety of ways to split up their current businesses.

Successfully navigating Section 355's requirements results in dealers and their dealerships beating the "double tax." There is no tax at the shareholder level on the fair market value of the stock distributed to the shareholders. At the dealership corporate level, there is no tax to the corporation on the distribution of the appreciated business property represented by the stock transferred to the shareholders when it is distributed to the shareholders.

This article focuses on how Section 355 can be used, and ***how it has been used*** to great advantage by some dealers in dividing up their corporate assets. →

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OVERVIEW AND SOME BASICS

Section 355 allows a corporation to divide up its business activities by creating or using an existing subsidiary and to distribute the stock of the subsidiary to its shareholders in a tax-free transaction. Essentially, there are three different ways whereby the shareholders split up their former investment among several different entities, placing some of the corporation's business assets or business functions in separate corporations. They can take the form of a spin-off, a split-off, or a split-up.

These three variations on the same theme all have to start from a parent-subsidiary relationship. In a ***spin-off***, the parent corporation distributes the stock of an existing or a newly created controlled corporation to its shareholders (i.e., the shareholders of the distributing corporation) without having or requiring the existing shareholders to surrender or exchange any of their stock in the distributing corporation in the process. In other words, the existing/parent corporation creates a new subsidiary (or uses an existing subsidiary), transfers to it a business activity, and then the parent distributes the stock of that subsidiary to its own shareholders without requiring them to give up any of the shares that they hold in the parent corporation.

In a ***split-off***, the starting point requires the creation of a new subsidiary or the use of an existing subsidiary. However, when the stock of the (new) subsidiary is ready to be transferred to the shareholders of the parent corporation, those shareholders of the parent are required to exchange (i.e., give up some of) their shares in the parent corporation in order to receive shares in the (new) subsidiary.

In a ***split-up***, the parent corporation creates at least two subsidiary corporations and transfers all of its business activities to them, so that the parent remains only as a holding company ... and then only briefly as such until it is liquidated. The parent corporation then exchanges all of the stock in the newly created subsidiaries with its shareholders so that in the process of the exchange of stock, the parent corporation has re-acquired all of its own previously outstanding stock. The parent corporation then liquidates, and only the newly created subsidiaries remain as separate corporations...which are now owned by the former shareholders of the parent.

Thus, a ***spin-off*** involves the distribution of the stock of the controlled corporation (the subsidiary) without requiring the parent corporation's shareholders to give up or surrender in exchange any shares they hold in the parent corporation as part of the transaction. No stock of the parent corporation is given up by the shareholders who receive a distribution of the new subsidiary's stock. Accordingly, a ***spin-off*** is a pro-rata distribution by one corporation of the stock of a subsidiary—either an existing subsidiary or a newly created one

In a ***split-off***, there is an exchange of the stock of the controlled corporation (subsidiary) which involves some or all of the shareholders of the parent who give up some or all of their stock in the parent corporation. Accordingly, a ***split-off*** is identical to a spin-off, except that in a split-off the shareholders of the distributing parent corporation surrender part or all of their stock in the parent in exchange for the stock of the subsidiary. In a ***split-up***, the parent corporation exchanges all of the stock of two or more newly created subsidiaries, which comprise the parent's only assets in exchange for all of the parent's outstanding stock, so that the parent re-acquires all of its own outstanding shares in an exchange transaction. In the ***split-up***, a parent corporation distributes the stock it holds in two or more pre-existing or newly created subsidiaries in complete liquidation.

If Section 355 did not apply to confer tax-free treatment, the ***spin-off*** would be a dividend, taxable to the shareholders receiving the stock of the subsidiary at least to the extent of the corporation's earnings and profits. If it weren't for Section 355, a ***split-off*** would be treated either as a dividend or as a sale of stock by the shareholders. And, absent Section 355, a ***split-up*** would be treated as a complete liquidation. What Section 355 does is that it permits the division of the corporation through the distribution of stock by one of these methods without having that division result in the recognition of gain or loss at either the shareholder level or at the corporate level.

Basic assumptions and use of terms in this article. ***First***, in the technical letter rulings issued by the IRS National Office, the parent corporation is referred to as "*Distributing*" and the subsidiary corporation is referred to as "*Controlled.*" In other words, the old parent-new subsidiary relationship is the same as the *Distributing-Controlled* relationship, respectively. ***Second***, many taxpayers use the term "spin-off" in general statements referring to all three spin-off, split-off or split-up possibilities without distinction. The term "*spin-off*" for the most part will be used in this article as referring to any one of the three Section 355 variants, unless from the context the use of the more specific term is necessary. ***Third***, the split-up variation seems to be less-frequently encountered, and will not be discussed to any extent in this article. The letter rulings involving auto dealerships reflect the split-off approach, except for LTR 9616023, which involved a spin-off. The absence of further mention in

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this article of the split-up should not lull one into a thought process which omits considering it as a possibility in the real world, because it can be a viable alternative in the right situations.

Two observations regarding the use of subsidiaries are probably in order. First, and typically, the more usual or "simple" Section 355 transactions will involve a single existing corporation setting up a wholly owned subsidiary to effect the divisive transaction. However, in some instances, an existing parent-subsidiary structure may be in place, in which situation it would be appropriate to use the existing subsidiary, or subsidiaries, or to create additional subsidiaries, to carry out the overall divisive plan.

Second, there is no requirement that only one subsidiary must be involved. In fact, in Letter Ruling 8712043 two new subsidiaries were created to accomplish the desired results.

As will be emphasized again later, one can only strenuously urge that dealers and their advisors should not even consider trying to obtain the benefits of a Section 355 divisive strategy unless they are willing to plunk down a user fee of about $4,000 in advance for an IRS ruling letter assuring the desired tax-free consequences. The presence of the five year active business history requirements seem to reflect an expectation that assets and property used in a business for at least five years may have appreciated–and earnings after five years may have been accumulated. If these expectations are accurate, the tax cost of engaging in a transaction that fails to qualify under Section 355 could be prohibitive both to the shareholders and to the corporation, since the corporation would be treated as if it had sold the assets that were distributed at their fair market values.

QUALIFYING FOR TAX-FREE STATUS

In order for a spin-off, split-off or split-up to be tax-free under Section 355, it must satisfy several requirements. Some of the requirements are contained in the Code and others result from court decisions.

(1) The distributions to shareholders must be "*with respect to their stock*," or the distributions must be made to security holders in exchange for their securities.

(2) Immediately before the distribution, *the distributing corporation must control the corporation* whose shares or securities it is distributing. In other words, the parent must have at least 80% of the combined voting power and at least 80% of the total number of shares of all other classes of stock issued by the subsidiary. Usually this is not a problem where a single corporation creates a new subsidiary capitalized solely with common stock.

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(3) Post-distribution ABC/Active Business Conduct: Immediately after the distribution of stock, both the distributing corporation and the controlled corporation (or corporations) must be engaged in the active conduct of a trade or business. In the split-up situation, the parent corporation does not have to meet this requirement–since it is a holding company that is about to be liquidated–but all of the controlled corporations must be engaged in the active conduct of a trade or business.

(4) Pre-distribution: 5 year ABC/ Active Business Conduct: Both the parent and the subsidiary (i.e., the controlled corporation or corporations) must have been engaged in the active conduct of a trade or business throughout the five year period ending on the date of distribution of the stock. Further refinements of this five year active conduct of a trade or business requirement provide that (i) the trade or business must not have been acquired within the five year period in a taxable transaction and that (ii) the trade or business must not have been conducted by another corporation, the control of which was acquired during the five year period in a taxable transaction.

(5) Typically, the distributing corporation must distribute all of the stock and securities in the controlled corporation. If it doesn't distribute all the stock, it must distribute enough stock to constitute "control," and it must establish that the distribution of less than all of the stock and/or securities in the controlled corporation was not part of a tax-avoidance plan.

(6) There must be an independent *corporate business purpose* for the transactions.

(7) The distribution transaction must not be used principally as a ***device*** for the distribution of earnings and profits. Here, the term ***device*** is more of a concept than something susceptible to precise definition in a few words or short sentences.

(8) There must be a *continuity of proprietary interest* by the parent's shareholders after the distribution so that the transaction is not followed shortly thereafter by a sale.

(9) There must be a *continuity of the pre-existing business enterprise* after the division.

IRS *ADVANCE* RULING LETTERS ASSURING TAX-FREE RESULTS ... A MUST

Significant tax liability can be incurred if a divisive transaction intended to be tax-free under Section 355 fails any one of the **subjective** or any one of the other more **objective** tests or requirements. Therefore, taxpayers and dealers are advised to not proceed with such transactions until they first obtain a favorable letter ruling from the IRS. The letter ruling is then →

required to be attached to the tax return filed for the year in which the distributions occur.

In addition, the regulations under Section 355 (at Reg. Sec. 1.355-5) and under Section 368 (at Reg. Sec. 1.368-3) require all parties involved in the distributions, surrenders and/or exchanges to attach detailed statements to their respective tax returns setting forth such data as may be appropriate in order to show compliance with the provisions of the Section and the particulars of the transaction.

BUSINESS DIVISIONS: IN GENERAL

There are two general types of business divisions where Section 355 might apply. The first is the ***vertical*** division of a single business in which the parent and the subsidiary (or the distributing and the controlled corporations) each conduct a business that includes all of the stages or functions of the larger business as it was conducted before the distribution.

The second type of division is the ***horizontal*** division of an integrated business along functional lines. A series of examples in the regulations at Reg. Sec. 1.355-3(c) illustrates some of the types of business divisions that will - or will not - be recognized or allowed as "functional" or "horizontal."

As qualifications, however, Reg. Sec. 1.355-2(d)(2)(iv) provides, in general, "The determination of whether a transaction was used principally as a device will take into account the nature, kind, amount, and use of the assets of the distributing and the controlled corporations (and corporations controlled by them) immediately after the transaction."

At 1.355-2(d)(2)(iv)(C), the regulation further provides that:

> "There is evidence of device if a business of either the distributing or controlled corporation (or a corporation controlled by it) is (1) a 'secondary business' that continues as a secondary business for a significant period after the separation, and (2) can be sold without adversely affecting the business of the other corporation (or a corporation controlled by it).
>
> "A secondary business is a business of either the distributing or controlled corporation, if its principal function is to serve the business of the other corporation (or a corporation controlled by it). A secondary business can include a business transferred to a newly-created subsidiary or a business which serves a business transferred to newly-created subsidiary. The activities of the secondary business may consist of providing property or performing services."

The essence of these regulations is that after distribution (of the stock in the subsidiary to the parent's shareholders), continued dealings between the corporations can be evidence that the entire transaction was a ***device*** to beat the tax on ordinary dividends. Note that the regulations do require the presence of a second condition before the distribution will be viewed as a device: the "secondary business" can be sold "without adversely affecting" the business of the other corporation. This explains why often there are either representations or IRS holdings in the rulings as to related party/intercorporate dealings after the distribution of stock occurs.

Business purposes commonly motivating the division of a business include (1) avoidance of shareholder disharmony, (2) equity for key employees, (3) better access to debt or equity capital, (4) cost savings and reduction of expenses, (5) minimization of labor-related problems, (6) competitive considerations, (7) avoidance of takeover, (8) facilitation of subsequent acquisitions, (9) risk insulation, and (10) enhanced profitability and shareholder value. Some of these are discussed in more detail in subsequent sections.

REVENUE PROCEDURE 96-30

Revenue Procedure 96-30 is the IRS's lengthy checklist questionnaire that tells taxpayers what information and representations they must include in a request for rulings under Section 355. Information to be submitted includes:

(1) Identifying information for the distributing and the controlled corporation(s).

(2) Ownership of interests in both corporations including the capital structure of both before and after the proposed distributions.

(3) Information concerning the history and nature of the businesses of the distributing and the controlled corporation. This includes showing that the active conduct of a business was carried on during the preceding 5 year period (with all of its ramifications).

(4) The business purposes or reasons for the proposed spin-off. This includes all reasons, whether corporate business reasons or non-corporate other (shareholder) reasons.

(5) Information to show that the distribution is not a ***device*** for the distribution of accumulated earnings and profits.

(6) Information and assurances as to the continuity of shareholder interest after the distribution.

(7) Explanations why the distribution of stock will not be a "disqualified distribution."

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(8) Other information relative to transfers and transactions between the corporate entities, indebtedness and cancellation of indebtedness, continuing transactions and transfers of money or property to the distributing corporation.

Required financial information to be submitted includes: complete balance sheets, including a consolidated balance sheet and separate, unconsolidated statements of income for each of the past five years for each active business.

After this financial information is scrutinized by the IRS, the Service requires and includes the following as a taxpayer representation in its ruling letter when it is issued: "The five years of financial information submitted on behalf of Distributing is representative of the corporation's present operations, and there have been no substantial operational changes since the date of the last financial statements submitted."

Where a reduction in Federal income taxes is anticipated, the IRS is extremely interested in whether there are any other corporate business purposes present. The presence of other corporate business purposes, along with the taxpayer's willingness to make certain representations to remove the taint of Federal tax avoidance, may overcome the Service's resistance to the "pure" reduction in Federal taxes.

In connection with (5) above, since a non-taxable spin-off cannot be a ***device*** for the distribution of accumulated earnings and profits, the absence of certain factors becomes important. A plan or intention to dispose of stock or securities, the presence of substantial earnings and profits, pro-rata distributions, investment or inactive assets, and liquidation, merger or sale of assets ... all raise IRS suspicion. The absence of many of these factors may convince the Service that the divisive transaction is not camouflage for a ***device.***

CORPORATE BUSINESS PURPOSES FOR SPIN-OFFs

In order for Section 355 to apply, corporate business purposes for the division of the business must be present, regardless of whether the business division is vertical or horizontal. These reasons are then further analyzed in several different ways by the IRS.

Section 4.04 of Revenue Procedure 96-30 requires a detailed description of <u>each</u> purpose ... whether or not it is a corporate business purpose ... for the distribution of stock of the controlled corporation. After describing <u>each</u> purpose, those purposes which are "corporate business purposes" must be further identified and further qualified.

As part of a qualification process, taxpayers are required to describe how each corporate business purpose is "a real and substantial nonfederal tax purpose germane to the business" of the distributing, controlled or affiliated group involved. Taxpayers will be required to include a representation that the distribution of stock of the controlled corporation is carried out for the corporate business purposes which they identify.

There is still another test that a corporation's business purpose must pass. Taxpayers must explain why each corporate business purpose cannot be achieved through a non-taxable transaction that does not involve the distribution of stock and which is neither impractical nor unduly expensive. For example, possible alternative transactions might include the transfer of assets to a partnership or to a limited liability company.

Overlapping Purposes: Often, an overlap between corporate business purposes and non-corporate business purposes may exist. The latter might possibly include shareholder planning, the achievement of a special tax status, or the reduction in Federal income taxes. In order to lessen the Service's concern (if that is ever really possible) about a potential non-corporate business purpose, the taxpayer may represent that it will engage in a specified course of action (such as making or not making an S election) in order to obviate the potential avoidance of Federal taxes. Typically, the taxpayer parent may be either a C Corp or an S Corp—but whichever the parent is, the subsidiary will have to be the same.

If the business divisive transaction will result in a reduction in Federal taxes, or if it appears that the transaction will achieve one or more other non-corporate business purposes, then in order to obtain a favorable ruling from the IRS, the taxpayer must convince the Service "by clear and convincing evidence" that the distribution is motivated in whole or substantial part by one or more corporate business purposes.

An Appendix to Revenue Procedure 96-30 provides guidelines which the IRS uses in evaluating whether a distribution satisfies the corporate business purpose requirements. The introduction to the Appendix states that the nine business purposes discussed therein are not an exclusive list of the only corporate business purposes for which the IRS will issue a favorable ruling. In other words, there may be other purposes than the nine it discusses in detail. Furthermore, the failure of a transaction to meet the Appendix guidelines does not, in and of itself, mean that the distribution is not carried out for a corporate business

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purpose. Ultimately, the Service may rule favorably on the transaction where other corporate business purposes are present.

Overall Standard: The Service will not issue a favorable Section 355 ruling unless it is satisfied (1) that the business divisive transaction is motivated, in whole or substantial part, by a real and substantial nonfederal tax purpose germane to the business of the distributing or controlled corporation, and (2) that the purpose cannot be achieved through a non-taxable transaction that does not involve the distribution of the stock of the controlled corporation and which is neither practical nor unduly expensive.

The nine specific corporate business purposes listed in the Appendix include six which are more likely to be found in the usual situations and three which are not. The six more commonly found corporate business purposes involve:

(1) Key employee incentives,

(2) Favorable borrowing opportunities,

(3) Cost saving opportunities,

(4) Elimination of shareholder disharmony and a better "fit and focus" on a going-forward basis,

(5) The resolution of problems with either customers or suppliers, and

(6) Significantly enhancing the protection of one or more businesses from the risks of another.

See pages 12-13 for more about these six business purposes.

The three corporate business purposes less frequently encountered are:

(1) To facilitate a stock offering,

(2) To tailor the distributing corporation's assets to facilitate a subsequent tax-free acquisition of that corporation by another corporation, and

(3) To tailor either the distributing corporation's assets or the controlled corporation's structure to facilitate a subsequent tax-free acquisition by another corporation.

SECTION 355 IS NOT FOR "NEW" COMPANIES: 5-YEAR ABC (ACTIVE BUSINESS CONDUCT) REQUIREMENT

Section 355 limits the availability of tax-free treatment to businesses that have "been around for a while." Section 355 contains not one, but five (5) active business tests and it requires that they have been engaged in for at least five years. There are five different 5-year rules:

(1) Both the distributing and the controlled corporations must have active businesses with **5-year** histories.

(2) Even an active business with a five year history must not have been acquired within the past **5 years** in a recognition transaction.

(3) Control of the corporation conducting the five year active business must not have been acquired by the distributing corporation or by the controlled corporation within **5 years** in a recognition transaction.

(4) A 50-percent-or-greater ownership interest must not have been acquired in the distributing or the controlled corporation, directly or indirectly, by any shareholder within **5 years** by purchase.

(5) If ***any*** stock in the controlled corporation (i.e., the corporation which is being distributed) was acquired by the distributing corporation within the last **5 years** in a recognition transaction (i.e., one where gain or loss was recognized by the transferor, in whole or in part), that stock will be treated as other property or "boot" with tax treatment prescribed by Section 356.

Collectively, these requirements are designed to prevent the temporary investment of liquid funds in a new business in preparation for a spin-off or other tax-free corporate division under Section 355. If the business has been conducted actively by the same owners for **5 years**, then presumably, a patient, long-term taxpayer would be in a position to satisfy these tests and show that the business was not a ***device*** created or acquired for the purpose of avoiding a tax on its accumulated earnings.

DEALERSHIP SPIN-OFF RULINGS

Because advance assurance of the tax-free treatment for all of the participants in a spin-off is generally advisable ... in fact, only the foolhardy or most aggressive taxpayer would consider proceeding without one ... there is a significant body of rulings available to the spin-off researcher. However, in looking for rulings in which dealerships were participants, one finds only five (5) appearing on the radar screen. (Readers who are aware of any others are encouraged to call them to our attention.)

There is a sixth: *Revenue Ruling 57-190.* In this case, the dealer was held to be ineligible for Section 355 tax-free treatment because it did not satisfy one of the 5 year (ABC) active business conduct requirements due to changing locations and shifting different franchise activies between locations. Although that holding may have been correct under the regulations then in effect, under the current/1989 regulations the dealer in that case would satisfy the 5 year test.

see **TAX-FREE SPIN-OFFS...**, page 10

(Continued from page 9)

DEALERSHIP RULINGS

- **LTR 9829050 ... 1998 ... Split-off**
  Settling Shareholder Disputes
- **LTR 9616023 ... 1996 ... Spin-off**
  Lowering Financing Costs
- **LTR 9522036 ... 1995 ... Split-off**
  Separating Parents from Their Children
- **LTR 8712043 ... 1986 ... Split-off**
  Satisfying Factory Realignment Rqmts
- **Rev. Rul. 75-337 ...1975 ... Split-off**
  Protecting 70-Year Old Dealer's Franchise

LTR 9829050 ... SETTLING SHAREHOLDER DISPUTES

In Letter Ruling 9829050 (April, 1998), the IRS ruled that a dealership owned by two brothers and one of their sons could be "divided" tax-free. The two truck dealerships ended up in one corporation owned by one brother and his son; the leasing and financing business activities ended up in the other corporation owned by the two brothers.

This divisive transaction was undertaken because of the management conflicts between one of the brothers and his nephew, clearly falling under the "fit and focus" corporate business purpose. The division of the business was accomplished by a split-off and this ruling is further discussed on pages 14-16.

LTR 9616023 ... LOWERING FINANCING COSTS

In Letter Ruling 9616023, a single corporation, owned by a single shareholder, successfully ran the Section 355 gauntlet in order to achieve lower financing costs. The single entity had operated two different franchises and wanted to separate the franchises and more cleanly separate the financing sources and their respective security interests in the vehicles they were financing. The tax-free division was accomplished by a spin-off, rather than a split-off. This letter ruling is discussed on pages 17-19.

LTR 9522036 ... SEPARATING PARENTS FROM THEIR CHILDREN

In Letter Ruling 9522036, a dealership capitalized with voting and non-voting common shares was owned by five family members...husband, wife and three children. The voting and the non-voting common shares were identical in all respects aside from the vote. The dealership divided itself by means of a split-off. (See diagram on page 23.) The husband-wife combination ended up owning the entity with the used car operations in it. The children ended up owning the entity with the new car and truck sales and service operations in it. In addition to the more usual ones, this ruling contained some different representations of interest:

(1) "Following the transaction, Distributing and Controlled will each continue, independently and with their separate employees, the active conduct of their respective businesses.

(2) "The liabilities assumed in the transaction and the liabilities to which the transferred assets are subject were incurred in the ordinary course of business and are associated with the assets being transferred.

(3) "Aside from possible short-term intercompany debt owed by Distributing to Controlled to reflect assets owed to Controlled in connection with the transaction, which debt will not amount to a security under Section 355, no intercorporate debt will exist between Distributing and Controlled at the time of, or subsequent to, the distribution of Controlled stock.

(4) "Payments made in connection with all continuing transactions between Distributing and Controlled will be for fair market value based on terms and conditions arrived at by the parties bargaining at arm's length.

(5) "Distributing is, and Controlled will be, an accrual basis taxpayer."

LTR 8712043: SATISFYING FACTORY REALIGNMENT REQUIREMENTS ... *A PROJECT 2000 PRECURSOR*

In Letter Ruling 8712043, the taxpayer had a combination of what can best be described as a *Project 2000* restructuring <u>and</u> a shareholder disharmony situation. In this case, the dealership was owned by four individuals, and it operated three franchises or dealerships and a body shop painting business. The Factory required the separation of one of the dealerships from the other two.

To *"undual"* the dealerships, two new corporations were created, each with capitalization consisting of common and convertible preferred stock. One entity owned one of the dealerships; the other new entity owned the other two dealerships. The two warring shareholders were separated and, hopefully, everybody lived happily ever after...although the preferred stock that the dealer ended up with was "Section 306" stock, which meant that it was subject to the special provisions of that code section which are slanted to generating ordinary income rather than capital gain to the holder on a sale.

This LTR also had a number of representations different from those mentioned in the previous letter rulings. These special representations related to →

shared administrative costs, inter-entity rental of real estate and future gifts. For more of the specifics relating to this LTR, see pages 20-22. It should be noted that this letter ruling predates January 5, 1989, which is the date of adoption of the current regulations under Section 355.

REVENUE RULING 75-337 ... PROTECTING A 70-YEAR OLD DEALER'S FRANCHISE ... AND HIS ESTATE PLANNING, TOO

Revenue Ruling 75-337 concerned an elderly dealer (70 years old) who had five daughters. Each daughter owned stock in the dealership. But only three of the daughters were active in the dealership. Something had to be done to protect the value of the dealership and to retain the franchise. The dealership corporation already had a subsidiary that was engaged in the business of renting automobiles.

Through a tax-free split-off, 75% of the stock in the auto rental subsidiary was transferred to the two daughters who were not active in the business in exchange for their shares of stock in the auto dealership. At the same time, the 70-year old dealer surrendered a portion of his stock in the dealership in order to receive the other 25% of the auto rental subsidiary. He wanted to own this 25% stock in the rental company directly so that he could will it to the two daughters who were not active in the business.

After the smoke cleared (see the diagram on page 24), the elderly dealer had increased the shareholdings of the three daughters who were actively involved in the auto dealership entity. He also then had an asset (i.e., the 25% interest in the auto rental business) that he could bequeath to his two daughters who were not active in the business.

The IRS ruled that the distribution of the stock "is germane to the continuation of the (parent company's) business in the reasonably foreseeable future." The Service said, "The execution of the plan will forestall an impending disruption of the [parent's] auto dealership business by reason of the current active family group being unable to renew the franchise upon the dealer's death or retirement."

The Ruling stated that the problem (1) was immediate due to the advanced age of the dealer and (2) was directly related to the retention of a franchise vital to the business of the distributing corporation. Note that this IRS ruling under Section 355 is a Revenue Ruling...unlike the four letter rulings discussed herein...and may be used or cited as precedent.

CONCLUSION

These dealer rulings show how several frequently encountered dealership situations may lend themselves to structuring within the tax-favored protection offered by Section 355.

LTR 8712043 is especially interesting in its potential application to dealers currently faced with Project 2000 demands to realign their franchises. But remember the general rule: It is inadvisable to undertake a Section 355 spin-off or split-off without first securing ***your own*** advance ruling from the IRS because letter rulings issued to others cannot be used or cited as precedent.. ✱

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2. "The New Section 355 Checklist Questionnaire," by D. Herskovitz, *Tax Executive*, Sept-Oct, 1996, p. 390.
3. "Section 355 Advance Rulings: 'A New Ballgame,'" by Glenn R. Carrington and Mark A. Schneider, *Tax Notes*, August 5, 1996, p. 751.
4. "New Guidelines for Spin-off Rulings Bring Consistency and Predictability but Problems Remain," by Gilbert D. Bloom and Lisa A. Kelloway, *Journal of Taxation*, July, 1996, p. 36.
5. "Divisive Spin-Offs Can Assist in Corporate Financing," by Michael S. Paul, *Taxation for Accountants*, March, 1994, p. 162.
6. "Business Purpose Is the Key to Tax-Free Spin-Offs," by Steven C. Thompson and Stephen J. White, *Taxation for Accountants*, February, 1994, pg. 98.
7. "Using a Split-Off in Estate Planning for a Closely-Held Business," by Deborah M. Bailin, *Estate Planning*, May-June, 1993, p. 156.
8. "The Final Sec. 355 Regulations," by R. Willens, D. Mason and G. Choate, *The Tax Adviser*, April, 1989, p. 221.

CORPORATE BUSINESS PURPOSES FOR SPIN-OFFS, SPLIT-OFFS & SPLIT-UPS

Section 4.04 of Revenue Procedure 96-30 lists nine corporate business purposes generally considered acceptable to justify corporate spin-offs, split-offs and/or split-ups under Section 355. It also provides the guidelines for information to be submitted to the IRS to substantiate these purposes. The Revenue Procedure states that the list is not exclusive. The six corporate business purposes present in the more "typical" situations are discussed below.

1. ***TO PROVIDE AN EQUITY INTEREST TO EMPLOYEES***: One corporate business purpose may be ***to provide an equity interest*** in a business of either the distributing corporation or the controlled corporation to a current or prospective employee or group of employees. In this case, the taxpayer must explain why the individual, or each individual, is considered a "key" employee, and why it is necessary to give that individual, or each individual, an equity interest of the type and amount proposed in the transaction. The taxpayer must also demonstrate that generally, within one year of the distribution, the employee or employees as a group will receive a significant amount in terms of percentage and value of the voting stock of either the distributing or the controlled corporation. The Service will closely scrutinize situations in which stock issued to the employee is subject to an option or restrictions.

As a overriding consideration applying to this - and all the others - it will also be necessary to demonstrate that the objective to be accomplished by ... transferring stock to the employee(s) ... cannot be accomplished by an alternative transaction that does not involve a distribution of the controlled stock and which is neither impractical nor unduly expensive.

2. ***TO FACILITATE BORROWING***: Where the corporate business purpose for the divisive transaction is ***to facilitate borrowing***, ordinarily the taxpayer will have to demonstrate that it needs to raise a substantial amount of capital in the near future to fund operations, capital expenditures and other business needs. It will also need to demonstrate that the divisive transaction will enable it to borrow significantly more money or borrow on significantly better non-financial terms. This "more favorable borrowing" corporate business purpose was the key in Letter Ruling 9616023.

3. ***TO SUBSTANTIALLY REDUCE COSTS***: Where the corporate business purpose is ***cost saving***, the IRS is ordinarily looking for a demonstration that the result will be significant cost savings. The taxpayer's analysis must explain this savings and explain why these savings cannot be achieved through other means. "Significant cost savings" generally are projection period cost savings equal to at least 1% of the base period net income of "distributings" affiliated group. Either a three year period or a five year period may be involved in the projection analysis of cost savings.

4. ***TO RESOLVE PROBLEMS WITH CUSTOMERS OR SUPPLIERS***: Where the corporate business purpose for the divisive transaction ***is to resolve problems with customers or suppliers who object*** to the taxpayer being associated with a business that competes with the customer or supplier, the taxpayer must demonstrate, to the satisfaction of the IRS, that one or more customers or suppliers have significantly reduced their purchases from, or sales to, them because of the competing interests. This "competition" corporate business purpose seems to describe what many dealers involved with Project 2000 realignments are experiencing. Note that the group involved here includes both customers and suppliers. See the discussion of LTR 8712043 in this regard.

5. ***TO RESOLVE MANAGEMENT, SYSTEMIC, OR OTHER PROBLEMS***: Where the corporate business purpose for the divisive transaction is that the separation will enhance the success of the businesses by enabling the corporations ***to resolve management, systemic, or other problems*** that arise (or are aggravated) by the taxpayer's operation of different businesses within a single corporation or affiliated group, the elimination or minimization of shareholder conflict and disharmony is preeminent. This corporate business purpose is described in Rev. Proc. 96-30 under a caption entitled "***Fit and Focus***," which has to do with rearranging the business so that there is a better "fit" of the pieces or parts enabling a more efficient "focus" on ongoing operations in the future. This apparently refers to corporations that find that certain operations no longer "fit" into the "focus" that they want to maintain on their core business.

Often, this phenomenon may be caused by, or contribute to, significant shareholder disharmony and a non pro-rata distribution may enable the corporation to transfer out the portion of the business that does not "fit" by distributing it to the shareholder or shareholders who want to continue and/or expand it on their own. This "fit and focus" category covers a wide variety of shareholder dispute situations or situations where the shareholders may not necessarily be significantly at odds, but simply desire to go their separate ways for the good of all concerned.

The Service ordinarily will not rule unless the distribution is a non-pro-rata distribution to enable a significant shareholder (5% or more ownership) or shareholder group to concentrate on a particular business.

In "fit and focus" type situations, the Service will scrutinize closely any continuing relationship that will remain between the distributing and the controlled corporations to determine if the relationship is consistent with the stated business purpose. Examples of continuing relationships inviting at least suspicion and further inquiry include common directors, officers, or key employees, the provisions of goods and services to the other company, or commonly owned property. The Service will also closely scrutinize situations where there is cross ownership of stock. Except for cases involving an internal restructuring of an affiliated group, any direct or indirect continuing interest in both distributing and controlled by a significant shareholder will be suspect. For example, if the purpose of a distribution is to allow a significant shareholder to concentrate on a particular business, the Service ordinarily will require, as a condition of the ruling, that the separating shareholders not maintain interests (including interests as employees or directors) in both the distributing and the controlled subsidiary corporations after the distribution. The IRS may make exceptions to this on a case-by-case basis.

6. ***TO SIGNIFICANTLY ENHANCE THE PROTECTION OF ONE OR MORE BUSINESSES FROM THE RISKS OF ANOTHER BUSINESS***: Where the corporate business purpose is ***to significantly enhance the protection of one or more businesses from the risks of another business***, the Service requires ample demonstration of the nature and magnitude of the risks faced by the "risky business." This includes claims history or the typical risk experience of similar businesses in the industry. The Service also needs to know whether assets and insurance associated with the risky business are sufficient to meet reasonably expected claims arising from the conduct of that risky business. Facts regarding the cost and availability of insurance generally will require third party substantiation.

THREE OTHER CORPORATE BUSINESS PURPOSES LISTED IN REV. PROC. 96-30 ARE:

1. Facilitating a stock offering,
2. Tailoring the assets to facilitate a subsequent tax-free acquisition, and
3. Tailoring either corporate assets or corporate structures to facilitate subsequent tax-free acquisitions by another corporation.

LTR 9829050: A TAX-FREE SPLIT-OFF TO SETTLE SHAREHOLDER DISPUTES

Distributing, the dealership corporation in this ruling, is engaged in the operation of two truck dealerships and the leasing and financing of trucks, trailers, equipment and real estate. Distributing conducts business in two states. The common stock of Distributing is currently owned as follows, 53.60% by Shareholder A, 41.72% by Shareholder B and 4.68% by Shareholder C. Shareholder A is the brother of Shareholder B and Shareholder C is the son of Shareholder B.

Shareholders B and C currently manage the truck dealerships and Shareholder A manages the leasing and financing business. Shareholder C has been primarily responsible for the growth and success of the truck dealerships. However, serious disputes have arisen between Shareholder A and Shareholder C regarding the management of the truck dealerships. Shareholder A espouses a conservative management style which Shareholder C has refused to follow. Shareholder C desires to expand further the truck dealerships. Shareholder A wants the corporation to concentrate on the leasing and financing business and even to end the truck dealerships.

Information was submitted to the IRS detailing the harm that the continuing disputes has caused the businesses of Distributing. In order to alleviate the continuing disruption to Distributing, two transactions were proposed.

PROPOSED TRANSACTIONS

1. Distributing will transfer the truck dealership business to Controlled, a new corporation, in exchange for all of the Controlled stock; and

2. Approximately 80 percent of the Controlled stock will be distributed to Shareholder B in exchange for a proportionate interest of Distributing stock. The remaining 20 percent of the Controlled stock will he distributed to Shareholder C in exchange for his complete interest in Distributing.

Following the proposed distribution, the stock of Distributing and Controlled will be owned as follows:

Shareholder	Distributing Percentage Ownership
Shareholder A	70
Shareholder B	30

Shareholder	Controlled Percentage Ownership
Shareholder B	80
Shareholder C	20

The taxpayer supplied financial information to show that Distributing had been conducting two separate businesses and that each had gross receipts and operating expenses representative of the active conduct of its respective business for each of the past five years.

REPRESENTATIONS MADE BY THE TAXPAYERS

1. The fair market value of the Controlled stock and other consideration to be received by Shareholder B and Shareholder C, respectively, will be approximately equal to the fair market value of the Distributing stock surrendered respectively by the two shareholders in the exchange.

2. No part of the distribution to be distributed by Distributing will be received by a shareholder as a creditor, employee, or in any capacity other than that of a shareholder of the corporation.

3. The five years of financial information submitted on behalf of Distributing is representative of the corporation's present operations, and with regard to such corporation, there have been no substantial operational changes since the date of the last financial statements submitted.

4. Following the transaction, Distributing and Controlled will each continue the active conduct of its business, independently and with its separate employees.

5. The distribution of the stock of Controlled is carried out for the following business purposes: (a) the retention of a key employee/shareholder, (b) the elimination of conflicts between two of Distributing's three shareholders, and (c) to enhance the ability of Controlled to market its services to other truck dealerships. The distribution of the stock of Controlled is motivated, in whole or in part, by one or more of these corporate business purposes.

6. Distributing is not an S Corporation and there is no plan or intention by Distributing or Controlled to make an S Corporation election pursuant to Section 1362(a).

7. There is no plan or intention by the shareholders or security holders of Distributing to sell, exchange, transfer by gift, or otherwise dispose of any of their stock in, or securities of, either Distributing or Controlled after the transaction.

8. There is no plan or intention by either Distributing or Controlled, directly or through any subsidiary corporation, to purchase any of its outstanding stock after the transaction.

9. There is no plan or intention to liquidate either Distributing or Controlled, to merge either corporation with any other corporation, or to sell or otherwise dispose of the assets of either corporation after the transaction, except in the ordinary course of business.

10. The total adjusted bases and the fair market value of the assets transferred to Controlled by Distributing each equals or exceeds the sum of the liabilities assumed by Controlled plus any liabilities to which the transferred assets are subject. The liabilities assumed in the transaction and the liabilities to which the transferred assets are subject were incurred in the ordinary course of business and are associated with the assets being transferred.

11. Distributing neither accumulated its receivables nor made extraordinary payment of its payables in anticipation of the transaction.

12 No intercorporate debt will exist between Distributing and Controlled at the time of, or subsequent to, the distribution of the Controlled stock.

13. Payments made in connection with all continuing transactions, if any, between Distributing and Controlled will be for fair market value based on terms and conditions arrived at by the parties bargaining at arm's length.

14. No two parties to the transaction are investment companies.

IRS RULINGS

1. The transfer of assets proposed by Distributing to Controlled in exchange for all of the stock of Controlled and the assumption of certain liabilities, followed by the distribution of the stock of Controlled to the exchanging shareholders, will be a reorganization within the meaning of *Section 368(a)(1)(D)* of the Code. Distributing and Controlled will each be "a party to a reorganization" within the meaning of *Section 368(b).*

2. No gain or loss will be recognized to - and no amount will be included in the income of - either of the exchanging shareholders (i.e., B and C) upon their receipt of the stock of Controlled in exchange for stock of Distributing ... *Section 355(a)(1).*

3. No gain or loss will be recognized to Distributing upon the transfer of assets to Controlled in exchange for stock or Controlled and the relief of liabilities ... *Section 361(a).*

4. No gain or loss will be recognized to Controlled on the receipt of assets described above in exchange for its stock ... *Section 1032(a).*

5. The basis of the assets received by Controlled will be the same as the basis of such assets in the hands of Distributing immediately before the transactions ... *Section 362(b).*

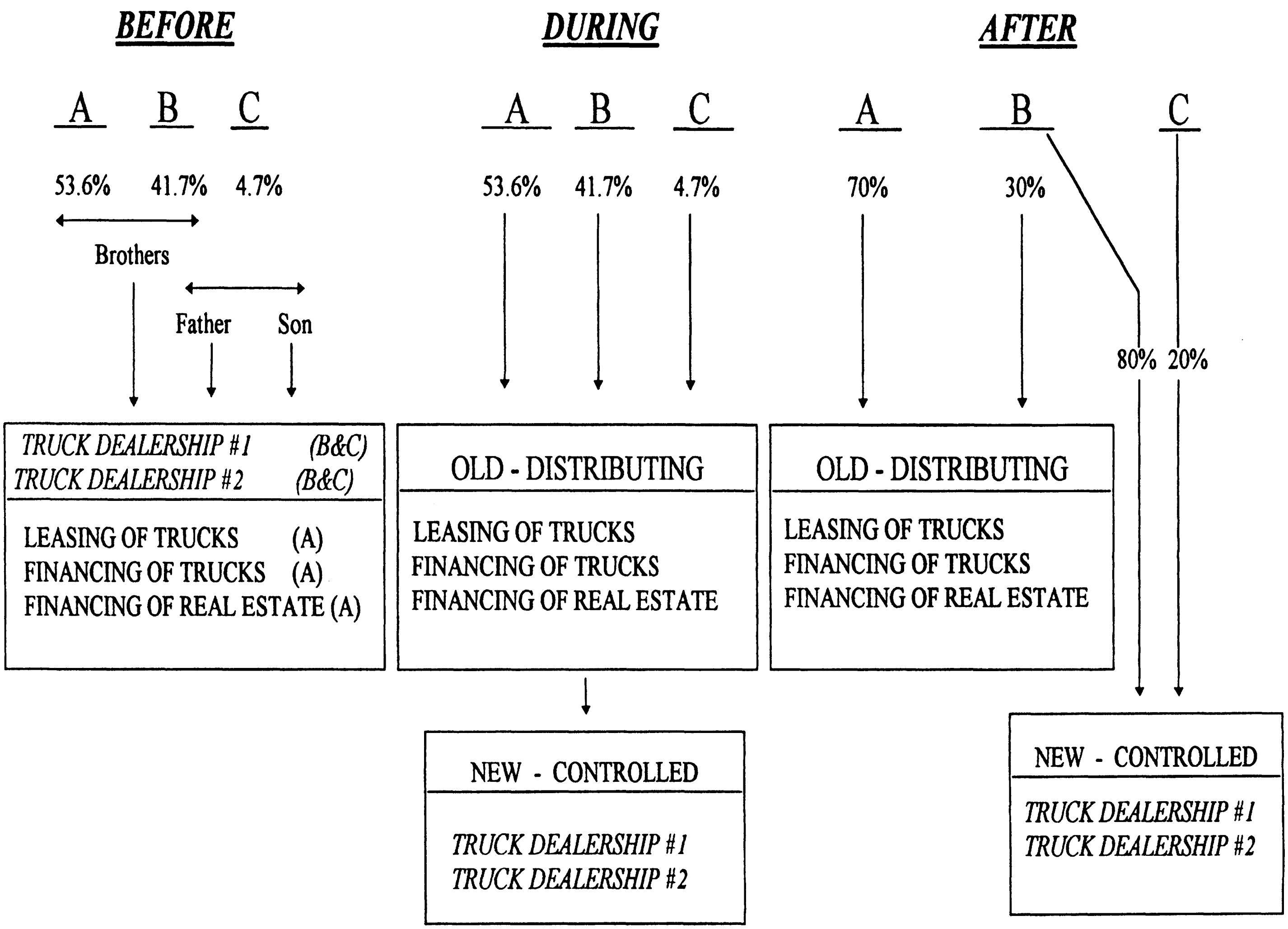
6. The holding period of Distributing assets received by Controlled will include the holding period during which such assets were held by Distributing ... *Section 1223(2).*

7. No gain or loss will be recognized to Distributing upon the distribution of all of its stock in Controlled to the exchanging shareholders in exchange for stock of Distributing ... *Section 361 (c)(1).*

8. The basis of the stock of Controlled in the hands of the exchanging shareholders (i.e., B & C) immediately after the distribution of such stock will be the same as the basis of the Distributing stock surrendered in exchange therefor ... *Section 358(a)(1).*

9. The holding period of the Controlled stock received in the exchange (by B & C) will include the holding period of the Distributing stock exchanged thereof, provided the Distributing stock is held as a capital asset on the date of the exchange ... *Section 1223(i).*

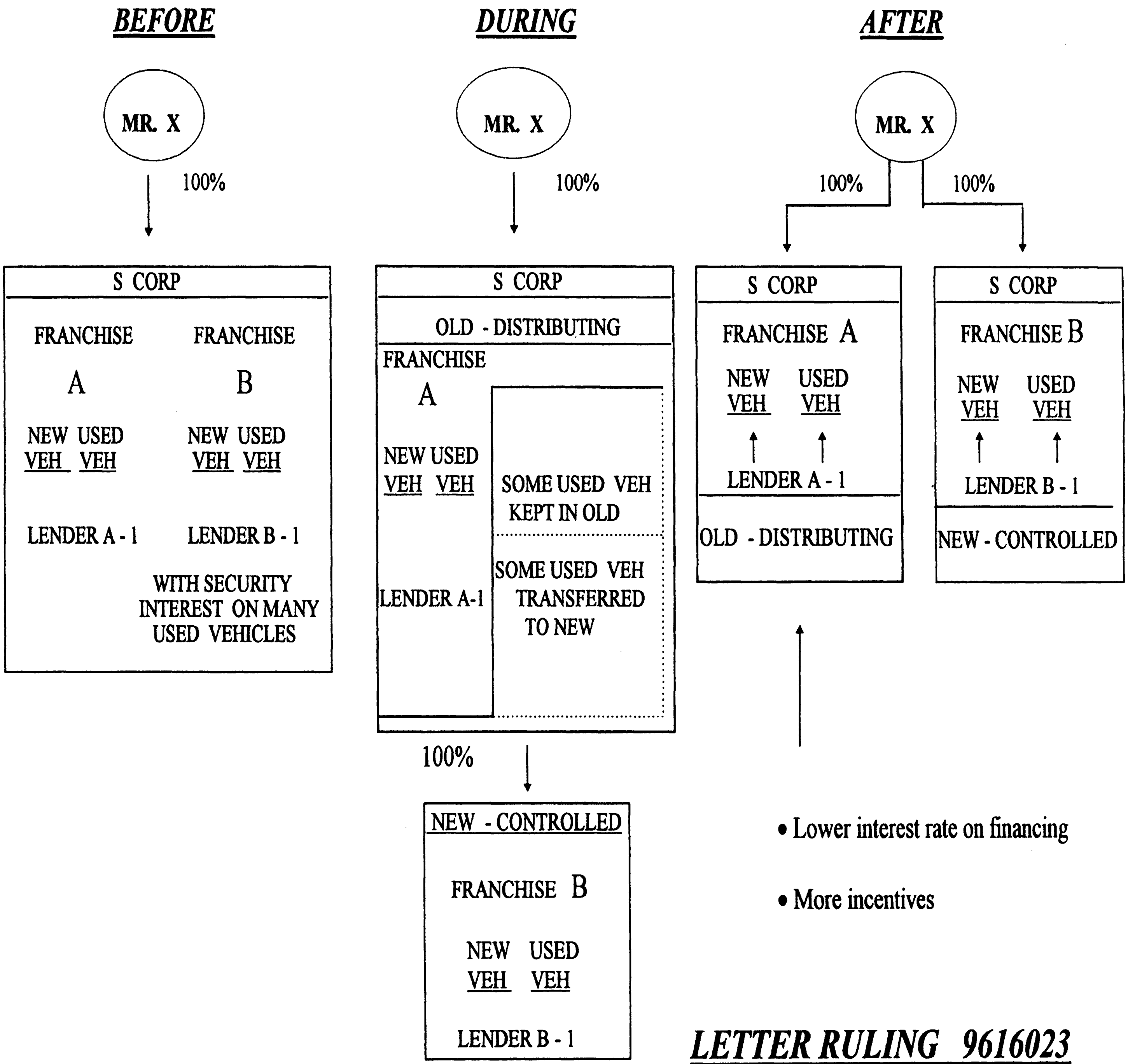
LTR 9829050



A - Conservative
Concentrate on Leasing
Get Out of Truck Dealership Business

C - Clashes With A
Wants to Expand Truck Dealership Business

LETTER RULING 9829050



LETTER RULING 9616023

LTR 9616023: A TAX FREE SPIN-OFF
TO LOWER INVENTORY FINANCING COSTS

Distributing, the dealership corporation in this ruling, is an accrual basis, calendar year Subchapter S Corporation. Distributing has 106 shares of common stock issued and outstanding, all of which are owned by Shareholder. Distributing is engaged in the automotive sales and service business, consisting of franchise *A* and franchise *B*. The IRS has received financial information which indicates that Distributing's automotive business has had gross receipts and operating expenses representative of the active conduct of a trade or business for each of the past five years.

Currently, lender ***A-1*** has a first security interest in and finances all of Distributing's new franchise *A* vehicles. Lender ***B-1*** has a first security interest in and finances all of Distributing's new franchise ***B*** vehicles, as well as all of Distributing's used vehicles. Distributing has provided detailed information that the proposed transaction will provide real and substantial financing cost savings. In particular, once Distributing transfers the franchise ***B*** assets and liabilities to Controlled and distributes the stock of Controlled to Shareholder, lender ***B-1*** will no longer have a first security interest in the used vehicles that remain in Distributing. As a result, lender ***A-1*** will finance the used vehicles that remain in Distributing, as well as additional vehicles, at reduced interest rate, with additional incentives.

PROPOSED TRANSACTIONS

1. Distributing will transfer all of the franchise ***B*** assets and some of Distributing's used vehicles to newly formed Controlled in exchange for all of the stock of Controlled and Controlled's assumption of liabilities.

2. Distributing will distribute the Controlled stock to shareholder.

3. Immediately following the distribution, Controlled will elect to be treated as a Subchapter S Corporation.

REPRESENTATIONS MADE BY THE TAXPAYERS

1. Distributing, Controlled, and Shareholder will each pay their own expenses, if any, incurred in connection with the transaction.

2. No part of the consideration distributed by Distributing is being received by Shareholder as a creditor, employee, or in any capacity other than that of a shareholder of Distributing.

3. Following the transaction, Distributing and Controlled will each continue independently and with their separate employees, the active conduct of all of the integrated activities of the business conducted by Distributing prior to consummation of the transaction.

4 The total adjusted basis and the market value of the assets transferred to Controlled by Distributing each equal or exceed the sum of the liabilities assumed by Controlled plus any liabilities to which the transferred assets are subject.

5. The liabilities assumed in the transaction and the liabilities to which the transferred assets are subject were incurred in the ordinary course of business and are associated with the assets being transferred.

6. No intercorporate debt will exist between Distributing and Controlled at the time of, or subsequent to, the distribution of Controlled stock.

7. The investment tax credit previously computed with respect to the Section 38 property transferred will be adjusted in the year of transfer to reflect an early disposition of the property. (I.e., investment credit recapture was triggered.)

8. No two parties to the transaction are investment companies.

9. The five years of financial information submitted on behalf of Distributing is representative of Distributing's present operations, and there have been no substantial operational changes since the date of the last financial statement submitted.

10. There is no plan or intention to liquidate either Distributing or Controlled, to merge either corporation with any other corporation, or to sell or otherwise dispose of the assets of either corporation subsequent to the transaction, except in the ordinary course of business.

11. There is no plan or intention by the shareholders or security holders of Distributing to sell, exchange, transfer by gift, or otherwise dispose of any of their stock in, or securities of, either Distributing or Controlled subsequent to the transaction.

12. Payments made in connection with all continuing transactions between Distributing and Controlled will be for fair market value based on terms and conditions arrived at by the parties bargaining at arm's length.

IRS RULINGS

1. Distributing's transfer of assets to Controlled in exchange for Controlled stock and the assumption of liabilities, followed by the distribution of the Controlled stock to Shareholder, will be a reorganization within the meaning of *Section 368(a)(1)(D)*. Distributing and Controlled will each be a party to the reorganization within the meaning of *Section 368(b).*

2. Distributing will recognize no gain or loss on the transfer of all of the franchise B assets and some of Distributing's used vehicles to Controlled in exchange for Controlled stock and the assumption of liabilities ... *Sections 361(a) and 357(a).*

3. Controlled will not recognize gain or loss on the receipt of the assets transferred by Distributing in exchange for stock of Controlled ... *Section 1032.*

4. Controlled's basis in the assets received from Distributing will equal Distributing's basis in the assets immediately before the transfer ... *Section 362(b).*

5. Controlled's holding period for the assets received from Distributing will include the period during which Distributing held such assets ... *Section 1223(2).*

6. Distributing will recognize no gain or loss upon the distribution of the Controlled stock to Shareholder ... *Section 361(c)(1).*

7. Shareholder will not recognize any gain or loss upon the receipt of the Controlled stock ... *Section 355(a)(1).*

8. The aggregate basis of the Controlled and Distributing stock in the hands of Shareholder after the Distribution will equal Shareholder's aggregate basis in the Distributing stock held immediately before the distribution, allocated in proportion to the fair market value of each in accordance with *Reg. Sec. 1.358-2(a)(2)* ... *Section 358(b).*

9. Shareholder's holding period in the Controlled stock received will include the holding period of the Distributing stock with respect to which the distribution was made, provided that Shareholder holds the Distributing stock as a capital asset on the date of the distribution ... *Section 1223(1).*

10. As provided in *Section 312(h)*, proper allocation of Distributing's earnings and profits will be made between Distributing and Controlled in accordance with *Reg. Sec. 1.312- 10(a).*

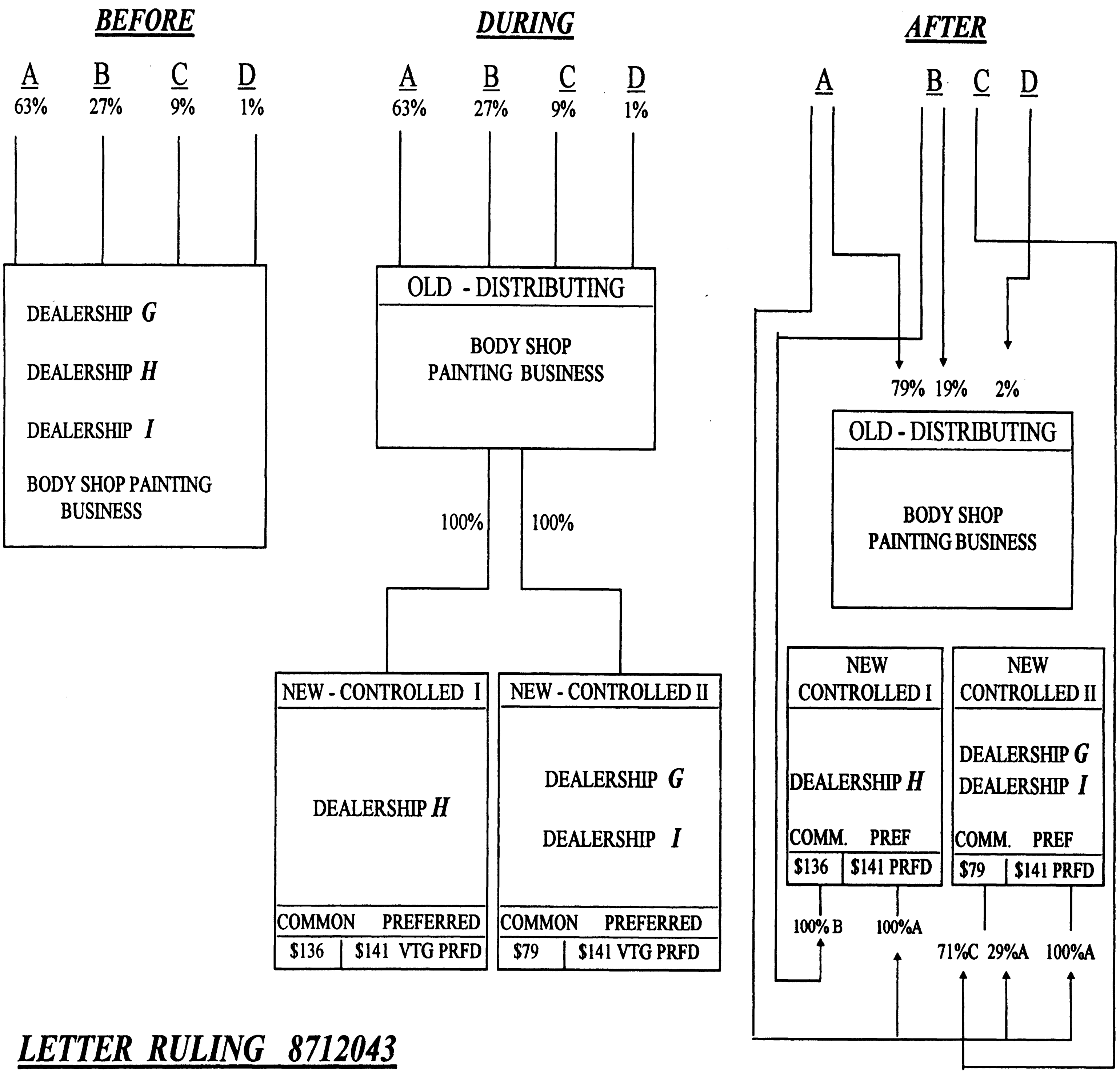
11. Distributing's *momentary ownership* of the stock of Controlled in connection with a reorganization under *Section 368(a)(1)(D)* will not cause Distributing to be an ineligible corporation under *Section 1361(b)(2)(A)*, and therefore will not terminate Distributing's election to be taxed as an S corporation under *Section 1362(d)(2).*

12. Distributing's *momentary ownership* of the stock of Controlled will not cause Controlled to be an ineligible corporation under *Section 1361(b)(2)(A)*, or to have an ineligible shareholder under *Section 1361(b)(1)(B)*. Therefore, Controlled is eligible to make a timely election to be an S Corporation for the first taxable year, provided that Controlled meets the other requirements of *Section 1361(b).*

13. Controlled is not required to include in its gross income any LIFO recapture amount under *Section 1363(d)* if Controlled timely elects to be an S Corporation for its first taxable year, and it otherwise meets the other requirements of *Section 1361(b).*

14. Because Distributing is an S Corporation, Distributing is not required to include in Its gross income any LIFO recapture amount any *Section 1363(d).*

LTR 9616023



LETTER RULING 8712043

LTR 8712043: PROJECT 2000 PRECURSOR A TAX FREE SPLIT-OFF TO SATISFY THE FACTORY

Distributing, the dealership corporation in this ruling, is an accrual basis corporation which owns and operates G, H and I automobile dealerships. Distributing also conducts a body shop painting business. Distributing's G, H and I automobile dealerships and Distributing's body shop painting business have each had gross receipts and operating expenses representative of the active conduct of a trade or business for each of the past five years. Distributing has outstanding 3,948 shares of common stock, which are held as follows:

Shareholder	Shares	Percentage
A	2,478	62.80%
B	1,070	27.10%
C	341	8.60%
D	59	1.50%
	3,948	100.00%

PROJECT 2000 SIMILARITIES - FACTORY REALIGNMENT

G Division and H Division are divisions of L that oversee their respective G and H automobile franchises. In July 1984, H Division was surveying the marketing area developed and served by Distributing to determine if new H dealerships should be established in the area. In December 1984, H Division advised Distributing that its survey had been complete and that it had tentatively decided to add another H dealership approximately ten miles from Distributing's dealership. Distributing believed a new H dealership would materially and adversely affect its H business and protested H Division's proposal before the State M New Motor Vehicle Board and directly to H Division.

In June 1985, H Division wrote Distributing stating that H Division would not create a new H dealership in Distributing's market. This decision was reached provided Distributing agreed to *dedual*, that is to establish separate operating entities for G and H, each having separate showroom and service facilities and each having stock ownership and dealer operator designations conforming to the policies and requirements of L. Upon the separation of the H franchise from Distributing, H Division also stated A could become a multiple dealer investor in both corporations provided A enters into a complete sellout agreement of his multiple dealer investment in either the G or H dealership within ten years from the date of separation of the G and H franchises into two corporations. A has represented that he will either gift or bequest his stock to the dealer-operator, enabling the dealer-operator to become a 100 percent dealer-owner in this ten year period.

SHAREHOLDER DISHARMONY: In addition, serious disputes have arisen between B and C on the management and operation of the G, H and I franchises which are having an adverse effect on the day-to-day operations of Distributing.

PROPOSED TRANSACTIONS

Controlled I (one of the two new subsidiaries set up, and the one to which Franchise H was transferred) is an accrual basis corporation which was formed to effectuate the proposed transaction. Controlled I will have outstanding 136 shares of voting common stock and 141 shares of voting preferred stock, all of which will initially be held by Distributing. The noncumulative convertible preferred stock will have equal voting rights with the common, a stated dividend rate, and a liquidation Preference.

Controlled II (the other of the two new subsidiaries set up, and the one to which Franchises G and H were transferred) is an accrual basis corporation which was formed to effectuate the proposed transaction. Controlled II will have outstanding 79 shares of voting common stock and 141 shares of voting preferred stock, all of which will initially be held by Distributing. The noncumulative, convertible preferred stock will have equal voting rights with the common, a stated dividend rate, and a liquidation preference.

REPRESENTATIONS MADE BY THE TAXPAYERS

In addition to the representations common to LTRs 9829050 and 9616023, the following additional representations more specific to the facts of this LTR were made:

1. Following the proposed transaction, Distributing, Controlled I and Controlled II will each continue the active conduct of their respective businesses independently and with their own separate employees, except that the corporations may share the services of certain administrative personnel. Any shared employees will be paid directly by each corporation determined by the parties after negotiations at arm's- length.

2. No intercorporate debt shall exist between Distributing and Controlled I or Controlled II at the time of, or subsequent to, the distribution of Controlled I or Controlled II stock, except for any indebtedness which may result from leasing of real property owned by Distributing to Controlled I and/or Controlled II or from any other transactions between Distributing, Controlled I and Controlled II which may arise in the normal course of their respective businesses. The terms and conditions of all inter-corporate transactions will be for fair market value arrived at by the parties after negotiations at arm's-length. None of the above inebtedness constitutes or will constitute stock or securities within the meaning of Section 355.

3. There is no plan or intention by the shareholders to sell, exchange, transfer by gift, or otherwise dispose of any of their stock in Distributing, Controlled I or Controlled II subsequent to the proposed transaction, except that A may gift shares of stock in either Controlled I or Controlled II to B or C, respectively, and may in the future make gifts of shares of Distributing to his children and/or grandchildren. Any such gifts will constitute, in the aggregate, no more than 50 percent of the total value of the shares of Distributing, Controlled I and Controlled II stock outstanding immediately after consummation of the proposed transaction.

IRS RULINGS

1. The transfer by Distributing to Controlled I and Controlled II of the assets solely in exchange for all of the stock of Controlled I and Controlled II and the assumption of certain liabilities, followed by the distribution of the Controlled I and Controlled II stock to A, B, and C in exchange for part of their Distributing stock, will each be a reorganization within the meaning of Section 368(a)(1)(D) of the Code. Distributing, Controlled I and Controlled II will each be "a party to a reorganization" within the meaning of Section 368(b).

2. No gain or loss will be recognized to Controlled I or to Controlled II on the receipt of the assets in exchange for Controlled I stock, or Controlled II stock.

3. The basis of the assets received by Controlled I and by Controlled II, respectively, will be the same as the basis of such assets in the hands of Distributing immediately prior to the transaction.

4. The holding period of the Distributing assets received by Controlled I and by Controlled II, respectively, will include the period during which such assets were held by Distributing.

5. No gain or loss will be recognized to Distributing upon the distribution of all of its Controlled I and Controlled II stock.

6. No gain or loss will be recognized to (and no amount will be included in the income of) A and B upon the receipt of the Controlled I stock in exchange for part of their Distributing stock.

7. No gain or loss will be recognized to (and no amount will be included in the income of) A and C upon the receipt of B Controlled II stock in exchange for part or all of their Distributing stock.

8. The basis of the stock of Controlled I and Distributing in the hands of B after the distribution will be the same as the basis of the Distributing stock held immediately before the distribution, allocated in proportion to the fair market value of each in accordance with Reg. Sec. 1.358-(a)(2).

9. The basis of the stock of Controlled 1, Controlled II and Distributing in the hands of A after the distribution will be the same as the basis of the Distributing stock held immediately before the distribution allocated in proportion to the fair market value of each in accordance with Reg. Sec. 1.358-2(a)(2).

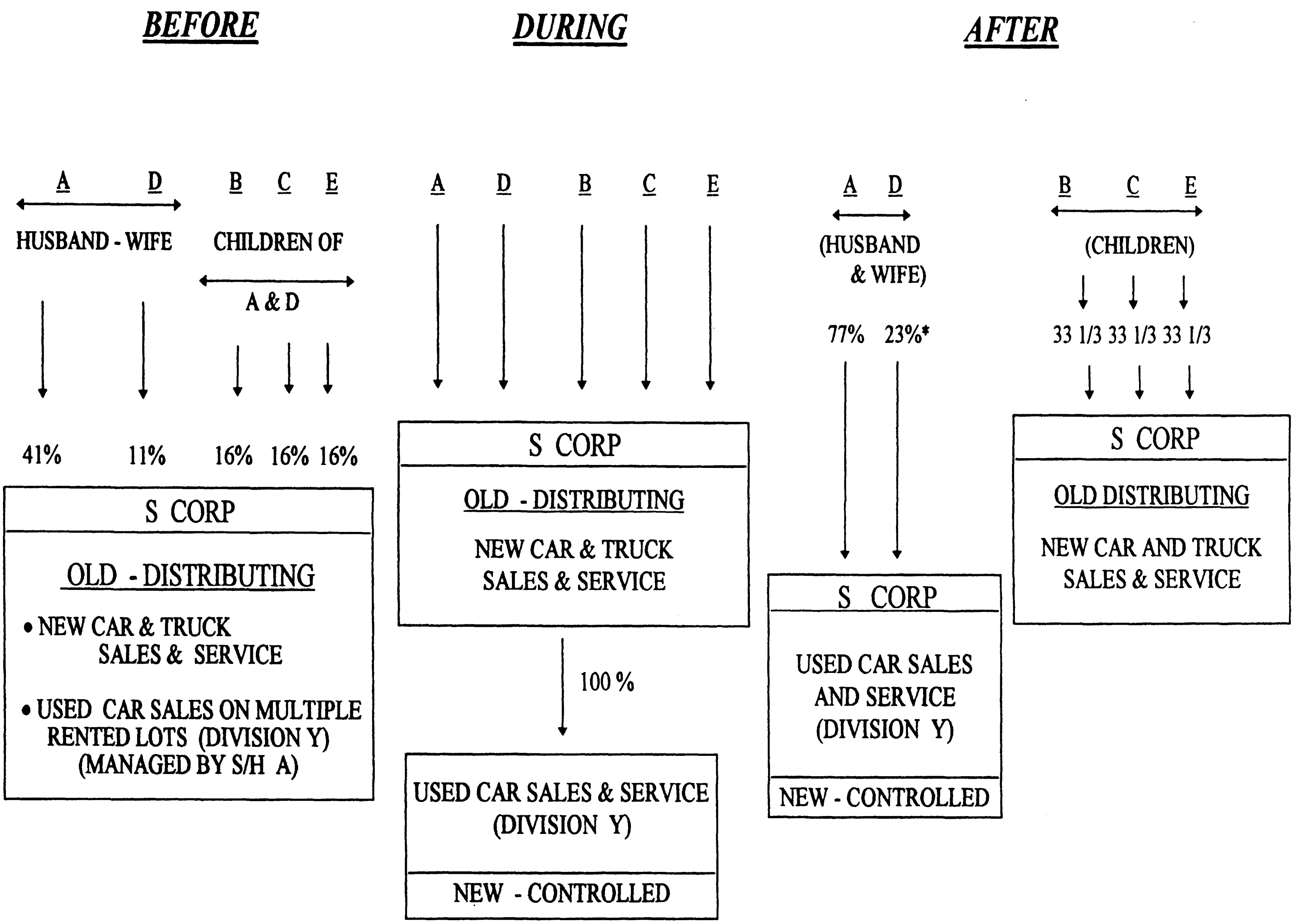
10. The basis of the Controlled II stock in the hands of C will be the same as the basis of the Distributing stock surrendered in exchange therefor.

11. The holding period of the Controlled I stock received by A and B and of the Controlled II stock received by A and C will, in each instance, include the holding period of the Distributing stock surrendered in exchange therefor, provided that the Distributing stock is held as a capital asset on the date of the exchange.

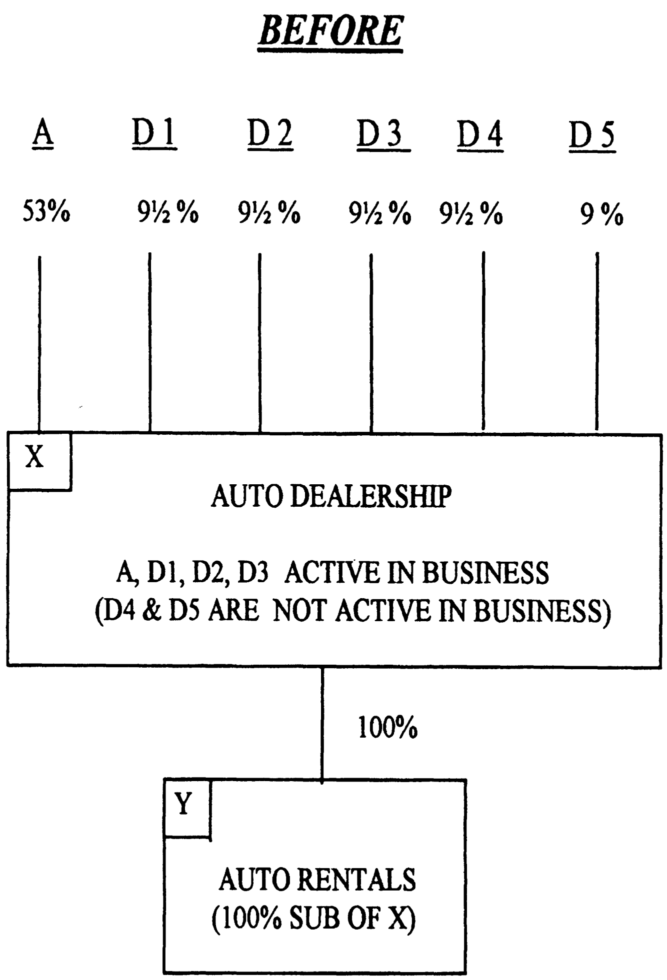
12. The Controlled I and Controlled II preferred stock to be received by A in the proposed transaction as described above, shall be considered "Section 306" stock as defined in Section 306(c) of the Code.

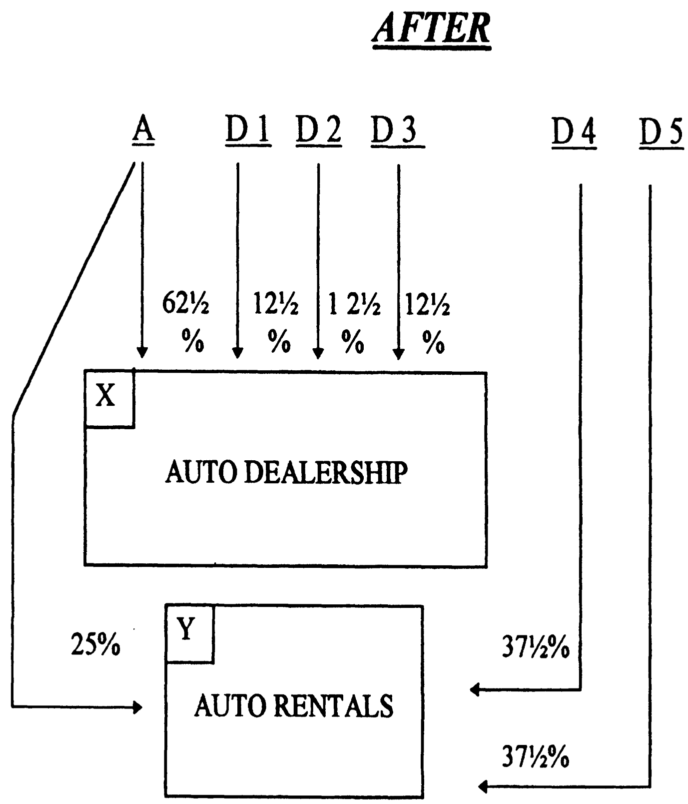
13. As provided in Section 312(h) of the Code, proper allocation of earnings and profits between Distributing, Controlled I and Controlled II will be made under Reg. Sec. 1.312-10(a).

LTR 8712043



LETTER RULING 9522036





FATHER WITH 5 DAUGHTERS; AUTO RENTALS (Y) IS A 100% SUB OF AUTO DEALERSHIP (X)

BEFORE: % OF X OWNED BY 3 DAUGHTERS ACTIVE IN BUSINESS: 28½ %

AFTER: % OF X OWNED BY 3 DAUGHTERS ACTIVE IN BUSINESS: 38%

NOTE: ALL PERCENTAGES ARE ROUNDED

REVENUE RULING 75-337

MEDIUM- & HEAVY-DUTY TRUCK DEALERS ALSO GET LIFO CONFORMITY VIOLATION RELIEF

R. P. 98-46

Last year, the IRS extended relief to auto and light-duty truck dealers who had LIFO conformity violations on their year-end Factory statements in any one of the six prior years. *Revenue Procedure 97-44* allowed only auto and light-duty truck dealers to keep their LIFO elections and reserves if they paid a 4.7% penalty tax based on their LIFO reserves at December 31, 1996. This 4.7% penalty tax was payable in three equal annual installments on May 31, 1998 ... January 31, 1999 ... and January 31, 2000.

In Revenue Procedure 98-46, the IRS recently extended this same conformity violation relief to ***all medium- and heavy-duty truck dealers.*** Most of the same requirements and conditions for relief apply. They pay their penalty tax in three equal annual installments with the first one due January 31, 1999. The second installment is due January 31, 2000 and the last installment is due January 31, 2001.

If the truck dealer was under audit on September 8, 1998, the first installment payment date is accelerated to December 1, 1998, and the IRS agent has to be notified of the dealer's action by December 15, 1998.

It is important to note that if a violation occurred on a calendar year 1997 financial statement, the dealer is not entitled to any relief. Relief is extended only for years ending <u>before</u> October 15, 1997.

Medium- and heavy-duty truck dealers will need to do "self-audits" for 1991 through 1996 ... or fiscal '92 through '97 ... to see whether or not payments are necessary. All of the questions that auto dealers faced before their May 31, 1998 payments were due have to be considered by the medium- and heavy-duty truck dealers before their first installment date. And there still have been no answers to any of these questions.

See pages 26 & 27 for the specifics of Revenue Procedure 98-46 for medium- and heavy-duty truck dealers.

INSTALLMENT PAYMENT DATES*

	Auto & Light-Duty Truck Dealers	Medium & Heavy-Duty Truck Dealers
First	May 31, 1998	January 31, 1999
Second	January 31, 1999	January 31, 2000
Third	January 31, 2000	January 31, 2001

* There are special accelerated first due dates for dealers under audit when revenue procedures were issued.

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

NAME(S):____________________

FIRM NAME:____________________

ADDRESS:____________________

CITY:____________ STATE:________ ZIP:________ PHONE: (____)________

AT A GLANCE	RELIEF FOR MEDIUM & HEAVY-DUTY TRUCK DEALERS REV. PROC. 97-44 ... AS MODIFIED BY REV. PROC. 98-46
RELIEF "GOOD NEWS"	• Dealers with conformity violations "within the scope of Rev. Proc. 97-44" will not have their LIFO elections terminated for any year ending before October 14, 1997. • LIFO adjustments must appear in the income statement ... but they do ***not*** have to be made to the Cost of Goods Sold account. • LIFO adjustments may appear ***anywhere*** on the Statement of Income.
LOOK-BACK PERIOD	• Six (6) most recent taxable years ending on or before October 14, 1997. • Calendar year taxpayers: December 31, 1991...1992...1993...1994...1995 & 1996. • Fiscal years (September or earlier): xx/xx/92...93...94...95...96 & 97.
PENALTY AMOUNT	• 4.7% times LIFO reserves on the last day of the last taxable year ended on or before October 14, 1997. • For calendar year dealerships: 4.7% times December 31, 1996 LIFO reserve(s).
METHOD OF PAYMENT	• Three equal installments: January 31, 1999...January 31, 2000...& January 31, 2001. • Option for dealers not under audit to pay entire amount in one installment due January 31, 1999.
IRS ENFORCEMENT	• Dealer is required to do a "self-audit" of Factory statements submitted ***"for credit purposes."*** • District Director may verify accuracy of dealer's self-audit. • Special relief extends only to LIFO conformity violations, risk of termination exists for all others.
DEALERS CURRENTLY UNDER AUDIT	• Allowed to obtain special relief if under audit on September 8, 1998. • Payment due date for first installment of settlement amount is accelerated to December 1, 1998. • Relief is also available to dealers at Appeals or in Federal Court.
SPECIAL RULES	• Transmittal memorandum *MUST* accompany each installment payment. • Permission to terminate LIFO will be held up if payments under Rev. Proc. are still due. • Payments are not accelerated by a change from C to S ... or by a change from S to C.
"BAD NEWS"	• Relief does not apply to years ending after October 14, 1997.
SOME QUESTIONS THAT NEED CLARIFICATION	• Many significant problems and unanswered questions remain. • Does IRS consider statements sent to the Factory as statements "for credit purposes"... possibly resulting in a conformity violation even though those statements were not sent to credit corp. because the dealer floorplanned elsewhere? • What about Factory statements that in prior years had no place on them for a LIFO adjustment and this was simply "overlooked" by the CPA? • What happens where used vehicles and/or parts are also on LIFO? How does Rev. Proc. apply? • What about multiple franchise dealers who had LIFO adjustments on some, but not on ***all***, of the statements that were sent to the various manufacturers? How does Rev. Proc. apply? • All the questions of interpretation raised by Rev. Proc. 97-44 are still unanswered. • See prior issues of *LIFO Lookout* for discussion of these questions.

MEDIUM & HEAVY-DUTY TRUCK DEALERS
CONFORMITY VIOLATION RELIEF UNDER REV. PROCS. 97-44 & 98-46

KEY TERMS	
PENALTY AMOUNT	• 4.7% of the LIFO reserves on the last day of the last taxable year ending before October 14, 1997. • Payable in three equal installment payments...see ***Important Dates*** below.
SETTLEMENT AMOUNT	• The amount that a dealer with a LIFO conformity violation must pay. The ***Settlement Amount*** is not a tax. It is not deductible as interest. It does not result in a basis adjustment to the LIFO inventories, nor does it affect prior LIFO layer increments or increment valuations.
LOOK-BACK PERIOD FOR SELF-AUDIT	• Six (6) most recent taxable years ending on or before October 14, 1997. For a calendar year taxpayer, the look-back period is the years ended December 31, 1991 through 1996.
MEMORANDUM ("ACCOMPANYING MEMORANDUM")	• This is a transmittal form the taxpayer is required to prepare, complete and send in with each installment payment so the IRS will be able to keep track of the payment status of the amount due under Rev. Proc. 97-44.
REV. PROC. 97-44 **REV. PROC. 98-46**	• The designation of the Revenue Procedure that originally spelled out the terms and conditions and the steps that an auto and light-duty truck dealer can take to avoid having its LIFO election terminated because of certain financial statement conformity violations. • Relief extended to medium & heavy-duty truck dealers by Rev. Proc. 98-46.
REV. RUL. 97-42	• The designation of the Revenue Ruling that describes the manner in which an adjustment for LIFO should be reflected in a dealer's year-end income statement.

IMPORTANT DATES FOR MEDIUM & HEAVY-DUTY TRUCK DEALERS	
1991 THROUGH 1996	• The ***six (6) year period*** with respect to which dealers are required to "self-audit" the year-end financial statements they submitted to the Factory for possible LIFO conformity violations.
FYE-92 THROUGH FYE-97	• Corresponding look-back or self-audit period for dealers with fiscal years ending January through September.
OCTOBER 14, 1997	• The cut-off date for Rev. Proc. 97-44 (and Rev. Rul. 97-42) determinations.
SEPTEMBER 8, 1998	• "Under Audit" date which accelerates the first installment due date to December 1, 1998.
DECEMBER 1, 1998	• For dealerships under audit on September 8, 1998, the date on or before which the ***first*** installment payment of one-third of the ***Settlement Amount*** is due. • If a dealer under audit elects to forego making installment payments, the entire ***Settlement Amount*** is due on December 1, 1998.
DECEMBER 15, 1998	• The date on which dealers under audit on September 8, 1998 must notify examining agents of their taking action under Rev. Proc. 98-46.
JANUARY 31, 1999	• Due date of the ***first*** installment of one-third of the ***Settlement Amount*** payment for dealers not under audit on September 8, 1998. • Due date for payment of the total ***Settlement Amount*** if a dealer not under audit on September 8, 1998 elects to make a single payment of entire ***Settlement Amount***.
JANUARY 31, 2000	• Due date for the ***second*** installment of one-third of the ***Settlement Amount*** payment.
JANUARY 31, 2001	• Due date for the ***third*** installment of one-third of the ***Settlement Amount*** payment.

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