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. DEMO VALUATIONS HIT AGAIN, THIS TIME BY A U.S. DISTRICT COURT LOOKING AT BMW's TREATMENT. The District Court recently said the IRS was right in requiring BMW of North America to forego the use of the more favorable valuation tables in valuing the demonstrator vehicle fringe benefit it provided to some 2,000 employees. The law's the law, and BMW did not satisfy all of its technical requirements to be able to use the Annual Lease Valuation Table.

This case, with a U.S. District Court's blessing, emphasizes the same technicalities the IRS hammered on in its previous letter rulings. For discussions of the prior IRS rulings, see the December, 1997 *DTW* for LTR 9801002 and the June, 1998 *DTW* for LTR 9816007.

The holding by the District Court of New Jersey in this case cost BMW $1.35 million and it is not surprising to anyone familiar with the tight wording limiting the availability of the special use valuation benefits. Dealers...and advisors...beware.

#2. USED CAR DEALERS "SELLING" NOTES TO LOAN SERVICING COMPANIES ... TWO MORE IRS RULINGS. In LTR 9840001, the IRS held that the transfer of credit-impaired customers' (sub-prime) notes by a used car dealer to a loan servicing company were sales, rather than "financings." In that ruling, the IRS also held that the amounts realized from the sales of the customer notes were equal to the sum of (a) the cash received for the customer note, plus (b) the fair market value of the dealer's right to receive any future distribution payments created by the sale.

Recently, the IRS issued two more rulings involving used car dealers under audit examination. These rulings, 199909002 and 199909003, have relatively similar fact patterns, although each has its own distinctions.

WATCHING OUT FOR

These seemingly favorable rulings for used car dealers haven't clarified the real issues: how to quantify the fair market value of the future (or back-end) payments...and how Section 483 should be applied to these deferred payments.

It would be nice to have a revenue ruling or a revenue procedure addressing these critical issues. However, that seems unlikely at the present time. These letter rulings (–002 and –003) and LTR 9840001 are discussed on page 8.

#3. FACTORY INCENTIVE PAYMENTS. We finally have some closure on the matter of automotive manufacturer incentive payments to dealership sales personnel. The IRS finally came out and said in writing that incentive payments to vehicle salespersons are

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not subject to Federal income tax withholding, Social Security, Medicare or Federal unemployment tax. Hooray!

This concession/guidance appeared on its web site (www.irs.ustreas.gov) and in Publication 3204...so that salespeople could "do the right thing" in preparing their 1998 income tax returns.

For more on this and other Form 1099 reporting developments, see page 12.

#4. DEALER GETS TAX RELIEF BECAUSE HE SOLD HIS DEALERSHIP PROPERTY UNDER THREAT OF CONDEMNATION. The Tax Court allowed an auto dealer to defer the gain on the sale of his dealership properties which he had sold under the threat of condemnation by a California city (Lancaster) Redevelopment Agency that was eyeing his dealerships for its auto mall.

The special relief provisions of Section 1033 were found to apply to his special fact pattern. But, what's really interesting about this case is the fraud penalty assertion by the IRS. For more on *Michael H. Johnson* (T.C. Memo. 1998-448), see page 14.

#5. UPDATE ON TECHNICIAN'S TOOL RENTAL PROGRAMS. At a recent American Bar Association meeting of the "Employment Taxes" committee, the Director of the IRS Office of Employment Tax Administration and Compliance mentioned several developments of concern.

Of most immediate interest to auto dealers was Tom Burger's mention that "someone out there" has been encouraging automotive repair shops to designate a portion of their wages as "tool rentals" apparently in an effort to get around the withholding tax liabilities associated with those wages. Mr. Burger warned: "We are actively looking at this issue." Undoubtedly, we'll hear more on this eventually...and we'll keep you posted.

#6. DEALERS CAN'T USE REPLACEMENT COST FOR PARTS INVENTORIES. The Tax Court recently issued its decision on a dealer's use of replacement cost for parts inventories on LIFO. The news wasn't good. And, it has troubling implications for **all** dealers, not just for those using LIFO. The Court held that:

1. The use of ***replacement cost*** in determining the current-year cost of the dealer's LIFO parts pool ***is contrary to the LIFO regulations***.

2. The use of replacement cost ***does not clearly reflect income***.

3. The dealer was entitled to ***no relief because the dealer failed to maintain "detailed inventory records."*** As a result, the IRS couldn't verify the dealer's inventory computations and/or their compliance with the regulations.

When the IRS added the entire parts LIFO reserve back into the dealer's income, the Tax Court said this was not the equivalent of the IRS terminating the dealer's LIFO election.

The Court noted that before electing LIFO, the dealer had made no attempt to determine whether it could have modified its perpetual inventory recordkeeping system so that it could have used invoice prices in valuing its parts inventory at cost. Has any dealer *ever* done this *before* electing LIFO for a parts inventory?

Mountain State Ford Truck Sales v. Comm. was filed March 2, 1999 (112 T.C. No. 7). Until clarified, interpretations of this case will vary, and no one knows how far the IRS will push it as precedent.

This case was decided based on the record before the Court. However, it implicates all dealers—whether or not they are on LIFO for parts—because the use of replacement cost to value parts inventories has always been accepted industry practice ... until now. This case is written up in the March, 1999 issue of the *LIFO Lookout* and you can expect to hear more about it in the future when the IRS and others really come to understand its implications.

#7. USED CAR LIFO COMPUTATIONS TAKE A HIT. In LTR 9853003, the IRS held that an auto dealer could not use a short-cut method for computing used vehicle LIFO inflation indexes. Instead, the Service required the dealer to use multiple official used car guides so that valuation comparisons could be made for each vehicle on an exact one year term basis.

To make matters worse...or at least more complicated...the IRS also said that consideration should be given to similarity in condition, mileage and options in order to *clearly reflect income*. What the IRS means by *clear reflection of income* will continue to cause problems wherever the IRS raises it as an issue.

Since many CPAs do not make exact one year matches to the date of acquisition, nor other more detailed comparisons in their used vehicle LIFO computations, these positions of the IRS will have to be reckoned with sooner or later. Letter Ruling 9853003 is discussed in the March, 1999 issue of the *LIFO Lookout*.

#8. RE: OUR RECENT SUBSCRIBER SURVEY. We thank those of you who responded for sharing your thoughts on our publications.

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Dealer Tax Watch Out

If you were not contacted by the firm we had conduct this survey because of the random nature of their selection process, we'd be pleased to send or fax you a copy of their questionnaire. This will only take a few minutes of your time to complete.

Several of you told us that you felt there either was too much overlap between our two publications (the *LIFO Lookout* and the *Dealer Tax Watch*) or that either one or the other would probably now be sufficient for your needs.

In the past, there has been some overlapping of dealer LIFO news between our two publications. This was simply because we didn't want to deprive those who subscribed only to the *Dealer Tax Watch* of certain auto dealer update information on LIFO issues because they were covered more thoroughly in the *LIFO Lookout.*

In the future, there will be no duplication. All LIFO-related subjects will be treated only in the *LIFO Lookout*; all other dealer-related tax issues will be covered in the *Dealer Tax Watch,* with only a brief summary in the *DTW* Update portion mentioning the dealer LIFO-related matters. For example, see Update items #6 and #7 on page 2.

Therefore, all in-depth auto dealer LIFO coverage will be included only in the *LIFO Lookout* in the future. Our web site includes the tables of contents for the current issues of both publications.

Several respondents indicated they would like to receive the publications on a more timely basis. We share your desire in this respect and will make a greater effort to get the publications into your hands on a more timely basis in the future.

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Some respondents suggested that by expanding the frequency to six issues per year, the information might be more timely. For the present, we are not planning to increase (or decrease) the frequency of publication, but as indicated above, we will strive to get each issue into your hands more promptly.

#9. UPCOMING CONFERENCE OF INTEREST. Our *Spring, '99 CPA-Auto Dealership Niche Conference* will be held May 10-12, at the Flamingo Hilton in Las Vegas.

The tax roundtable Tuesday morning brings together many of the key names associated with tax developments in the industry: **Ms. Mary Burke Baker**, Motor Vehicle Industry Specialist, **Mr. Willard J. De Filipps, CPA**, **Mr. R.B. Grisham**, Executive Vice President, National Independent Automobile Dealers, **Mr. James C. Minnis, Esq.**, Director, Regulatory Affairs, National Automobile Dealers Association, and **Mr. Robert Zwiers**, Crowe Chizek & Company.

Conference topics include: Industry outlook, dealer consolidation in public markets, Factory Project 2000 downsizing, new financial products, dealership valuations, financial statement analysis and benchmarks, computer utilization and purchase negotiation strategies, used vehicle LIFO calculations, a special session on the *Mountain State Ford Truck Sales* decision, related finance companies, and much more.

For a detailed conference brochure, call (847) 577-3977 or fax (847) 577-1073, or visit the Conference web site at http://www.defilipps.com.

DEMO VALUATIONS HIT VERY HARD AGAIN IN *BMW OF NORTH AMERICA, INC.*

DEMO WARNING

Some people believe that bad news messages come in threes. If true, that could also be said about IRS "messages" on the use of demonstrators. First came LTR 9801002 last year when the Service held that the employees of a dealership were not entitled to exclude the value of the use of the vehicles from gross income as a working condition fringe because the substantiation requirements of Section 274(d) had not been satisfied. In this ruling, the dealer also lost the benefit of the more favorable Annual Lease Valuation Table.

Next came LTR 9816007. This ruling involved the IRS reneging on its own advice given in a prior audit on how the taxpayer could apply the demonstrator valuation rules. The taxpayer in this ruling was a distributor of vehicles manufactured by an affiliated company and it, too, lost the benefit of favorable treatment.

Now comes *BMW of North America, Inc. vs. United States,* a decision dated December 22, 1998 out of the United States District Court for the District of New Jersey. This case is a real wake-up call for all taxpayers–dealers or otherwise–who are using the Annual Lease Valuation Table to reduce the valuations of their precious auto use fringe benefits.

In this decision, the IRS was upheld and BMW of North America was hit hard. BMW lost the benefit of lower demonstrator fringe benefit valuations for the vehicles it had provided to some 2,000 employees. The reason: It failed to properly apply the valuation rules in connection with the use of the Annual Lease Value Table. This case certainly was not on the "fast track"...since the years involved were 1988 and 1989. However, the dollars are big: An assessment for additional employment taxes of roughly $1.35 million.

Under BMW's fringe benefit policy in those years, it assigned a particular series of BMW models to employees based on the employee's job title. The higher up the corporate ladder, the higher the series model assigned to the employee. "7 Series" autos went to vice presidents, "5 Series" autos went to department managers and "3 Series" autos went to section managers and field employees. If a model was in short supply or over supply, however, the employee might have been assigned a model different from the one normally assigned to his/her job title and classification. BMW employees could not choose the color and features of the vehicles that were assigned to them since the assignment was made by BMW based on its existing inventory supply. For the 1998 model year, the Manufacturer's Suggested Retail Price (MSRP) for the "7 Series" BMWs ranged from $54,000 to $69,000, ... for the "5 Series" it ranged from $32,000 to $47,500 ... and for the "3 Series," it ranged from $25,000 to almost $35,000.

In 1988 and 1989, BMW provided more than 2,000 vehicles to its employees as fringe benefits ... and it treated the use of a BMW vehicle by an employee as a fringe benefit for which it calculated a value that was included on each employee's W-2 wage statement. BMW paid Federal employment tax with respect to that income, as well.

To determine the taxable value of the auto fringe benefit, BMW elected to use the Annual Lease Value Table found at Reg. Sec. 1.61-21(d)(2)(iii). This table is one of three "special valuation allowances" provided in the regulations where vehicles are made available to employees. The other two special valuation allowances are (1) the cents-per-mile valuation method and (2) the commuting valuation method. Generally, the commuting valuation method is not available where there is more than minimal personal use other than commuting or where the employee using the vehicle owns any stock or is highly paid.

DETERMINING "FAIR MARKET VALUE" WHEN USING THE ANNUAL LEASE VALUE TABLE

Regulation Section 1.61-21(d)(5) provides that the "fair market value" of the vehicle to be used in connection with the Table "is the amount that an individual would have to pay in an arm's length transaction ***to purchase*** the particular automobile in the jurisdiction in which the vehicle is purchased or leased. ...Any *special relationship* that may exist between the employee and employer must be disregarded. ...Also, the employee's *subjective perception* of the value of the automobile is not relevant to the determination of the automobile's fair market value."

Obviously, the determination of "fair market value" is not an exact science. Reasonable people, acting reasonably and in the utmost good faith, could reach different conclusions with respect to the "fair market value" of the use of an automobile.

In determining "fair market value," BMW used the employee purchase price for the base model vehicle assigned to the employee's job position. The employee purchase price was the price at which the vehicle was offered for sale to BMW employees under an employee car purchase program...and that was

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approximately the same as the vehicle's wholesale price. BMW used the price for the base model in the relevant series (i.e., the "3 Series" or "5 Series"), and it usually did not distinguish between models within a series. In addition, BMW used the base model vehicle for the series assigned to the employee's job position even though sometimes an employee would, for the convenience of BMW, drive a vehicle from a different series–for example, a "5 Series" vehicle instead of a "3 Series" vehicle.

BMW said that it used the employee purchase price of the base model vehicle as the fair market value of the vehicle in order to reflect certain factors that would have depressed the sales price of the assigned vehicle if it had been offered for sale on the open market. These factors included the restrictions placed by BMW on the use of the vehicle and the frequent assignment of slow-moving, unpopular or end-of-model-year vehicles to employees. The IRS disagreed and said that the only restrictions placed on employees in a written policy in 1988 and 1989 related to maintenance and parking requirements. The IRS also claimed that there was no evidence in the record that any specific vehicles assigned in 1988 or 1989 were unpopular or end-of-model-year vehicles.

The IRS position was that BMW "improperly applied" the special lease valuation rule that applies if the Table is going to be used. The IRS said that the fringe benefit values determined by BMW were incorrect because the numbers BMW plugged into the Table for the "fair market value" were too low. The consequence, according to the IRS, was that BMW was not entitled to use the special valuation rules, including the Table. As authority for its position, the IRS cited Reg. Sec. 1.61-21(c)(5) which is discussed in the next section as the "Poison Pill Penalty."

The IRS position was that, by default, BMW must use the general valuation rules of Reg. Sec. 1.61-21 to determine the taxable value of the vehicle use fringe benefit. These general rules require that the fair market value be determined "on the basis of all the facts and circumstances." And, in these particular circumstances, that value equals the amount that an individual would have to pay in an arm's-length transaction ***to lease*** the same or comparable vehicle on the same or comparable conditions in the geographic area in which the vehicle is available for use. An example of a comparable condition is the amount of time that the vehicle is available to the employee for use (i.e., a one year period). Reg. Sec. 1.61-21(b)(4).

THE POISON PILL PENALTY...PUT THERE TO PREVENT AN ABUSE OF THE RULES

The key issue was whether or not Reg. Sec. 1.61-21(c)(5) is a penalty provision which prevents taxpayers from using ***any*** special valuation rule if they have not properly applied ***any*** special valuation rule to a fringe benefit.

The Court held that this regulation is, indeed, a penalty provision and the IRS may invoke it to prevent the use of *any* special valuation rule when it finds that the taxpayer has improperly applied such a rule.

Initially, the IRS was unsuccessful in arguing that its interpretation was a long-standing and considered agency view. After that preliminary sparring, the Court turned its attention to the wording of the "penalty" provision.

Reg. Sec. 1.61-21(c)(5) states that "... The valuation formulae contained in the special valuation rules are provided only for use in connection with those rules. Thus, when a special valuation rule is properly applied to a fringe benefit, the Commissioner will accept the value calculated pursuant to the rule as the fair market value of that fringe benefit. However, ***when a special valuation rule is not properly applied to a fringe benefit*** (see, for example, paragraph g(13) of this section), or when a special valuation rule is used to value a fringe benefit by a taxpayer not entitled to use the rule, ***the fair market value of that fringe benefit may not be determined by reference to ANY value calculated under ANY special valuation rule***. Under the circumstances described in the preceding sentence, the fair market value of the fringe benefit must be determined pursuant to the general valuation rules of paragraph (b) of this section." (Note: it is this last sentence which feeds into Reg. Sec. 1.61-21(b)(4)'s requirement to use the arm's-length ***cost to lease*** the vehicle criteria.)

The Court said that it interpreted the third sentence in the regulation to mean that when the special valuation rule for cars is not "properly applied" in determining the fringe benefit value of a car, the taxpayer cannot use ***any*** special valuation rule in calculating the fringe benefit value of the car. Thus, a taxpayer who wrongfully determines FMV in using the Annual Lease Valuation Table in paragraph (d) cannot use either of the other two special valuation rules, i.e., the special cents-per-mile valuation rule of paragraph (e), or the commuting valuation rules in paragraph (f) of the 1.61-21 Regs. Furthermore, the fourth sentence explains that the taxpayer must follow the *general* valuation rules if the taxpayer is precluded from using the *special* valuation rules.

The Court observed that the IRS interpretation of the paragraph (c)(5) rule is that it extends a promise in the second sentence (i.e., the Commissioner promises to accept the valuation), and then places a limit on that promise in the third sentence.

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The Court added that the general principle of voluntary compliance within our tax system also supported the IRS' interpretation. The Court said: "In such a system, it would make sense to have a penalty provision such as paragraph (c)(5) to induce taxpayers to properly apply the *special* valuation rules, which are usually more beneficial to them than the *general* valuation rules. Without such a penalty provision, taxpayers could improperly apply the special valuation rules to their benefit until caught, and then go back and properly apply the same beneficial rules the second time, losing nothing. The Court interprets paragraph (c)(5) to prevent such a situation, and as an attempt to prevent an abuse of the rules."

BMW argued that the IRS interpretation should be rejected because the IRS was unable to explain its standard. However, the Court said that "the IRS's failure to articulate an exact standard for the type of error that will preclude a taxpayer from applying the special valuation rules does not render the IRS's interpretation of the regulation invalid. There could be a variety of improper applications of the special valuation rules in determining fringe benefits, all of which cannot be contemplated by and listed in the regulation. Such improper applications could range from a single arithmetic error to a blatant disregard of the rules contained in the special valuation provisions. The IRS must apply the regulation to the facts set before it."

BMW also argued that the IRS interpretation "undermines the predictability and usefulness of the special valuation rules because it makes the rules available or unavailable to the taxpayer on a vehicle-by-vehicle basis." The Court dismissed this argument by observing that a taxpayer could avoid uncertainty by properly applying the special valuation rules.

Thus, the Court held that based on the plain language of the regulation, tax policy and logical construction, Reg. Sec. 1.61-21(c)(5) is a penalty provision that the IRS may invoke to prevent those taxpayers who have improperly applied a special valuation rule to a fringe benefit from using any special valuation rule to then determine the value of that fringe benefit. A taxpayer who improperly applies a *special* valuation rule must apply the *general* valuation rules. These *general* valuation rules are found in Reg. Sec. 1.61-21(b)(4) and they are based upon an arm's-length transaction to lease—as distinguished from a transaction to purchase—the vehicle.

Readers desiring more intellectual stimulation can read the part of the decision in which BMW, the IRS and the Court kicked around the meaning/interpretation of the "(g)(13)" reference in paragraph (c)(5). Warning: That stuff gets really deep.

(Continued from page 5)

BMW DIDN'T PROPERLY DETERMINE FMV OF AUTOS

The IRS contended that BMW violated the regulation in taking into account a "special relationship with its employees" in valuing the fringe benefit. The IRS also said that BMW failed to value the "particular automobiles" that were driven by its employees, and this also violated Reg. Sec. 1.61-21(d)(5).

This regulation provides that "...For purposes of determining the Annual Lease Value of an automobile under the Annual Lease Value Table, the fair market value of an automobile is the amount that an individual would have to pay in an arm's-length transaction ***to purchase*** the particular automobile in the jurisdiction in which the vehicle is purchased or leased. ... (That amount includes sales tax and title fees, as well as the purchase price.) ...Any special relationship that may exist between the employee and the employer must be disregarded. ...Also, the employee's subjective perception of the value of the automobile is not relevant to the determination of the automobile's fair market value...."

The IRS argued that BMW used the "employee purchase price" which was typically "dealer cost," to which the company then applied the special valuation tables. Because employees often received models from different series of BMW vehicles than the "assigned" models that BMW had valued, the IRS said that BMW did not value the vehicle that the employee actually drove, rather BMW valued the vehicle that was assigned to the employee. In this context, the IRS admitted that "under its interpretation of the penalty provision in paragraph (c)(5), the taxpayer's ability to use the Annual Lease Value Table must be made on a car-by-car basis so that an error in valuation with respect to one vehicle may prevent the taxpayer from using the Annual Lease Value Table with respect to that vehicle only." (Remember, 2,000 vehicles were involved in this case.)

The Court analyzed BMW's use of the employee purchase price (i.e., the price at which the vehicle was offered for sale to BMW employees under an employee car purchase program and...approximately the same as the vehicle's wholesale price) as the fair market value for the vehicles. The Court first observed that apparently BMW felt that this price encompassed the discounts that would be appropriate to reflect vehicle use restrictions, slow-selling models and damage that existed with regard to vehicles assigned to its employees. These factors would have had a negative effect on the fair market value of the employee-assigned vehicles compared to typical BMW vehicles sold in the market place. Thus, BMW was arguing that it used the employee purchase price to determine the fair market value of the vehicles not →

because of its employer-employee relationship with the vehicle users (as is clearly prohibited by the regulations), but rather because the employee purchase price happened to be a price that BMW felt adequately represented the reductions in fair market value that would occur due to factors mentioned above if the vehicle were sold in a arm's-length transaction.

The Court then rejected BMW's argument. The Court observed that "the fair market value of an automobile is the amount that an individual would have to pay in an arm's-length transaction to purchase the particular automobile in the jurisdiction in which the vehicle is purchased or leased." However, BMW had introduced no evidence that it was BMW's usual practice to purchase automobiles *with use restrictions* in the open market! Furthermore, the Court said it could not conceive of a situation where that would be the case. Although such restrictions might occur when leasing a vehicle, the regulation applicable in this case (i.e., (d)(5)) specifically contains the word "purchase" and the fact that the word "lease" is used elsewhere (such as in (b)(4)) indicates that such a distinction was intentionally made. Thus, the Court held that BMW improperly took into account use restrictions when calculating the fair market value of the vehicles.

This regulation also required that "any special relationship that exists between the employer and the employee must be disregarded" in calculating the fair market value of an automobile. The use restrictions in this case were clearly a product of the employer-employee relationship. Taking this relationship into account in determining value is specifically prohibited by the regulation.

COLOR AND OPTION LIMITATIONS

BMW had also reduced the fair market values of some or all of the vehicles because of the restrictions that its employees could not always choose the color or the options on their assigned vehicles. The position of the IRS was that BMW's attributing a reduced value to restrictions on color or option choices violated the prohibitions against using *subjective perceptions of value* under both the general and the special valuation rules.

The Court found that the restrictions on option and color choices cannot be considered in determining fair market value under the *special* valuation rules of paragraph (d)(5). The small amount of good news for taxpayers arising out of this *BMW* case is that the Court did hold that *restrictions on color and option choices* could be present in a lease. Accordingly, such restrictions could be a "comparable condition" allowing a reduction in value under the *general* rule for valuing fringe benefits (i.e., Reg. Sec. 1.61-21(b)(4)) to which unsuccessful special use valuation "wanna-bees" must default. In other words, the Court held that BMW was not precluded from taking restrictions on color and option choices into account in determining the fair market value of the fringe benefit under the cost "to lease" criteria in paragraph (b)(4).

THE CONSEQUENCE OF FAILING TO USE FMV

Since the Court found that BMW had not properly applied the lease valuation rules, it further found that BMW was precluded from using those rules and the Annual Lease Valuation Table to determine the value of the fringe benefits of the vehicles it provided to its employees. Instead, BMW was required to use the *general* valuation rules in Reg. Sec. 1.61-21(b). Specifically, (b)(4) requires the use of the amount that an individual would have to pay in an arm's-length transaction ***to lease*** the same or comparable vehicle on the same or comparable conditions in the same geographic area.

LESSONS FROM THIS CASE

The rules for demo valuation are buried in the vast provisions of Reg. Sec. 1.61-21. The key rules are as easy to remember as the combination to an old gym lock: ...**(d)(5)** ...**(c)(5)** ...**(b)(4)**. If a taxpayer fails to satisfy the fair market valuation rules at **(d)(5)**, then **(c)(5)** throws the taxpayer out of the special rules completely, and **(b)(4)** applies by default and produces a much higher taxable value for the fringe benefit.

The Court's holding in the *BMW* case makes it clear that taxpayers are not eligible to use the Annual Lease Valuation Table—or any other special valuation approach—if they have made reductions for ***ANY*** of the following factors in determining "fair market" values used in the Lease Table:

1. Any ***special relationship*** that may exist between the employee and the employer,

2. The employee's ***subjective perception*** of the value of the automobile,

3. The ***cost incurred by the employer*** in connection with the purchase or lease of the automobile (except in extremely limited situations), or

4. ***Anything that is part of the full purchase price***, including all sales taxes and all title fees. (Watch those floor mats...and don't waive those fees!)

If any of these factors have been allowed to create a reduction in the FMV of the vehicle, you cannot use the Lease Valuation Table and you must use higher valuations based on the arm's-length cost to lease the vehicle. So, if you're using the Annual Lease Valuation Table, the *BMW* case makes it imperative to go back for a second look at how you've valued the vehicles.

IRS GIVES GREEN LIGHT...BUT NO REAL DIRECTION... TO BUY-HERE, PAY-HERE SALES OF SUB-PRIME NOTES TO UNRELATED LOAN SERVICING COMPANIES

Used car dealers continue to receive IRS approval for sale treatment when they transfer their customers' sub-prime notes to unrelated loan servicing companies. Recent LTRs 199909002 and 199909003, both dated November 9, 1998, involved dealers who were under IRS audit examination. These LTRs continue to reflect the favorable attitude the IRS had expressed earlier in LTR 9840001.

All three rulings involved used car dealers who operated in essentially the same way and for whom the IRS reached identical conclusions after going through identical analyses. The December, 1998 *Dealer Tax Watch* contains extensive discussion of LTR 9840001, including the IRS factor-by-factor analysis of the *sale vs. financing* issue (pp. 17-19) and the Code, Regulations and case history analysis required to determine the *amount realized* on the sale (pp. 20-22). Those discussions are not repeated here.

Note: Recently the IRS started numbering letter rulings using all four digits to represent the year 1999. Previously, LTR 199909002 would have been designated as 9909002 and its companion ruling, as 9909003. For simplicity, these 1999 letter rulings often will be abbreviated in this article as LTR -002 and LTR -003.

The two more recent rulings involve the additional questions of whether a mark-to-market election could be made under Section 475 (in LTR -002) and whether the dealer, operating as a sole proprietor, was required to use the accrual method (in LTR -003). This article will compare and contrast LTR 9840001 with the two more recent LTRs.

The dealers in all three rulings sold used vehicles to purchasers who had substantially impaired credit ratings in exchange for cash and their customer purchase notes. The customer's note was always secured by a lien on the automobile. On the sale of a vehicle, the amount the dealer realized was the cash received plus the issue price of any customer note, which (assuming adequate stated interest) was the face amount of the customer note.

The dealers would then sell these customer notes to an unrelated loan servicing company (Company) for cash plus the right to receive additional distribution payments in the future. On the sale of the customers' notes, the amount the dealer realized for tax purposes was the cash received from the Company (the advance payment) plus the fair market value of dealer's right to receive subsequent distribution payments. At the time of sale, the dealer also realized a loss on the sale of customer notes. That loss was equal to the difference between the dealer's adjusted tax basis in the customer's note and the amount realized.

The dealers in all three rulings had treated the transfer of customers' notes as sales. The dealer in LTR 9840001 had treated ***only*** the advance payment received from the loan servicing company as the amount it realized from the sale of the customer's note. The dealer's adjusted basis in a customer's note equaled the outstanding principal balance of that customer's note at the time it was sold to the Company. Accordingly, the dealer calculated the loss from the sale of a customer's note as the difference between the advance payment received from the Company and its adjusted basis in the customer's note.

LTRs -002 and -003 do not specify what amounts those dealers actually treated as the amount realized. Instead both rulings (-002 and -003) merely state that "on the sale of a customer note, Taxpayer's amount realized was the amount received from the Company (the advance payment) plus the fair market value of the Taxpayer's right to receive the distribution payments. Thus, Taxpayer realized a loss on the sale of a customer note equal to the excess of taxpayer's adjusted basis in the customer note over/and Taxpayer's amount realized." LTR -002 used the word *over* and -003, used the word *and.* The IRS did not go any further in expressing a position on what else the dealers in -002 and -003 should have done.

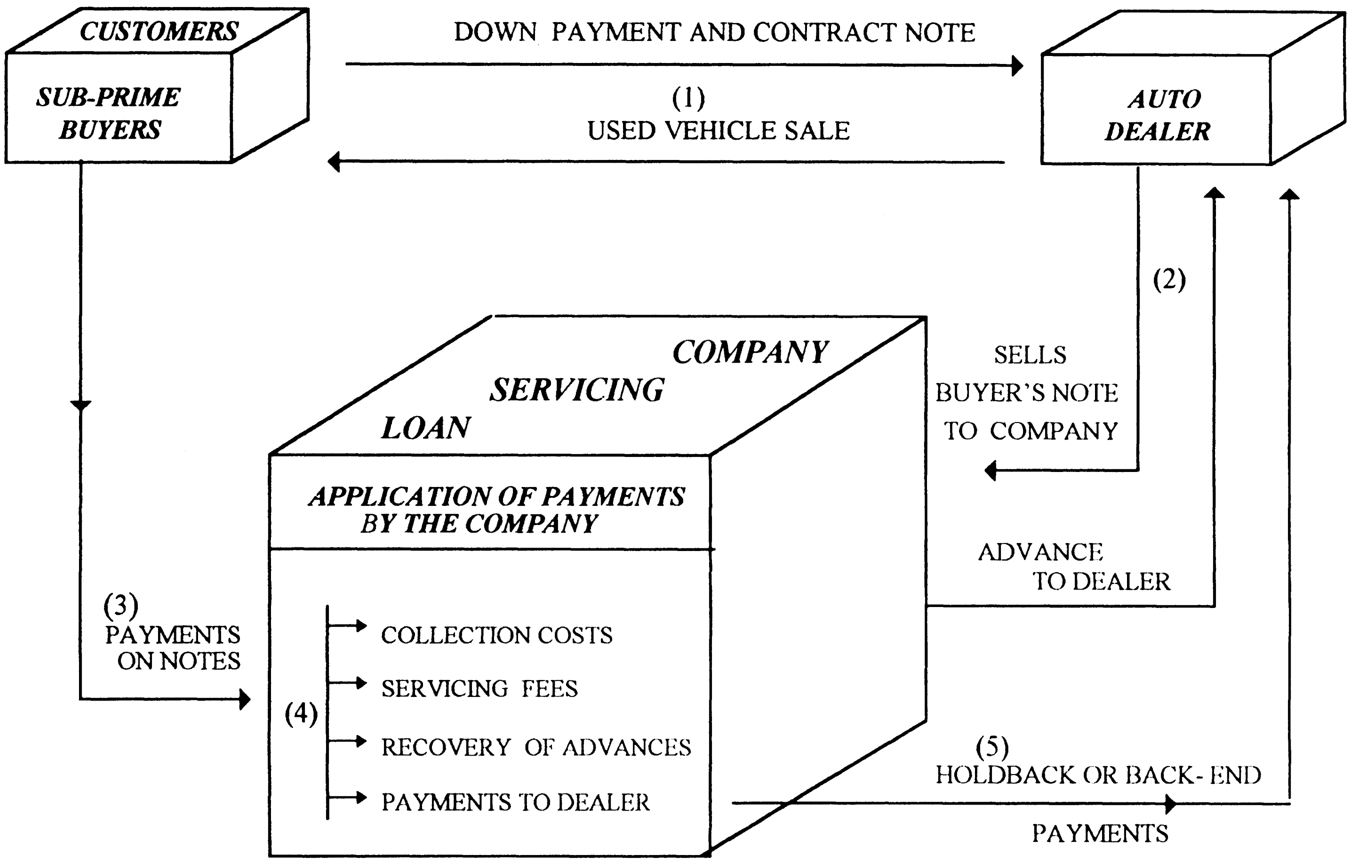
The loan servicing companies in two of the three rulings had encouraged the dealers to report the transactions as sales for income tax purposes.

HOLDINGS COMMON TO ALL THREE RULINGS

1. The used car dealer's (Taxpayer's) transfers of customer notes to an unrelated loan servicing company (Company) were ***sales.*** If the transactions between the dealer and the loan servicing company were ***sales***, then the dealer would be required to recognize any gain or loss for Federal income tax purposes under Section 1001 of the Code. Alternatively, if the transactions were ***secured financings***, then the dealer would be treated as having ***borrowed the advance payment*** from the Company using the customer notes as collateral, and the dealer would not have to include the borrowed amounts in gross income.

see **IRS GIVES GREEN LIGHT**, page 10

LOAN SERVICING PROGRAM ARRANGEMENTS



- The dealer sells a used vehicle to a *sub-prime* customer. The dealer receives a cash down payment and a contract installment note from the buyer. The buyer's note is always secured by a lien on the vehicle. The buyer's note represents the balance of the vehicle purchase price, plus related interest and the cost of any additional products (such as credit, life, accident insurance and/or extended service warranty contracts) sold to the buyer.
- The dealer sells the buyer's contract/note to a loan servicing company and receives a cash advance. This advance, when combined with the buyer's down payment, is designed to provide the dealer with an initial positive cash flow.
- As the buyer makes payments on the note to the Company, any further payments are remitted to the dealer only after:

  ... the Company has been reimbursed for any out-of-pocket collection costs,

  ... the Company has received its loan servicing fee (usually 20%) attributable to such payments, and

  ... the Company has recovered <u>all</u> of the advance previously made to the dealer.
- Customers' notes are usually sold to loan servicing companies in batches of either a given number of contracts or aggregate dollars of face amounts.

(Continued from page 8)

2. The ***amounts realized*** from sales of the customer notes equaled the sum of (a) the cash received for the customer note, plus (b) the fair market value of the dealer's right to receive future distribution payments created by the sale.

3. The one-time, non-refundable enrollment fee paid by the dealer upon signing up with the loan servicing company was a Section 263 capital expenditure . As such, it could be amortized over 15 years as a Section 197 intangible.

Sale–Rather Than Financing–Treatment In all three rulings, in concluding that the dealers had ***sold*** their customers' notes to the loan servicing companies, the IRS analyzed the following factors:

1. Whether the parties treated the transfers as sales;
2. Whether the purchasers of the vehicles who issued the notes were notified of the transfer of the notes;
3. Which party handled collections and serviced the notes;
4. Whether payments to the Company corresponded to collections on the notes;
5. Whether the Company imposed restrictions on the operations of the dealer that are consistent with a lender-borrower relationship;
6. Which party had the power of disposition;
7. Which party bore the credit risk; and
8. Which party had the potential for gain.

Determination Of The "Amount Realized" By The Dealer On The Sale Of Customer Notes. In determining the *amount realized* by the dealers, all three letter rulings repeat identical analyses of Code Sections 1001, 483, 1275 and 451, and the Supreme Court's holding in *Commissioner v. Hansen*. The National Office in each ruling concluded that *the dealer did not have a fixed right to distribution payments at the time the dealer sold the customer notes to the loan servicing company, and that the dealer's case was distinguishable from Hansen.*

Different loan servicing companies have different loan servicing agreements. However, in general, each dealer's customers had poor credit, and the customer notes were of poor quality. Because of the poor creditworthiness of the customers, the loan servicing company's collection costs were uncertain and sometimes significant. The loan servicing company was obligated to pay distribution payments to the dealer only if it collected enough from the customers to recover (1) all its collection costs on the transferred customer notes; (2) its servicing fee–usually 20%–on the customer notes; and (3) any outstanding advances on the customer notes.

These circumstances resulted in reasonable doubt as to whether any future distribution payments would be made to the dealer. In light of these facts and circumstances (which were absent from the *Hansen* case), the dealer's right to distribution payments was contingent upon future events that were uncertain at the time the dealer sold the notes to the Company.

At precisely the same points in their identical analyses, the IRS concluded in both LTRs -002 and -003 that "...The amount realized by Taxpayer from the sale of the customer notes does not necessarily include the full amount of future distribution payments. Rather, the amount realized (from the sale of the customer notes) is equal to (a) the cash received, plus (b) the fair market value of Taxpayer's right to receive the (future) distribution payments."

This wording in LTR -002 and -003 varies slightly from the conclusions expressed by the Service in LTR 9840001. In LTR 9840001, the Service said: "The amounts realized from sales of the customer notes equal (a) the cash received for the customer note, plus (b) the fair market value of Taxpayer's right to receive the distribution payments created by the sale." In addition to this conclusion, the IRS had said in LTR 9840001 that because there was reasonable doubt that any future collection payments would be made to the dealer (thus differentiating the dealer from *Hansen*), the "taxpayer should ***not*** include the amount of future distribution payments in the amount realized on the sale of the customer notes."

In LTRs -002 and -003, is the IRS trying to correct itself or clarify the conclusion it expressed in 9840001? It would seem that the difference in wording in LTRs -002 and -003 is apparently intended to at least remove some interpretive questions.

In the December, 1998 *Dealer Tax Watch* we had indicated that dealers and CPAs might interpret the wording of 9840001 to mean that the fair market value of the right to receive subsequent distribution payments would (always?) be zero. We had reported that in October, 1998 at the AICPA Conference, the IRS Motor Vehicle Industry Specialist had said that "LTR 9840001 was not saying that the fair market value is zero".

The determination of the fair market value...i.e., the quantification or process of putting a dollar amount on... the back-end payments would depend on the facts and circumstances and other considerations, including whether or not the pools were capped.

Here again, it appears that the IRS was unwilling to express a position on what else the dealers in -002 →

and -003 should have done to quantify the amount realized or how Section 483 should be applied in these cases. A few simple examples, including amounts, would have been most helpful even if they were included in a footnote to the rulings.

LTR -002 & MARK-TO-MARKET ASPECTS

In addition to the three common issues above, LTR -002 raised two more: (1) did the dealer make an unauthorized change in accounting method by making an election under Section 475 without IRS consent while under examination, and (2) assuming the dealer could make the election, how would the customer notes transferred by the dealer be valued?

In this letter ruling, the dealer had elected to use the mark-to-market accounting method for an open year that ended before December 24, 1996 and for all later years. The dealer had made this election by timely filing the appropriate statement with an amended tax return for that year. The election had been made while the dealer was under IRS audit for that year and it was made without the consent of the District Director. Also, the election had not been made during one of the window periods described in Rev. Proc. 97-27. The dealer had filed a Form 3115 in connection with this change in accounting method, but it had not provided a copy of the Form 3115 to the examining agent.

The National Office held that the dealer was eligible to make the mark-to-market election under Reg. Sec. 1.475(c)-1(b)(4)(i) and that the election had been made in a timely manner.

However, the customer notes could not be marked to market once they had been sold by the dealer. In addition, the IRS held that the dealer's right to future distribution payments from the loan servicing company did not constitute "securities" under the definitions in Section 475(c)(2) and, therefore, they could not be marked to market.

This election was made under pre-1998 law. Unfortunately, the IRS Restructuring and Reform Act of 1998 amended Section 475 to prohibit subsequent mark-to-market elections by auto dealers. Generally, for tax years ending after July 22, 1998, the Act provides that notes, bonds or debentures which arise from the sale of non-financial goods or services could not be marked to market. Consequently, dealers who made such elections for pre-1998 years now have to change from that mark-to-market method, spreading the Section 481(a) adjustment over four years.

LTR -003 & THE REQUIREMENT TO USE THE ACCRUAL METHOD

LTR -003 raised a special issue because the dealer involved was an individual who used the cash receipts and disbursements method of accounting. This special issue was whether the dealer was required to use the accrual method to account for the purchase and sale of used automobiles.

It should come as no surprise that the IRS held that the dealer was required to change to the accrual method.

The IRS analyzed Sections 446 and 471 and the regulations thereunder. The Service noted that Reg. Sec. 1.446-1(c)(2)(i) provides that in any case in which it is necessary to use an inventory, the accrual method of accounting must be used with regard to purchases and sales, unless otherwise authorized under the regulations.

Since the dealer transferred used automobiles to its customers, and the purchase and sale of such merchandise were income producing factors in the dealer's business, this required the dealer to maintain an inventory and, thus, the dealer was required to use the accrual method. No authorization to the contrary could be found in the regulations.

The Service further held that the dealer's change from the cash basis to the accrual method of accounting would require a Section 481(a) adjustment, all of which should be taken into account in the earliest year under examination. The National Office also observed that Section 481(b) may limit the amount of tax arising from the Section 481(a) adjustment.

GUIDANCE IS STILL NEEDED

The essence of all three letter rulings is that once the fair market value of the back-end distribution payments is determined, then Section 483 will apply to recharacterize a portion of these payments into principal and interest components. Therefore, there is more to these rulings than meets the eye.

Several significant questions remain unanswered for all dealers. These include

(1) How is the fair market value of the back-end payments to be quantified?

(2) How should the imputed interest provisions of Section 483 be applied to these deferred payments to create interest income?

There is no guidance on these and other significant questions at the present time. If the IRS and dealer representatives are unable to provide further guidance—preferably in a revenue ruling or revenue procedure—these questions will result in inconsistent handling motivated by desired tax results and equally inconsistent acceptance or challenge when—or if—audited by IRS examiners.

IRS FINALLY ISSUES GUIDANCE ON AUTOMOTIVE MANUFACTURER INCENTIVE PAYMENTS TO SALESPERSONS

PUB 3204 ETC.

PUBLICATION 3204

In a rather quiet way, the IRS provided long-awaited clarification in Publication 3204 of how automobile manufacturer's incentive program payments should be treated. The IRS said that incentive payments to vehicle salespersons are not subject to Federal income tax withholding, Social Security, Medicare or Federal unemployment tax.

Publication 3204 was released "just in time" for employees receiving these payments to know how to handle them on their 1998 income tax returns...as "other income" on Page 1 of Form 1040.

Apparently, this was also timed to act as a reminder to individuals that they should not try to claim offsetting unreimbursed employee business expenses in Schedule C against these incentive program payments. Instead, those expenses really belong in Schedule A where they may be subject to other limitations.

The full text of Publication 3204 appears on page 13. It also appeared in the Spring, 1999 edition of the *Social Security Administration/Internal Revenue Service Reporter*, a newsletter for employers.

Interestingly, this publication or notice does not mention the IRS' position that if manufacturer incentive payments fail to satisfy all of the requirements of Revenue Ruling 70-337, those payments will be subject to the full battery of reporting requirements and income and employment taxes.

DEALER HIT WITH BACKUP WITHHOLDING FOR NOT FILING FORMS 1099

In LTR 199906037, the IRS held that a used car dealer's payments of commissions and fees in excess of $600 to independent contractors should have been reported on Forms 1099 by the dealer. The dealer, operating as a sole proprietor, had deducted these payments in Schedule C of his individual income tax return.

During the two years under audit, the dealer had paid commissions to auto wholesalers for locating and transporting cars to his dealership for purchase. The dealer also had paid auto repair shops, auto body shops, and auto detail services for work performed on his dealership's cars. These independent contractors were paid by checks drawn on the dealership account.

The dealer had failed to obtain the Social Security/TIN numbers of the individuals to whom he had made the payments which he should have reported on Forms 1099.

That failure rendered the dealer subject to 31% backup withholding under Section 3406.

FORMS 1099 FOR TRIPS

Recent Letter Ruling 199909046 did not involve an automobile manufacturer or auto dealership employees. It involved a manufacturer whose products were sold to independent dealers and who sponsored incentive award programs to encourage dealers to purchase its product. The incentive awards were trips that included transportation, accommodations and all other expenses.

The trips were awarded to top dealers, based on the wholesale purchase of products by the dealer. The amount of retail sales of the products by the dealer was not a factor in trip award determinations.

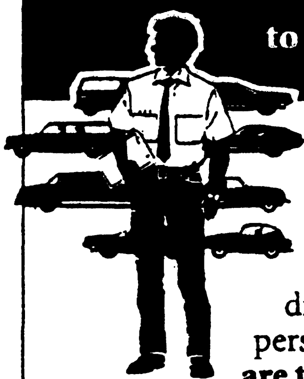
The manufacturer provided a dealer who was awarded the trip with a form on which the dealer could designate the names of the individuals who would take the trip. After the dealer had made such designations, all further arrangements for transportation, accommodations and payment of other expenses were made by the manufacturer.

The IRS concluded that the manufacturer was required to file information returns under Section 6041 for trips awarded to non-corporate dealers if the fair market value of the trip awarded was $600 or more in any taxable year.

The Service also concluded that the manufacturer was not required to file information returns with respect to the individuals designated by the dealers to take the trips.

Automotive Manufacturers' Incentive Program

to Vehicle Salespersons

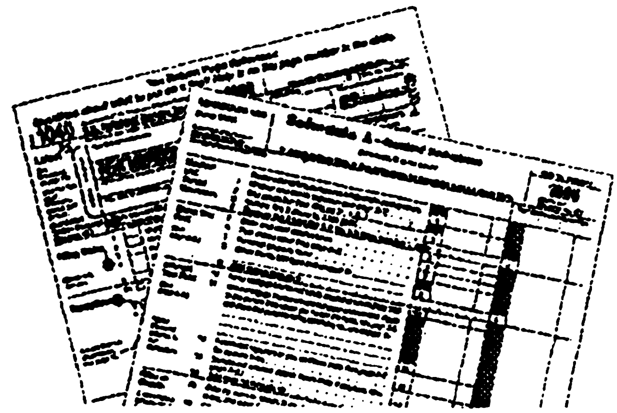


Did you know that **incentive payments** paid by an automotive manufacturer whether directly to individual salespersons or through a dealer **are taxable income?**

The good news is that these payments, reported on Form 1099-MISC, *Miscellaneous Income*, are not treated as wages. Therefore these incentive payments from the manufacturer are not subject to Federal income tax withholding, social security, Medicare, or Federal unemployment tax. Also, these payments are not considered to be self-employment income and therefore are not subject to self-employment tax.

If you are the recipient of a manufacturers' incentive payment, you need to report the income on a Form 1040, *U.S. Individual Income Tax Return*,—page 1, under **Income** [line titled "Other income"], when you file your income tax return. The expenses that you incur to get the incentive payment may be deductible on **Schedule A**, *Itemized Deductions* (Form 1040),—under **Job Expenses and Most Other Miscellaneous Deductions** [line titled "Other expenses"] and are subject to the 2% adjusted gross income limitation.

NOTE: This income may **not** be reported on Schedule C (Form 1040), *Profit and Loss from Business*, because recipients of these payments are not engaged in an individual trade or business and are therefore not self-employed. Similarly, **no** expenses may be taken on Schedule C to offset incentive payment income.



If your tax return is prepared by someone other than yourself, make sure that the preparer is aware of the filing guidelines described previously for incentive payments. For information on taxable income to include bonuses and awards, see Publication 525, *Taxable and Nontaxable Income*. You may call the IRS at 1-800-829-3676 (1-800-TAX-FORM) to order free IRS tax publications and forms, or you can download and print publications, forms, and other tax information materials from the Internet or the IRS Bulletin Board System - *Internal Revenue Information Services* (IRIS).

World Wide Web - www.irs.ustreas.gov
File Transfer Protocol - ftp.irs.ustreas.gov
Telnet - iris.irs.ustreas.gov
IRIS - (703) 321-8020

From a fax machine, dial (703) 368-9694 and follow the voice prompts to get an index of IRS tax forms or to get a specific form faxed back to you.

Often your tax questions can be answered by reading tax publications and related forms. But when you need more information, you may call the IRS at 1-800-829-1040.

Working To Put Service First
www.irs.ustreas.gov

IRS Department of the Treasury Internal Revenue Service Publication 3204 (12-98) Catalog No. 25742N

AUTO DEALER ALLOWED TO DEFER GAIN ON SALE OF DEALERSHIP PROPERTY UNDER THREAT OF CONDEMNATION

RELIEF OR FRAUD?

Automobile dealers often get into disputes involving their property with the cities, towns, municipalities or other agencies or boards having some dominion over them. Sometimes these disputes rise to the level of condemnation proceedings, or result in the threat of condemnation of their property.

A recent Tax Court Memo Decision involves a California dealer who took advantage of the relief found in Section 1033 to defer the gain on the sale of dealership property that he sold under the threat of condemnation. (*Michael H. Johnson*, T.C. Memo 1998-448, filed December 23, 1998).

In this case, the dealer's Ford and Lincoln/Mercury properties were subject to the Lancaster Redevelopment Agency (LRA) which prepared a redevelopment plan–what else?– and was interested in obtaining the dealer's property. Apparently, the dealer had some initial choice over locating in either the Palmdale Auto Mall or the Lancaster Auto Mall. During the period in question, the City of Lancaster was engaged in an auto mall development competition with the City of Palmdale. The LRA wanted Mr. Johnson's dealerships to relocate to its mall as an anchor tenant. However, Mr. Johnson had signed an agreement concerning a planned relocation to the Palmdale Auto Mall about five months before the LRA made a proposal to him conveying its interest in his relocation of his dealership(s) to the Lancaster Mall.

While under contract with Palmdale, Mr. Johnson tried to negotiate with Lancaster to move his dealerships to the Lancaster Mall. Between April 1990 and September 1990, he sent several letters to Lancaster city officials in an effort to communicate the terms of his offers. The City Council of Lancaster (LCC), however, was unwilling to negotiate with Mr. Johnson during this time. A letter dated June 22, 1990, specifically mentioned Lancaster's unwillingness to negotiate with Mr. Johnson and during this period, Lancaster rejected Mr. Johnson's proposals.

In early 1990, Mr. Johnson's negotiations concerning the relocation of his dealerships to the Palmdale Auto Mall began to deteriorate. This was due, in part, to the fact that the developer of the Auto Mall made representations that were not the position of Palmdale and to which Palmdale was unwilling to commit. Eventually Mr. Johnson withdrew from his agreement to relocate to Palmdale. After terminating discussions with Palmdale in mid-October 1990, Mr. Johnson intended to remain at the 23rd Street property or to sell his dealerships to a third party.

After learning that Mr. Johnson's negotiations with Palmdale had terminated and that Mr. Johnson's withdrawal had upset Palmdale city officials, the Lancaster City Attorney informed the LRA that it had the power and the authority to condemn or to threaten to condemn Mr. Johnson dealership properties. The LLC and LRA approved the use of threats of condemnation against Mr. Johnson. The LRA directed its staff to notify Mr. Johnson that the LRA would condemn the 23rd Street property.

On numerous occasions, the Lancaster officials told Mr. Johnson that the City was going to condemn his 23rd Street dealership properties unless he agreed to sell the property to Lancaster and relocate his dealerships to the Lancaster Mall.

Mr. Johnson sought advice regarding Lancaster's threats from the attorney he had retained in connection with the Palmdale Auto Mall negotiations. Mr. Johnson specifically asked this attorney: "Can they do that?" He was advised that (1) Lancaster had the authority to condemn the 23rd Street property, (2) whether or not Lancaster and the LRA had the ability to condemn was not an issue, and (3) the only issue would be the fair market value of the property. The attorney made it clear to Mr. Johnson that he would not be able to win a condemnation fight.

The negotiations between the LRA and Mr. Johnson while the City was informing him that it would condemn the 23rd Street property were hostile, strained, tense and difficult. Lancaster repeatedly told Mr. Johnson that it would condemn the property. Over time, these meetings became progressively more contentious.

In September of 1991, Mr. Johnson entered into an agreement with Lancaster and the escrow documents expressly stated that the transaction was "in lieu of an action in eminent domain."

In 1992, Mr. Johnson acquired property in the Lancaster Auto Mall that was "property similar or related in service or use to" his 23rd Street dealership property. Mr. Johnson relocated his dealerships to the Lancaster Auto Mall immediately upon vacating the 23rd Street property.

→

RELIEF UNDER SECTION 1033

As a general rule, gain realized from the sale or other disposition of property must be recognized for tax purposes. However, Section 1033 provides that if property, as a result of condemnation or threat or imminence thereof, is compulsorily or involuntarily converted into money, no gain shall be recognized if

(1) the taxpayer elects nonrecognition treatment,

(2) the taxpayer purchases property similar or related in service or use to the property converted within the statutory time period, and

(3) the cost of the replacement property equals or exceeds the amount realized on the conversion.

Section 1033 is a relief provision enacted by Congress to allow taxpayers to replace property involuntarily converted without recognizing any gain resulting from that conversion. Mr. Johnson satisfied all of these requirements and easily succeeded in meeting all three tests for non-recognition treatment.

IRS ASSERTS FRAUD

What is interesting about this case is not so much the specifics of the contentious negotiations between Mr. Johnson and the City of Lancaster. Rather, it is the hard line position the IRS took in arguing that the dealer didn't qualify for relief treatment under Section 1033 because he wasn't under a ***real*** threat of condemnation.

In fact, the IRS assessed the dealer a $690,000 fraud penalty under Section 6663(a) on top of the $920,000 income tax deficiency. (That's a 75% fraud penalty.)

The only issue was related to whether the LRA had made a threat of condemnation. Was it a ***real*** threat...or were its "threats" remote, and thus not the basis for deferring the gain on the sale under Section 1033?

The IRS made much of the fact that Mr. Johnson appeared to be involved in a ***structured transaction.*** The IRS argued that factors motivating him to negotiate a deal with Lancaster were different than they appeared to be on the surface. The IRS ignored the testimony of "the multitude of witnesses who stated that numerous Lancaster city officials threatened Mr. Johnson with condemnation of the 23rd Street property."

The IRS emphasized the facts that (1) the dealer reminded Lancaster city officials to be sure to include in written documents the fact that Lancaster was acquiring his property under threat of condemnation and (2) that Mr. Johnson was concerned about the tax implications of a move to the Lancaster Auto Mall.

WHO'S THE REAL BAD GUY HERE?

The Court interpreted the IRS position as follows:

"(The IRS) believes the dealings between Lancaster and Mr. Johnson were a structured transaction. This belief is based, in part, on a letter Mr. Johnson wrote to...the former city manager of Lancaster, dated June 22, 1990, in which Mr. Johnson explained the factors motivating him to negotiate a deal with Lancaster. Among the many factors listed in the letter were (1) Lancaster's ability to perform a friendly condemnation, and (2) Section 1031 (i.e., Section 1033) treatment for the exchange of the 23rd Street property. In the letter, Mr. Johnson stated that this 'virtually eliminates' his potential tax liability.

"...(The IRS) casts Lancaster as powerless, compliant to Mr. Johnson's demands, and fearful of not acceding to his will; (the IRS) portrays Mr. Johnson as forcing Lancaster into feigning threats of condemnation so his dealerships could be accorded Section 1033 treatment. (The IRS) contends that when Mr. Johnson rejected the Palmdale deal, 'he had Lancaster exactly where he wanted.'

"It is from this viewpoint that (the IRS) argues that Mr. Johnson could not believe the threats of condemnation were likely to be carried out because (he) forced Lancaster to pretend to threaten him..."

In disagreeing with the IRS, the Court said, "Lancaster and Mr. Johnson were involved in bitter, antagonistic, contentious and hostile negotiations. There was a sense of mutual mistrust between Mr. Johnson and Lancaster officials." The Court cited "credible" testimony by Lancaster city officials to this effect, such as, "Every time Mr. Johnson tried to renegotiate the deal, we (the LCC) just ratcheted down harder and harder on the terms of the deal," or "...Mr. Johnson was 'a hard negotiator' and 'a predator'."

ULTIMATELY...RELIEF & NO PENALTIES

The Court stated that the fact that Mr. Johnson may have had tax concerns regarding the sale of his dealership properties to Lancaster while under the threat of condemnation did not lead it (the Court) to conclude that the deal struck between Lancaster and Mr. Johnson was structured or collusive. The Court had found as facts that several Lancaster city officials made very clear threats of condemnation to Mr. Johnson.

The Court concluded that Mr. Johnson had reasonable grounds to believe, and did believe, that Lancaster authorized the threats of condemnation and was likely to carry them out unless a sale or exchange took place. Therefore, the Court held that a "threat of condemnation" existed and the dealer sold his property because of repeated threats of condemnation from a number of city officials.

Accordingly, relief, no fraud... no penalties.

ANNUAL LEASE VALUE TABLE ... REG. SEC. 1.61-21(d)(2)(iii)

Automobile Fair Market Value	Annual Lease Value
9,000 to 9,999	2,850
10,000 to 10,999	3,100
11,000 to 11,999	3,350
12,000 to 12,999	3,600
13,000 to 13,999	3,850
14,000 to 14,999	4,100
15,000 to 15,999	4,350
16,000 to 16,999	4,600
17,000 to 17,999	4,850
18,000 to 18,999	5,100
19,000 to 19,999	5,350
20,000 to 20,999	5,600
21,000 to 21,999	5,850
22,000 to 22,999	6,100
23,000 to 23,999	6,350
24,000 to 24,999	6,600
25,000 to 25,999	6,850
26,000 to 27,999	7,250

Automobile Fair Market Value	Annual Lease Value
28,000 to 29,999	7,750
30,000 to 31,999	8,250
32,000 to 33,999	8,750
34,000 to 35,999	9,250
36,000 to 37,999	9,750
38,000 to 39,999	10,250
40,000 to 41,999	10,750
42,000 to 43,999	11,250
44,000 to 45,999	11,750
46,000 to 47,999	12,250
48,000 to 49,999	12,750
50,000 to 51,999	13,250
52,000 to 53,999	13,750
54,000 to 55,999	14,250
56,000 to 57,999	14,750
58,000 to 59,999	15,250
In excess of $59,999: (.25 x the FMV) + $500	

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De Filipps' DEALER TAX WATCH

First-class

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