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. CAN IT REALLY BE TRUE? ARE THERE FEWER AUDITS GOING ON? Based on conversations with CPAs around the country, it appears that the IRS is auditing fewer dealerships...and auditing those far less intensively than one would have anticipated from all we've heard about "hot IRS issues" in the past.

We understand that in the Detroit area, the IRS apparently did a few very limited "8300 Audits." These audits didn't take long, but if the IRS found Form 8300/ Cash Transaction Reporting violations, the penalty was extreme: $25,000 per occurrence. The IRS position with these dealers was simply: "You've been warned about this before, so there's no excuse for noncompliance now." Do the math: five or six violations (x) $25,000–even if inadvertent or resulting from hiring an inexperienced (or improperly trained) clerk–adds up fast.

There's nothing new to report on IRS activity in auditing LIFO conformity settlement payments. Nor is there anything new to report on the status of the IRS disallowance of the use of the replacement cost method for parts inventories. These and other problem areas were covered at our *SPRING 1999 CPA-AUTO DEALERSHIP NICHE CONFERENCE*. See page 12 for more in our *Mid-Year Tax Issues Round-Up*.

The June, 1999 *LIFO Lookout* contains lengthy comment on why we believe NADA should restrain its efforts in helping the IRS at this time with the replacement cost issue raised by *Mountain State Ford Truck Sales*.

#2. TECHNICIAN TOOL "REIMBURSEMENT" PLANS ... A WIN-WIN FOR DEALERSHIPS & THEIR TECHS? Our 1999 Conference panel was notable in that it did not add new or unexpected "hot IRS topics" to the list. One subject discussed - but not really at any length - involved dealership service technician tool reimbursement plans. Recently, two internal IRS legal memoranda addressing rental plans became available for review, and these ILMs provide some basis for speculation as to what the IRS will be looking for when it develops a case for full-blown audit.

See the article and attachments beginning on page 3 for an analysis of these ILMs and a review of some of the promotional literature available from tool reimbursement plan marketers.

Until the IRS audits one of these dealership plans ***in actual operation***, no assurance can really be given as to the acceptability of these plans. It appears that these plans have worked out favorably for other industries in the past. But following the operation of these plans from pure (dollar-for-dollar) reimbursement plans to "fair market value rental arrangements" presents a host of problems, not the least of which are the individual technician's tax return filing require-

WATCHING OUT FOR

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ments, a real shifting of tax liabilities for rental payments taxable as self-employment income, and the credibility of information technicians initially provide in support of payments alleged to be made under accountable plan rules.

Once the IRS carefully analyzes the legal arguments against allowing payments to technicians for their "initial investment" in tools to be recovered tax-free under arrangements intended to qualify under Section 62(c), much of the glow should wear off of these plans. Also, some states, including Florida, impose sales tax on rental payments. The idea of thousands of service technicians collecting and remitting state sales tax payments (periodically?) can't help but make you smile.

To some, common sense suggests that if a dealer could buy tools for the equivalent of a few years' worth of rental payments, then something doesn't seem right with the economics of these plans, and their claimed win-win benefits for dealership technicians seem too good to be true. There's no free lunch, and some technicians may be surprised if they find that they are left to pay the dealership's share of the FICA tax disguised as part of their liability for self-employment tax on rental payments.

#3. RECENT IRS ADVICE ON DEALER LIFO POOLING. The National Office was recently asked to rule on whether a car dealer with multiple franchises and several locations *all in the same city* could use one pool under the Alternative LIFO Method for all new cars. In TAM 199911044, the National Office gave its approval which it qualified as based on the dealer's specific fact pattern.

The dealer in question had five franchises issued by two manufacturers. He conducted operations at three different locations, all within the same city. Not surprisingly, the applicable franchise requirements included conditions involving exclusivity and certification of personnel. The books and records, checking and payroll account activity were all centralized. There were some managerial employees, and there were other employees who worked when and as needed at all three of the locations. The dealer advertised each location and each franchise separately and also ran generic advertisements promoting the dealership as a whole. All of the inventory at all locations was financed through a "single line of credit ...secured by all of (the dealer's) vehicles."

Many dealers have fact patterns which vary significantly from this simplistic fact pattern, especially with respect to multiple versus separate checking accounts, multiple lines of credit with different captive finance subsidiaries and/or other banks (rather than just one), and multiple locations that are more geographically diverse and not necessarily all within the same city. This TAM shows how an aggressive agent might try to create multiple LIFO pools for many dealers who do not have such a simple fact pattern.

#4. SETTING UP A RELATED FINANCE COMPANY...HELPING THE DEALER GET THE JOB DONE. We recently became aware of a resource package of materials that CPAs working with Buy-Here, Pay-Here used car dealers should find helpful in going through the process of setting up a related finance company. See page 14 for our review of this resource/reference material.

#5. NEW ADVISORY SERVICE HELPS DEALERS COLLECT COMMISSIONS ON LIFE INSURANCE POLICIES THEY SELL THEMSELVES & OTHER FAMILY MEMBERS. Although not in the usual range of dealer tax news, a service now available to dealers warrants mention for your consideration in consulting activities with dealers.

This new program is called "*Dealer Participation Program*," and it guarantees a reduction in premiums currently paid on existing life insurance policies without changing life insurance companies, reducing the policy's death benefit or changing agents. The cost of obtaining new life insurance can also be reduced substantially by means of an arrangement with the life insurance company that pays the sales commission and all future renewals directly to the dealer.

Dealers are a natural for this type of arrangement because they already have insurance licenses or can readily obtain them.

We are told that this new program allows a dealer to buy any type of life insurance product for himself, his family or his business *without* using an insurance agent or broker. A special marketing arrangement permits the dealer to sell the insurance and receive all the commissions, bonuses and renewals normally paid to an agent or broker. For example, the annual premium on a three-year-old $2,500,000 "second to die" policy, insuring a male (age 72) and a female (age 64) was reduced by over $33,000 from, $69,763 to $36,700. In addition to this substantial premium reduction, the dealer also received the maximum first year life insurance commission of over $23,000. The dealer pays nothing because the fee charged by the provider of the service is based on a percentage of the dealer's first year savings. Therefore, there is no out-of-pocket cost to the dealer, even after that fee is paid.

This new program is offered by Insurance Support Services, Ltd. in Deerfield, Illinois. For additional information on this program call Anthony A. Freeman at (847) 267-0400 or fax him at (847) 940-0027.

TECHNICIAN TOOL RENTAL & REIMBURSEMENT PLAN A FREE LUNCH...WITH SOME INDIGESTION?

For the past several years, dealers and their CPAs have been hearing about possible arrangements whereby dealers can split hourly wage payments to service technicians who provide their own tools into two separate payments.

One payment continues to be a payment for services rendered, and thus, wages reportable on Form W-2. The second payment is intended to be for the use or reimbursement of tools owned by the technician which are provided as a condition of employment. These arrangements are sometimes lumped together and loosely referred to as "tool rental plans." But, in reality, these payments fall into at least three separate categories more accurately described as either (1) ***R***ental arrangements, (2) ***R***eimbursement arrangements or (3) ***A***llowance arrangements. Often, payments start out under one arrangement and cross over into another.

It was recently reported that the largest publicly held group of auto dealerships in the country has signed up for one of these arrangements. Many CPAs with whom we have discussed these "tool rental plans" have indicated that many of their dealers have also signed up.

There are at least four organizations marketing "tool rental plans." All of them seem to originate from the application of a rental arrangement program in other industries before the "accountable plan" rules in Section 62 came into the law in 1986-88. These organizations are (1) *Profit Plus, Inc.*, (2) *Pro-Check, Inc.*, (3) *Tool Cheq, Inc.*, and (4) *Cash Management*, and nothing in this article should be construed as an endorsement of the programs they provide.

To date, the IRS has not issued any private letter rulings or technical advice memoranda addressing the specifics of a program involving automobile dealers and their technicians. Under the Freedom of Information Act, the IRS has recently made public *ILM 199917011* in which it outlined an approach for determining whether such payments to employees - separately from wages - might be disguised wages subject to employment taxes.

This internal legal memorandum (ILM) is dated January 13, 1999, and was issued by the Employee Benefits & Exempt Organizations Branch. This ILM does not give any type of IRS blessing to any type of plan. The legal memo simply indicates how the IRS is likely to pursue this issue in the future in order to have a well developed case. And this, in turn, suggests what any dealer signing up for a tool rental program can expect from an inquisitive IRS agent.

The IRS Motor Vehicle Industry Specialist has indicated that she is in the process of evaluating technician tool rental programs and looking to the Employee Benefits people in Washington for assistance on this.

KEY ISSUES

(1) Are the payments being made under an ***accountable*** plan?

(2) Are the payments made under the plan fair-market value amounts determined at arm's-length?

(3) How is the plan ***actually*** *operating*, as opposed to the written description of how the program is ***supposed to*** operate? and

(4) Are the rental payments received by the technicians subject to self-employment tax in their individual tax returns (reportable on Schedule SE)?

The general rules underlying these arrangements are reasonably strict and straightforward. (A detailed analysis of the accountable plan rules appears on page 8.)

For an illustration of the benefits claimed for both the dealership and for its technicians, see page 5. The reduced employment tax liability is clearly driving the transaction from the dealership's standpoint. Consequently, dealers implementing these plans could be skating on thin ice until the IRS actually puts their plan under its microscope in a real-live audit situation.

ILM 199917011

This ILM originated from a request within the IRS for advice about the treatment of payments made by an employer to its employees for the use of unspecified equipment. Although the nature of the payments was intended to be eliminated from the memo in the redacting process, in one place the word "tool" appears where it apparently should have been eliminated. Accordingly, ILM 199917011 can be read with specific reference to a tool arrangement program, and the issue is whether the payments to employees for the use of tools are wages for employment tax purposes. The employment taxes involved are the FICA (Federal Insurance Contributions Act) taxes, FUTA (Federal Unemployment Tax Act) taxes and income tax withholding.

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Technician Tool Rental...

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The fact pattern is relatively simple because it assumes that the workers are employees and that worker classification (i.e., employee vs. independent contractor status) is not involved. It limits its discussion to whether–for employment tax purposes–the employer is properly treating amounts made under the arrangement. It does not discuss how an employee should report any payments not paid under an accountable plan.

In general, wages for employment tax purposes are defined as all remuneration for employment unless otherwise excluded. There is no statutory exception from what is included in "wages" for amounts paid by employers to employees for employee business expenses. However, Reg. Sec. 1.62-2(c)(4) provides that amounts that an employer pays to an employee for employee business expenses under an ***accountable plan***

(1) Are excluded from the employee's gross income,

(2) Are not required to be reported on the employee's Form W-2, and

(3) Are exempt from the withholding and payment of employment taxes.

The ILM discusses the ***accountable plan*** payment requirements (see page 8) and two cases having a bearing on the issue. The ILM also mentions an anti-abuse provision which provides that if a payor's reimbursement or other expense allowance arrangement evidences a pattern of abuse of the rules of Section 62(c), ***all*** payments made under the arrangement will be treated as made under a ***nonaccountable plan***.

The ILM does not mention of Reg. Sec. 1.62-2(i) which states that requirements are to be applied on an employee-by-employee basis. This regulation provides that the failure by one employee to substantiate expenses under an arrangement will not cause amounts paid to other employees to be treated as paid under a nonaccountable plan. Thus, the viability or *bona fides* of the plan is not intended to be determined on an overall basis where substantiation is the issue, but rather it is to be determined on an employee-by-employee basis.

Under the caption "Case Development, Hazards, and Other Considerations," one finds probably the most useful information in this ILM in the form of suggestions for how a case should be developed by obtaining all of the relevant facts. See page 11 for a list of some of the questions that the IRS is likely to ask should a dealer's plan eventually become the test case or guinea pig for the industry.

Under this caption, the ILM apparently states: "The most important fact to know...is that IRS has not ruled on the validity of...arrangement, and...is incorrect. We also have not ruled that an employer may reduce liability for employment taxes by recharacterizing wages as...."

The ILM points out that the IRS Private Letter Ruling Program does not allow it to rule on whether commercial products marketed and sold to the public comply with the provisions of the Internal Revenue Code. If a taxpayer submitted a request for a Private Letter Ruling on whether it had established an accountable plan, the IRS might be able to issue a ruling, provided all of the other requirements of Revenue Procedure 99-1 were met.

CONDITIONS, CONCERNS & CAVEATS

ILM 199917011 is careful not to express any acceptance by the IRS of any type of rental reimbursement or allowance arrangement. Because it is the first document to be issued under the FOIA on the subject, those eagerly awaiting some expression from the IRS on this subject may "read too much" into what it says. Although the ILM contains a section captioned "Issue" and "Conclusion," the contents of both are dreadfully uninformative. Here is the entire "Issue" discussion:

"This is in response to your e-mail of...concerning the proper treatment of payments an employer makes to its employees for use of the employee's (tools/equipment?). In addition to your e-mail, you provided copies of materials from X, which we have enclosed. This response will discuss '...' and then whether the arrangement...by X is an accountable plan."

Equally unimpressive is the conclusion, which follows in its entirety:

"We cannot conclude that the same result will apply in every case. However, this memo suggests an analysis to follow in...cases. The issue is whether the (payments) are wages for Federal employment tax purposes. If the (payments) are paid pursuant to an accountable plan, the payments are not wages for employment tax purposes. Thus, the issue that must be resolved in these cases is whether the arrangement is an accountable plan."

All of this reflects the art of appearing to say something of meaning, while saying nothing of any real substance.

The particular guidance that practitioners might hope to find in a document like this is somewhat undermined because the fact pattern presented as the typical employer arrangement is one where the amount treated as wages subject to employment taxes ($8) is only 25% of the total hourly payment of $32. The other

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TYPICAL PRESENTATION OF BENEFITS FOR TECHNICIAN RENTAL, REIMBURSEMENT AND/OR ALLOWANCE PLANS

SAVINGS FROM THE EMPLOYER-DEALERSHIP SIDE

	CURRENT WAGE PLAN	TOOL USAGE PLAN: WAGES	TOOL USAGE PLAN: TOOL USAGE
Monthly Payroll Base (assuming 10 employees)	$ 40,000	$ 26,000	-
F.I.C.A. (6.2%)	2,480	1,612	-
Medicare (1.45%)	580	377	-
Workers' Compensation	3,200	2,080	-
General Liability	1,200	780	-
Payment for Tool Usage	-	-	14,000
Fee for Admin. & Check Writing			1,120
Total Costs	$ 47,460	$ 30,849	$ 15,120
Monthly Savings Factor	***$ 1,491***		
Annual Savings Factor	***$ 17,892***		
10 Year Savings	***$ 178,920***		

SAVINGS FROM THE EMPLOYEE-TECHNICIAN SIDE

	CURRENT WAGE PLAN	TOOL USAGE PLAN: WAGES	TOOL USAGE PLAN: TOOL USAGE
Monthly Earnings	$ 4,000	$ 2,600	$ 1,400
Federal Tax W/H (15%)	(600)	(390)	(210)
State Tax W/H (3%)	(120)	(78)	(42)
F.I.C.A.	(248)	(161)	-
Medicare	(58)	(38)	-
State Disability Ins.	(20)	(13)	-
Fee for Admin. & Check Writing	-	-	(21)
Net Take-Home Pay	$ 2,954	$ 1,920	$ 1,127
Monthly Savings/Increase	***$ 93***		
Annual Savings/Increase	***$ 1,116***		
10 Year Savings/Increase	***$ 11,160***		

Note: This does not reflect any possible liabilities for self-employment tax on net income from rental of personal property

(Continued from page 4)

$24 is the payment made to the employee for the use of the unspecified equipment/tools provided as a condition of employment. The very high ratio of payment for the use of the tools to the payment for wages subject to employment taxes suggests that the underlying fact pattern could be distinguishable from the more typical dealership-technician scenario where current programs suggest that the tool payments could approximate 30-35% of the technician's hourly wage rate.

The ILM makes it clear that the IRS now doesn't consider Revenue Ruling 68-624 as having any real bearing or precedential value in the analysis. (See page 9.) This is because that revenue ruling was issued long before the "accountable plan" requirements became part of Section 62(c).

Although the ILM discusses two cases, neither have any direct bearing on the dealership-tool technician situation. However in the analysis of one of the cases, the ILM states that significance should be attached to the fact that the Court refused to (1) apply a "substantial compliance rule" to Section 62(c) or (2) to allow the taxpayer to argue different versions of the same facts.

A concluding note to the ILM identifies an incorrect statement made in the information presented for review. This ILM note clarifies that the rental income the employee would receive under the arrangement would be subject to SECA tax because Section 1402(a)(1) excludes only rental income from real estate from the definition of net earnings from self-employment. Rental income received for the use of other ***personal*** property is not excluded from the definition of net earnings from self-employment. See *Stevenson v. Commissioner* (T.C. Memo 1989-357).

ILM 199921003

A second legal memorandum–ILM 199921003, dated February 2, 1999–involved a similar analysis of a position paper submitted to the Employee Benefits & Exempt Organizations Branch by District Counsel. This position paper involved "rig rentals" paid in a specialized industrial situation where rig welders provide equipment which generally includes a truck, welder and welding tanks. The position paper submitted for review had concluded that payments would be made under an accountable plan ***in every case***, and the ILM did not agree with that conclusion.

ILM 199921003 concluded that whether the rig rentals were wages depended on whether the rig rentals were paid pursuant to an accountable plan. If they were, the payments were not wages for income tax purposes. It stated: "Thus, the issue that must be resolved based upon the facts and circumstances of each case is whether the rig rentals are paid pursuant to an accountable plan. We recommend that the Examination Division develop an appropriate case for litigation."

For the most part, ILM...21003 says exactly the same thing that...17011 says. However, it more explicitly states the need to look to the facts and circumstances of each case to resolve the tax issues.

WHEN DO "PAYMENTS" BECOME "RENTALS"?

Generalizing from the promotional literature we have reviewed, it seems that no one really wants to come out and lay all of the specifics of the plan on the table for the IRS to consider. For example, some literature describes a program consisting of two parts: (1) payments which are made to employees for their equipment under a Section 62(c) accountable plan, and (2) payments for the use of the equipment under a rental contract arrangement. Other literature describes payments as simply constituting "reimbursements" for the cost and use. If a plan is imprecise in its language, terminology and actual operation in separating accountable plan payments from rents, then all payments will be treated as having been made under a nonaccountable plan.

Disaster! The problem with payments made under a ***nonaccountable*** plan is that when characterized as such, they will subject the employer/payor to the full complement of employment taxes. Furthermore, payments which clearly are rent (i.e., *for the use of* equipment, as distinguished from reimbursements for the purchase of equipment) do not fall within the accountable plan rules...nor do they fall within the nonaccountable plan rules. They are simply rental payments.

One wonders why the IRS called attention in the ILMs to the "anti-abuse" provision in the regulations, if not to send a not-so-subtle message to program promoters that they better be very careful in their semi-fiduciary capacities (since they are issuing payroll-related checks) to properly discharge all of their recordkeeping and payroll-related responsibilities. Query: Could these promoters and/or their "common paymaster" entities become liable to the IRS for failure to withhold employment taxes in some cases (i.e., where the dealership that should have withheld the taxes is insolvent or judgment-proof)?

One problem–which could be significant–confronts technicians who sign up and immediately claim to have investments in their tools for which they will be receiving off-setting reimbursements as part of their first series of weekly compensation payments after signing up for the program. Part of the problem can

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relate to proving initial cost or other basis in the tools; perhaps another part of the problem relates to the dates of acquisition of those tools and whether those dates preceded employment with the current-dealership employer. How far can a promoter "stretch" to accommodate a technician's poor records and still satisfy the accountable plan requirement for proper substantiation?

There are other problems, like credibility. How much credibility can really be attached to the statements of a technician who invests $10,000 - $20,000 or more in tools who says he has not taken a tax deduction or depreciated them in prior years returns? Another problem relating to including payments equal to a technician's alleged investment in tools and equipment is that if these tools were bought before his employment by the dealership making the payment, how can that dealership justify the reimbursement of payments that initially were not made for its benefit under the accountable plan rules? Granted, the dealer is making a payment for the use of that equipment in the business, but the connection with that payment being a "reimbursement" is strained - to say the least. That payment is simply a rental payment.

Furthermore, there is a real inconsistency in telling technicians that they can simply "decide" whether or not they now want to be reimbursed for their investment in tools under a so-called "accountable" plan. This gross oversimplification ignores a number of well-established principles, not the least of which (1) require the filing of amended returns to deal with situations where depreciation should have been claimed, but wasn't, (2) the "allowed or allowable" rule under which the tax basis for depreciable property must be reduced by depreciation that could have been claimed but wasn't, and (3) the Section 179 "election to expense" requirements that could apply in the year of purchase and the proper mechanics for making this election. Finally, without proper safeguards, what's to prevent technicians from selling their tools back-and-forth to each other so that they will always be receiving "reimbursements" under an accountable plan alleged to be tax-free? What will constitute proper documentation and/or certification to prevent this, and whose responsibility will it be to maintain this documentation for review by the IRS?

As evidence of the blur in thinking about how separate payment components are to be treated, in one case, literature refers to the establishment of a tested and accepted ***reimbursement*** allowance...to reward employees ***for using*** their own tools.

Another potential problem in these plans is that technicians seem to have the choice of either participating or declining to participate in the program. If some employees can elect to participate, while others may decline, doesn't this elective or optional feature impair the credibility of any payments made under the plan as being "ordinary and necessary" to the dealership's business? In determining whether expenditures are "ordinary," the Courts look to what is normal, usual or customary in the taxpayer's business—and that is always a question of fact.

Payments may start out under one arrangement, intended to be a direct reimbursement of the cost of the tools, and subsequently become rentals when the payments have exceeded actual cost. (Or is it adjusted tax basis, or is it estimated cost, or is it estimated value?) Presumably, plan providers would be tracking this and would be including only rental payment amounts on Forms 1099 once the amounts excludable as having been paid under the accountable plan rules have been reached.

Is there any distinction between situations where an employee is providing tools and where an employee is providing a piece of heavy equipment, machinery or a vehicle? In the case where tools are not being provided, is it possible for the employee to also be engaged in the trade or business of renting the machinery or vehicle separate and apart from his acting as an employee in the trade or business of providing services? Is this dual capacity situation likely to be found in the typical auto dealership-service department technician tool situation?

Where an employee is being reimbursed by the employer for the use of tools, the IRS has generously concluded that the rules in Section 62(c) are applicable. These rules apply to amounts received by an employee under a reimbursement or other ***expense*** allowance arrangement. As evidenced by the wording and the examples in the regulations, these reimbursement situations were more typically expected to be applied to situations involving reimbursements for employee meals, lodging, travel and other related and incidental ***expenses***.

In fitting tool reimbursement arrangements into the "accountable plan" rules under Section 62(c) one might argue that the IRS is allowing a square peg to be forced into a round hole. The IRS has indicated that in order for payments to meet the accountable plan requirements, payments must satisfy the business connection, substantiation and excess payment refund requirements. So far, the IRS has not raised the more basic threshold question of whether the Section 62(c) rules were even intended to apply to plans of this type. After all, if payments under these arrangements can be interpreted as not being subject to employment

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THE ACCOUNTABLE PLAN REQUIREMENTS UNDER SECTION 62(c)

In general, wages are defined for FICA, FUTA and income tax withholding purposes as all remuneration for employment unless otherwise excluded, per the definitions found in sections 3121(a), 3306(b) and 3401 (a), respectively.

There is no statutory exception from wages for amounts paid by employers to employees for employee business expenses. However, Reg. Sec. 1.62-2(c)(4) provides that amounts an employer pays to an employee for employee business expenses under an ***accountable plan*** are excluded from the employee's gross income, are not required to be reported on the employee's Form W-2, and are exempt from the withholding and payment of employment taxes.

Whether amounts are paid under an accountable plan is governed by Section 62 which includes the provisions on employee reimbursement or other expense allowance arrangements. Section 62 generally defines "adjusted gross income" as gross income minus certain ("above-the- line") deductions. Section 62(a)(2)(A) allows an employee an above-the-line deduction for expenses paid by the employee, in connection with his or her performance of services as an employee, under a reimbursement or other expenses allowance arrangement with the employer.

Section 62(c) provides that an arrangement will not be treated as a reimbursement or other expense allowance arrangement if (1) such arrangement does not require the employee to substantiate the expenses covered by the arrangement to the person providing the reimbursement, or (2) such arrangement provides the employee with the right to retain any amount in excess of the substantiated expenses covered under the arrangement.

Under Reg. Sec. 1.62-2(c)(1), a reimbursement or other expense allowance arrangement satisfies the requirements of Section 62(c) if it meets all of the following three requirements:

1. ***Business connection***: An arrangement meets the ***business connection*** requirement if it provides advances, allowances (including per diem allowances, allowances for meals and incidental expense, and mileage allowances), or reimbursements for business expenses that are allowable as deductions by Part VI (Section 161 through Section 196), Subchapter B, Chapter I of the Code, and that are paid or incurred by the employee in connection with the performance of services as an employee. (Reg. Sec. 1.62-2(d).) The ***business connection*** requirement will not be satisfied if the payor arranges to pay an amount to an employee regardless of whether the employee incurs or is reasonably expected to incur these business expenses.

2. ***Substantiation***: The ***substantiation*** requirement is met if the arrangement requires each business expense to be substantiated to the payor (the employer, its agent or a third party) within a reasonable period of time. (Reg. Sec. 1.62-2(e).)

3. ***Returning amounts in excess of expenses***: This third requirement is met if the arrangement requires the employee to return to the payor within a ***reasonable period of time*** any amount paid under the arrangement in excess of the expenses substantiated. (Reg. Sec. 1.62-2(f).)

The determination of a reasonable period of time will depend on the facts and circumstances. Reg. Sec. 1.62-2(g)(2)(i) provides that actions that take place within the safe-harbor time periods below will be treated as taking place within a reasonable period of time:

1. An advance made within 30 days of when an expense is paid or incurred,
2. An expense substantiated to the payor within 60 days after it is paid or incurred, or
3. An amount returned to the payor within 120 days after an expense is paid or incurred.

If an arrangement meets the business connection, substantiation and return-of-excess requirements, all amounts paid under the arrangement are treated as paid under an "accountable plan." (Reg. Sec. 1.62-2(c)(2)(i).)

Nonaccountable Plans: If an arrangement does not satisfy one or more of the three requirements, ***all*** amounts paid under the arrangement are paid under a ***nonaccountable plan.*** Amounts paid under a nonaccountable plan: (1) are included in the employee's gross income for the taxable year, (2) must be reported to the employee on Form W-2, and (3) are subject to withholding and payment of employment taxes.

The business connection requirement of paragraph (d), the substantiation requirement of paragraph (e) and the returning amounts in excess of expenses requirement of paragraph (f) will be *applied on an* ***employee-by-employee***

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basis. Thus, for example, the failure by one employee to substantiate expenses under an arrangement will not cause amounts paid to other employees to be treated as paid under a nonaccountable plan. (Reg. Sec. 1.62-2(i).)

If a payor's reimbursement or other expense allowance arrangement evidences a ***pattern of abuse***, all payments made under the arrangement will be treated as made under a nonaccountable plan. (Reg. Sec. 1.62-2(k).)

REVENUE RULING 68-624

Although Rev. Rul. 68-624, has not been declared obsolete, the Employee Benefits Branch believes it should not be relied upon to exclude tool arrangement payments from wages. The analysis in Rev. Rul 68-624 is incomplete under current law because it does not consider whether the...payments are paid under an accountable plan. Under current law, such payments can be excluded from wages only if they are paid under an accountable plan. ***An employment contract that merely allocates compensation between wages and (tool usage payments) will not satisfy the requirements of Section 62(c).*** To exclude employee reimbursements or other expense allowance payments from wages an employer must establish an *accountable plan.*

The question raised in Revenue Ruling 68-624, is what percentage of the total amount paid by a corporation for the use of a truck and the services of a driver is allocable as wages of the driver for FICA purposes. The facts specify that the corporation hires a truck and driver to haul stone from its quarry to its river loading dock at a fixed amount per load and allocates one-third of the amount paid the employee as wages and two-thirds as payment for the use of the truck.

Revenue Ruling 68-624 holds that an allocation of the amount paid to an individual when the payment is for both personal services and the use of equipment must be governed by the facts in each case. If the contract of employment does not specify a reasonable division of the total amount paid between wages and equipment, a proper allocation may be arrived at by reference to the prevailing wage scale in a particular locality for similar services in operating the same class of equipment or the fair rental value of similar equipment.

FIVE WARNINGS RE: SERVICE TECH RENTAL PLANS

1. The ***big downside risk for dealers*** in these plans is the tremendous liability they may face for all employment taxes if the IRS determines that any payments have been made under a nonaccountable plan arrangement. Note that <u>all</u> payments are deemed to be made under a nonaccountable plan if <u>any</u> of the payments fail to satisfy the accountable plan requirements.
2. The ***big downside risk for service technicians*** in these plans is their potential liability for self-employment tax on the payments they receive which constitute net income from their rental of personal property. *Stevenson v. Commissioner* (T.C. Memo 1989-357) held that "net earnings from self-employment" under Section 1402(a) includes net rental income from leased *personal* property. Query: On what basis can payments to technicians for the use of tools (i.e., "rentals") be differentiated?

   Other indirect implications for technicians participating in a "tool rental" plan may arise unexpectedly if the issue of compensation/wages becomes subject to garnishment, divorce (child support) proceedings, disputes with creditors, or social security eligibility questions.
3. Despite letters of endorsement and the inclusion of old reference materials in promotional literature, dealers should expect that the IRS will look very closely at these plans. Plan "status" for purposes of Worker's Compensation under state law or individual insurer definitions is not binding on the IRS or on the Courts in evaluating these arrangements. Dealers should be advised that, before signing up for these plans, they should ask the promoters to indemnify them for any payroll tax liabilities they might be assessed in the future in the event that any payments under the plan fail to achieve <u>and maintain</u> Section 62(c) accountable plan status.
4. To date, the IRS has not issued any letter rulings or memoranda specifically approving any plan involving dealership service technician tool rentals.
5. Different promoters have different plans, and the operations under each plan may vary. One cannot infer either favorable or unfavorable possible outcomes from one plan to another.

(To date, we have requested, but have not been able to review any substantive opinion letters from CPA firms or attorneys concerning service technician payment plans.)

taxes, doesn't that conflict with the Congressional policy of trying to insure that the optimum number of potentially eligible persons will be provided for under the Social Security provisions and programs?

Crude variations of technician tool reimbursement arrangements may simply designate some arbitrary amount or percentage of the technician's earnings or hourly wages as a (tool) reimbursement for business expenses or as a rental payment. It would appear that such arrangements would fail the second and third requirements for payments under accountable plans, and those payments would be wages subject to employment taxes. This is consistent with the statements in ILM 199917011 which reject the application of Revenue Ruling 68-624. See page 9.

ARE PROGRAMS WRONG IN SAYING THAT RENTAL PAYMENTS ARE NOT SUBJECT TO SELF-EMPLOYMENT TAX?

Technician reporting of payments which are really rentals in their income tax returns is not as simple as some promotional literature suggests. Furthermore, the likelihood that these rental payments are subject to self-employment tax could raise a real problem because if they are, the dealer is shifting part of an overall tax burden to the technicians. The enrollment forms provided by one program specifically state that the income from the payment for the use of the tools is not subject to self-employment tax.

The literature provided by plan promoters really glosses over the uncertainty attendant with how technicians should report the receipt of tool usage payments in their personal tax returns. The instructions for including amounts on Page 1 of Form 1040 state that line 21 should include "income from the rental of ***personal*** property if you are engaged in the rental for profit but were **not** in the business of renting such property." Deductible expenses related to this income should be reported on line 32 and identified as "PPR," presumably referring them to personal property rental income offsets. Query: Aren't the tools used by a skilled employee being used in the same trade or business that he is engaged in? And, isn't the technician "involved in that rental activity with continuity and regularity"? (See the instructions for Form 1040, Schedule C where this is discussed.)

As noted elsewhere, it would appear that this income in addition to being subject to regular income tax is also subject to self-employment tax. Section 1402(a)(1) excludes only rental income from real estate from the definition of net earnings from self-employment. Accordingly, the Tax Court Memo Decision *Stevenson v. Comm.* (T.C. Memo 1989-357) probably should not be ignored and, if not ignored, results in the technician paying almost both halves of the self-employment tax Social Security equivalent.

The instructions for Form 1040, Schedule SE (Self-Employment Tax) do not specifically include personal property rentals included on line 21 of Form 1040 in the enumeration of "other income and losses included in net earnings from self-employment," nor do these instructions exclude personal property rentals included on line 21 of Form 1040 from the enumeration of "income and losses not included in net earnings from self-employment." With hundreds or thousands of technicians reporting amounts on Forms 1099 on line 21, hopefully, the Form 1040 instructions will be expanded in the future to clarify the proper treatment of technician tool rental payments for self-employment tax purposes.

The instructions to Schedule C indicate only that Schedule E should be used to report rental real estate income that is not subject to self-employment tax. The instructions to Schedule E say that Schedule E should not be used to report income and expenses from the rental of personal property, such as equipment or vehicles. The instructions continue: "Instead, use Schedule C or C-EZ if you are ***in the business of*** renting personal property. You are in the business of renting personal property if the primary purpose for renting the property is income or profit, and you are involved in the rental activity with continuity and regularity." The instructions finally provide that only "if your rental of personal property is not a business, see the instructions for Form 1040, lines 21 and 32, to find out how to report the income and expenses."

The payments made under tool allowance and reimbursement arrangements present some interesting interpretive problems, since they must comply with Section 62 requirements which are intended to cover individuals engaged in a trade or business activity.

SOCIAL SECURITY CONSIDERATIONS

It appears that in some instances a technician's Social Security benefits may not be affected. However, the Social Security caps change each year and annual computations, depending on the technician's other eligible wages would need to be made. At least one plan provider offers a supplementary disability insurance coverage feature in connection with its technician tool arrangement payments.

WORKER COMPENSATION INSURANCE MATTERS

Payments under these tool arrangements may reduce a dealership's worker compensation insurance premiums. Apparently, they will with certain insurance companies and/or in certain states and they will →

SO YOU WANT TO BE A TEST CASE, DO YOU? HERE'S SOME OF WHAT THE IRS WILL WANT TO KNOW...

IRS Legal Memorandum 199917011 includes the following questions and inquiries as essential for the IRS to pursue in order to prepare a well-developed case. Ironically, these follow the general statement that "It may not be assumed that every (payment under a reimbursement arrangement) is a disguised payment of wages or that an employer cannot establish an arrangement that satisfies the accountable plan requirements."

1. When did the employer begin compensating its employees in part with such payments?
2. Did the employer make such payments prior to the enactment of the Tax Reform Act of 1986 or the Family Support Act of 1988? How common are such arrangements in the industry?
3. Why did the employer decide to make such payments, and did the employer have any motivations other than simply reducing its employment taxes? (Note: a reduction of unemployment compensation expense might be one legitimate reason.)
4. Is the arrangement written or is it unwritten? Is it described in an employee handbook? How clearly does it differentiate between reimbursement payments and payments for the use of equipment?
5. Does the arrangement reflect an arm's-length transaction? Does it specify the employer's basis for allocating amounts between wages and rentals? How did the employer determined that amount? Does the payment reflect the fair market value of the actual use?
6. If there is a lease, does the lease have a specific term? What happens if the employee terminates employment before the end of the lease?
7. How do the employees understand or think the arrangement should work? (Note: the ILM suggests that workers should be interviewed to find out their understanding of the plan notwithstanding a written arrangement)

   This suggestion is followed by the statement that "...a written arrangement or the employer may specify that employees must agree to let other employees use their (tools/equipment)." "...If another employee never actually uses the (tools/equipment) the requirement is meaningless."
8. Are the specified terms of the arrangement are actually followed?
9. Are the employees required to supply (i.e., must they supply) the (tools/equipment)?
10. Are the (tools/equipment) left at the work site?
11. Who bears the cost of maintaining and insuring the tools?
12. How does the taxpayer's specific arrangement fit within the fact patterns found in *Welch v. Commissioner* (T.C. Memo 1998-310) and *Trans-Box Systems v. US* (a case involving independent contractor and worker classification issues.)

Technician Tool Rental...

(Continued)

not with other insurers or in other states. Each insurance carrier seems to have the ability to accept or not accept payments under these technician reimbursement plans as exempt from their premium base.

PLAN PROVIDERS

More information concerning the *Profit Plus, Inc.* program can be obtained by calling Steve Dockins at 949-363-6066 or by accessing the web site of Profit Systems, Inc. at www.profitsys.com. Information concerning the *Pro-Check, Inc.* program can be obtained by calling James Nummer at 616-527-4010. Information regarding *Tool Cheq, Inc.* can be obtained by calling Douglas Black at 303-369-6590.

It is our understanding that none of these plans, to date, has been the subject of any IRS letter ruling or Technical Advice Memoranda. Furthermore, we have not seen any "opinion letters" by legal or accounting firms relative to these programs. As discussed previously, the IRS recently disavowed the application of Revenue Ruling 68-624 to these payments because that Ruling preceded the legislation enacting the "accountable plan" rules. Therefore, claims in promotional literature should be carefully weighed or questioned to see if those statement specifically refer to payments being made to an automobile dealer's technicians for equipment rentals.

see **TECHNICIAN TOOL RENTAL...**, page 16

MID-YEAR TAX ISSUES ROUND-UP

MID-YEAR TAX PANEL

A survey of mid-year tax issues was provided by the Tax Panel consisting of Mary Burke Baker, Robert Zwiers, James Minnis and Willard De Filipps on the second day of the *SPRING 1999 CPA-AUTO DEALERSHIP NICHE CONFERENCE* held in Las Vegas, May 10-12.

Mary Burke Baker is the IRS Examination Industry Specialist of the Motor Vehicle Industry Specialization Program. Her responsibilities include identifying, developing and coordinating motor vehicle issues on a nationwide basis to promote fairness, consistency and technical accuracy among taxpayers and the Service. She works extensively with the IRS National Office and field agents, as well as with motor vehicle industry associations, representatives and practitioners.

Robert Zwiers is the National Automotive Tax Executive with Crowe Chizek and Company, LLP's office in Grand Rapids, Michigan. Previously, Bob served for 11 years as the National Motor Vehicle Industry Specialist of the IRS. As a senior member of the IRS Industry Specialization Program, he was involved in determining the direction and application of Federal tax issues affecting the Motor Vehicle Industry. At the IRS, Bob was significantly involved with automobile dealership issues and public rulings for methods of accounting, LIFO inventory, extended service contracts and the LIFO conformity settlement.

James Minnis is the Director, Regulatory Affairs, National Automobile Dealers Association in McLean, VA. He is extensively involved in coordinating with the IRS NADA's positions on such critical issues as the application of the demonstrator auto rules and the impact of the disallowance of the use of replacement cost for dealer's parts inventories.

Willard De Filipps writes several dealer tax-related publications, including the *Dealer Tax Watch* and the *LIFO Lookout*. He also consults with CPAs and dealerships on a variety of issues.

Mary Burke Baker spoke of the renewed commitment within the IRS in recognizing that it can't unilaterally impose interpretations involving critical issues on taxpayers in an industry without first getting input from practitioners, manufacturers, dealers and other taxpayers to provide information on what it is like "out there in the *real* world." She indicated that since she has now been involved with the Motor Vehicle Industry for about a year, she has become much more familiar with the industry issues and is rapidly moving up to speed on them.

Mary discussed valuation of used vehicles, subprime financing by used car dealers, record maintenance with respect to dealer software (Revenue Procedure 98-25), leasing-related issues and the IRS' interest in service technician tool rental payments. Her last comment on such rental payments was that if the tool payments were actually rentals, then the technicians' liability for self-employment tax would have to be considered.

THE HOTTEST TOPIC OF ALL... REPLACEMENT COST VS ACTUAL COST FOR PARTS INVENTORIES

The tax issue or topic of greatest interest was the industry-wide problem created by the recent IRS victory in the Tax Court disallowing the use of the replacement cost method for a truck dealer's parts inventory. This case, *Mountain State Ford Truck Sales* (112 TC No. 7), was discussed extensively by Jim Minnis as part of his prepared remarks as a panelist. It was also the subject of a well-attended special evening session.

During this interactive session, Will De Filipps reviewed the particulars of the *Mountain State Ford* case and explained that, until the Internal Revenue Service officially issues definitive guidance, taxpayers using the replacement cost method must continue to do so unless - or until - they receive permission from the IRS to change their methods of accounting. (For extensive coverage of the *Mountain State Ford* case, see the March and June, 1999 issues of the *LIFO Lookout*.)

Due to practitioner and taxpayer interest in what the IRS has to say, we've included a summary of Mary Burke Baker's presentation outline on the facing page.

Other issues addressed by the Panel included changes in accounting methods, reasonable dealer compensation, Producer Owned Reinsurance Companies and special application techniques and elections for dealers under the Section 263A cost capitalization rules for inventory.

INTERNAL REVENUE SERVICE
MOTOR VEHICLE INDUSTRY SPECIALIZATION

*Presented by Mary Burke Baker**
at the SPRING 1999 CPA-AUTO DEALERSHIP NICHE CONFERENCE
* (616) 235-1593

MVISP TEAM MEMBERS
- Mary Baker, Industry Specialist
- Terry Harris, Assistant Specialist
- Tim Coyle, Team Member
- Fred Gavin, Appeals
- Grant Gabriel, District Counsel
- Jeff Mitchell, Chief Counsel
- Richard Berken, Chief Counsel
- Willie Armstrong, Chief Counsel
- Melissa Brainard, Audit Aide

IRS MISSION STATEMENT
- Provide America's taxpayers top quality service
- Help them understand and meet their tax responsibilities
- Apply the tax law with integrity and fairness to all

ROLE OF THE ISP
- To coordinate the identification, development and resolution of issues common to the motor vehicle industry
- This requires communication and cooperation between industry personnel and IRS personnel

CURRENT EVENTS
- Inventory issues
    - LIFO - Parts inventory
    - LIFO conformity
    - Used car LIFO
    - LIFO pooling
    - Used car writedowns
- Subprime financing
- Dealer software programs
- Manufacturers' incentives
- Leasing issues
    - Capital cost reduction
    - Interest subvention
    - Residual value insurance
- Demonstrators
- Service technicians' tools
- ISO 9000
- Remanufactured cores
- Research credit

LIFO - PARTS INVENTORY
- *Mountain State Ford*, 112 TC No. 7
    - Cost is actual cost
    - Replacement cost doesn't clearly reflect income
    - Termination appropriate
    - Restoration of reserve not abusive
    - Administrative burden not determinative
- Impact on industry
    - "No harm, no foul?"
    - Termination?
    - Change in method?
    - Software considerations
- IRS response
    - Analysis of case
    - Discussions with the industry
    - IRS pronouncement?

LIFO CONFORMITY
- Revenue Ruling 97-42
- Revenue Procedures 97-44 and 98-46
- "Election" of settlement
- "Unelection" of settlement
- Mathematical errors
- Compliance checks
    - Initial settlement
    - 2nd and 3rd payments

USED CAR LIFO
- An oxymoron?
- How to value the item
    - Age to age, or model to model?
- Other problems inherent to LIFO
    - Valuation Dates
    - Pricing
    - Recordkeeping
- TAM 9853003
- Simplified method-revenue procedure?

LIFO POOLING
- TAM 199911044
    - Franchises
    - Geography
    - Management
    - Recordkeeping
    - Advertising
- Sport utility vehicles
    - Cars or trucks or other?

USED CAR WRITEDOWNS
- Revenue Ruling 67-107
- Reg. 1.472-2 or 1.472-4?
- PLR or TAM

SUB-PRIME FINANCING
- 2-sided issue - Dealer & finance company
- Dealer TAMs 9840001, 199909002, 199909003
- Sale
    - Amount realized = cash + FMV other
    - Back-end distributions
        - Determining FMV
        - Contingent payments - Section 483
            - Principal
            - Interest
        - Payment trail
- MSSP Audit Techniques Guide
- Revenue procedure
- Consistency between dealers and finance companies

DEALER SOFTWARE
- Revenue Procedure 98-25
    - Electronic records
    - Retention/Accessibility
    - Hardware & software concerns
- *Mountain State Ford* (parts)
    - Revision of programs for actual cost
- IRS/Industry initiative
    - Identify & rectify problems

MANUFACTURERS' INCENTIVES
- Current policy
    - Revenue Ruling 70-337 Benchmark
    - Wages? - No!
        - FIT? - No!
        - FICA? - No!
    - Self-employment income? - No!
        - SECA - No!
        - Schedule C deductions? - No!
    - Taxable income? - Yes!!!
- Affects many industries
- Ongoing questions
    - Degree of dealer involvement
    - Specific programs

LEASING ISSUES
- Capital cost reduction
    - Dealer role - lessor or agent for lessor?
    - Current income
    - Adjustment to basis?
- Interest subvention
- Residual value insurance
    - TAM 9830001

DEMONSTRATOR VEHICLES
- Section 61
- Section 132
- Section 274
- Notice 89-110
- LTR 9801002
- LTR 9816007
- Recordkeeping requirements

SERVICE TECHNICIANS
- Service technicians
    - Reimbursement for tools in lieu of wages
    - Escape FIT & FICA
    - Accuracy of valuation
    - Accountable plan?

IN CONCLUSION...
- A mutual goal - to understand complex tax law so it can be applied fairly and consistently
- We need your help to accomplish our mission
- Your comments and suggestions are welcome and appreciated.

HOW TO START AND IMPLEMENT YOUR OWN FINANCE COMPANY ... THE MYSTERIES UNRAVELED

RFC RESOURCE GUIDE

When a dealer sells a used vehicle, he is required to recognize all of the profit on the sale of the vehicle at the time the sale is made. Often, the full amount of the customer's note is not collected. Even though not all of the receivable may be collectible, the dealer is taxed initially on all of the profit relating to that sale and the receivable. Accordingly, dealers are paying tax, in some cases, on so-called phantom income.

A used car dealer operating a buy-here, pay-here lot can create the opportunity to defer tax on some of the income until it is actually collected by the related finance company. This is done by setting up a related finance company (RFC) and selling the customers' notes to the RFC at a discount. Many dealers have done this to either assure their survival or to improve their profitability in the tough market populated by credit-impaired or credit-challenged purchasers.

The RFC defers recognition of the income over the period during which it collects payments on the notes and, if some of the note eventually becomes uncollectible, the balance at that time is simply written off. The *Dealer Tax Watch* has included many articles on the tax advantages of RFCs and IRS rulings bearing on them.

We recently became aware of a resource - reference package intended for used car dealers entitled *How to Start and Implement Your Own Finance Company... The Mysteries Unraveled.* These materials have been assembled and marketed by Kenneth Shilson, CPA.

The materials included in this "How To" kit include a *Workbook*, a videotape (approx. 20 minutes) and two audio tapes (approx. 1 hour total) on which Mr. Shilson gives answers to "*More Than 100 Of The Best Questions*" he has been asked about starting up related finance companies and making them work effectively.

The *Workbook* consists of (1) an outline of the video presentation which can be followed while watching the tape, (2) an article entitled "A Captive Finance Company: Why You Need One," (3) IRS technical reference materials, (4) sample agreements, (5) sample accounting and tax elections, (6) a listing of the 112 questions on the audio cassettes and (7) other information relative to the availability of Mr. Shilson's continuing support for a limited time.

The IRS technical reference materials include a portion of the *IRS-MSSP Independent Used Car Dealer Audit Guide* and a copy of Letter Ruling 9704002. These technical materials do not refer to an earlier IRS Letter Ruling 9534023 in which the IRS approved a related finance entity arrangement. For a discussion of LTR 9534023, see the September, 1995 *Dealer Tax Watch* (pg. 19) and for a comparison of these two LTRs, see *DTW*, March, 1997 (pg. 11).

The *Workbook* includes a sample asset purchase agreement, general transfers and assignments, and various powers of attorney. Other agreements which are more situation specific (management company agreements Q-44 and agreements documenting sharing of overhead items Q-45) are not included.

The *More Than 100 of the Best Questions* on the two audio cassettes contain many helpful insights on both operational and tax aspects of buy-here, pay-here/RFC relationships. The *Workbook* lists only the questions. Although the listener can take notes while listening to the answers on tape, it would be more helpful to have a transcript of all of the answers included as part of the workbook materials. It would also make research easier if similar questions were grouped by category (operations, tax considerations, state licensing requirements, what to do first, most common errors, etc.), rather than simply presented sequentially.

Mr. Shilson states that a dealer really shouldn't be considering a related finance company arrangement unless his note portfolio is at least $500,000. In previous *DTWs*, others have suggested a lower threshold, as low as $200,000, as the minimum portfolio size that warrants consideration of an RFC.

Although the primary purchaser of these materials may be a used car dealer, the materials and workbook should help a CPA provide valuable assistance to buy-here, pay-here clients. A dealer considering setting up an RFC is advised to begin by contacting lending sources to set up lines of credit for the RFC and to not wait until the last minute before year-end to start structuring transactions between the dealership and the RFC.

The really valuable insights and contacts to successfully assist dealers in this area are more likely to be obtained if the purchaser of the package avails himself or herself to the "continuing support" that Mr. Shilson makes available for a period of 45 days after purchase of the materials. One learns from listening

→

IRS 13 COMMANDMENTS FOR RFCs

1. The RFC should be a *separate, legal entity.*
2. The RFC should *meet all licensing requirements* of the jurisdiction in which it operates.
3. The RFC should be *adequately capitalized* in order to pay for the contracts.
4. *As to employees,* the RFC should have its own employees and compensate them directly. However, an RFC may have shared employees with the dealership.
5. The RFC should *obtain and maintain all appropriate* local business and similar *licenses.*
6. The RFC should have a *separate telephone number.*
7. The RFC should have a *separate business address,* which may be a Post Office box.
8. The RFC should *maintain a separate set of books and records.*
9. The RFC should *comply with all title, lien, and other recordation rules* in its particular jurisdiction.
10. The RFC should *notify customers of the purchase of their notes.* (This notification should be in writing.)
11. The RFC and the dealership should have a *separate written contract for the sale* of the receivables. The contract should comply with the appropriate state law and provide evidence of how the fair market value (i.e., the discount) was determined.
12. The RFC should *pay the dealer for the receivables at the time of purchase.* the RFC can generate the cash to make the payment from any combination of (1) capitalization of the RFC, (2) bank or third party borrowings or (3) borrowings from related entities or shareholders. However, borrowings from related entities or shareholders can diminish the validity of the overall arrangement.
13. The RFC should be *operated in a business-like manner* at all times.

Note: These "13 Commandments" are part of Chapter 8 in the IRS *Independent Used Car Dealer Guide* (April, 1996). They are listed as the factors an agent should analyze in determining the validity or form of an RFC. The *Guide* adds: "Clearly, to the extent that these attributes are absent, a serious question exists as to the substance of the RFC." ✻

How to Start and Implement Your Own Finance Company (Continued)

to the tapes that this additional assistance can include, but is not limited to:

1. Establishing contacts with third party institutional financing sources with whom a newly formed RFC can establish its lines of credit.

2. Modification of existing dealership software to properly account for RFC collections on notes purchased from the dealership, or recommendation of computer programs for this purpose.

3. Contact with third party buyers of notes if the dealer does not know from whom they can get third party offers. These are critical in establishing the arms-length nature and fair market value inherent in setting discounts for the bulk packaging sale of notes.

4. A more detailed discussion of the tax planning opportunities that may be available through setting up different tax year-ends or entities and how the tax elections (illustrated in the materials workbook) can be more effectively tailored in a given situation.

5. Suggestions for bulk packaging customer receivables for sale to the RFC.

Mr. Shilson's firm is in Houston, Texas, and he has consulted with dealers and CPAs in many other states. He writes extensively for the *Used Car News* and is instrumental in the annual National Buy-Here, Pay-Here Convention.

CPAs advising used car dealers should also be aware of the recent formation of the NABD, National Association of Buy-Here, Pay-Here Dealers. For information on associate membership in this organization, call Mr. Shilson at (713) 290-8171 or fax him at (713) 680-BHPH for more information. Also, the possibility of forming a Used Car Dealer/CPA Resource Group is being considered and further information on this can be obtained by calling Mr. Shilson as well.

✻

(Continued from page 11)

STATE SALES TAX ON RENTALS?

Some states provide that rental payments are subject to state sales tax. This should be checked out on a state-by-state basis. Specifically, a potential problem could exist with rental payments to technicians in the state of Florida, as a recent conversation with the State Sales Tax Department informally confirmed that those payments would be subject to Florida's sales tax on rents.

This could be especially critical for Florida CPA firms who have become involved in the recent privatization effort by the Florida Institute of CPAs and the Florida Department of Revenue in setting up a Certified Audit Program under which Florida CPAs have the opportunity to go in and conduct sales tax audits on their clients.

CONCLUSION

In looking at information provided by plan providers, it's hard to ignore the testimonials they include from satisfied customers who have been "audited" and safely passed various levels of scrutiny by different agencies. But, these should all be taken with a grain of salt. As stated earlier, we are aware of no situation, to date, in which the Internal Revenue Service has looked specifically at the initial structuring and/or at the actual operation of any technician tool rental or reimbursement arrangements.

The rules and procedures the IRS may follow in evaluating and in auditing all of the participants in technician tool plans have not yet been fully developed. In actual operation, some plans may be more compliant with the Section 62 accountable plan rules than others.

Dealers should go into these plans fully aware that they are clearly aggressive tax strategies and not without significant downside risks. Despite glowing endorsements and herd-mentality, these plans could potentially backfire in a tragic way for both dealerships and technicians who rely on tax-saving emotion...rather than on the receipt of a specific letter of approval for the plan from the IRS.

The *De Filipps' Dealer Tax Watch* newsletter is a quarterly publication of essential tax information by Willard J. De Filipps, CPA, P.C., 317 West Prospect Avenue, Mt. Prospect, IL 60056. It is intended to provide accurate, general information on tax matters and it should not be construed as offering accounting or legal advice or accounting or legal opinion on any specific facts or circumstances. The contents are intended for general information purposes only. Readers should consult their certified public accountant, attorney and/or other competent advisors to discuss their own situations and specific income, gift and estate tax questions. Mechanical or electronic reproduction or photocopying is prohibited without permission of the publisher. Annual subscription: $325. Back issues available for $70 each. Not assignable without consent. Any quoted material must be attributed to *De Filipps' Dealer Tax Watch* published by Willard J. De Filipps, CPA, P.C. Editorial comments and article suggestions are welcome and should be directed to Willard J. De Filipps at cpawjd@aol.com. Phone: (847) 577-3977; FAX (847) 577-1073. **INTERNET**: http://www.defilipps.com. © Copyright 1999 Willard J. De Filipps. *De Filipps' Dealer Tax Watch* format designed by *Publish or Perish, Inc.* (630) 627-7227.

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